

THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN SUB-SAHARAN AFRICA

Dr. Samuel Adams

Abstract

The study examined the determinants of foreign direct investment (FDI) in Sub Saharan Africa between 1970 and 2000. Results indicate that trade liberalization has been the main determinant of FDI over the three decades. However, the low level of FDI inflows to the region, suggest that liberalization policies are necessary but insufficient in attracting FDI. Policy makers in the region should therefore focus on institutional reforms and improve the business climate to enhance the region's chances of attracting more FDI. On the other hand, multinational enterprises could exploit the favorable FDI policy environment to negotiate favorable terms of entry and reap the benefits of being first-movers.

Introduction

Foreign direct investment (FDI) inflows to the various regions of the world have grown dramatically in the past two decades. The total world FDI inflows, which stood at \$59 billion in 1982, grew dramatically to \$648 billion in 2004 (United Nations Conference on Trade and Development [UNCTAD], 2005). By the end of 2004, the total foreign aid (grants) and net official flows (aid and debt) to developing countries were \$47.4 billion and \$22.6 billion, respectively, while net FDI flows were \$165 billion dollars (Global Development Finance [GDF], 2005). As a result, by the end of the twentieth century, FDI had become an important alternative in the development finance process.

However, FDI inflows have tended to concentrate in a few countries. Of the \$648 billion of global FDI inflows in 2004, the developing world received nearly \$165 billion, of which Sub Sahara Africa (SSA) accounted for only \$12 billion, or about 2% global inflows. It is important to note though that FDI inflows had increased to nearly \$36 billion by the end of 2006, it was mainly due to high oil and gas prices (UNCTAD, 2008). Bende-Nabende (2002) claims that despite SSA countries offering incentives to investors yet they do not make it to the "short list" when it comes to locational investment decisions for FDI. Africa's situation presents a paradox, as most studies report that the return on investment is greater in Africa than in any other region of the world and yet the region accounts for the least amount of FDI inflows (UNCTAD, 1999). UNCTAD (1999) indicates that the rate of return of U.S. investment in Africa stood at 25.3%, compared to 12.5% in Latin America and 16.2% in Asia.

This paper contributes to the literature on the determinants of FDI in two main ways. First, a regional study helps to reduce any bias associated with having countries that are very different in the regression analysis. Crenshaw (1991), Singh & Jun (1995), Root & Ahmed. (1979), and Kobrin (2005), for example, claim that a broad consensus on determinants of FDI has been elusive because most studies have analyzed determinants of FDI by pooling structurally diverse countries. Further, Sethi et al. (2003) argue that multinational enterprises usually evaluate prospective FDI destinations

on a regional basis. Second, the study analyzes the dynamic nature of FDI determinants between 1970 and 2000 as multinational enterprises (MNEs) are known to continuously pursue new strategies to enhance their competitiveness. Thus, the study will help to identify whether the determinants of FDI in the context of SSA have changed in the last three decades.

The rest of the paper is organized as follows: Section 2 discusses the theoretical and empirical literature on FDI. Section 3 describes the data and methodology, and Section 4 analyzes the results. Section 5 presents the implications, direction for future research, and offers concluding remarks.

Literature Review

Theoretical Review

Though many theories of the determinants of FDI have emerged over the past 50 years, no one theory predominates. The theories that have gained prominence in explaining FDI are based on market imperfection and market failure (Hymer, 1976, Knickerbocker, 1973; Rugman, 1981; Dunning, 1981). A brief review of the market imperfection and market failure theories follows.

Hymer (1976) claims that FDI can be used as a means of transferring knowledge and other firm assets, both tangible and tacit, in order to organize production abroad. Knickerbocker (1973), on the other hand, argues that most MNEs follow their rivals into new markets as a strategic response in a process of oligopolistic rivalry (the so-called bandwagon effect or "follow the leader" syndrome). Bird (1999) refers to the bandwagon or contagion effect as "herd behavior" of foreign investors for which there may not be a universal agreement on the underlying macroeconomics. It may reflect the firms' uncertainty and a reluctance to be isolated or left behind. Recently, however, the theory of internalization and the eclectic theory dominate the FDI literature. Internalization theory basically describes the ability of a multinational enterprise (MNE) to

use its internal market to produce and distribute products in an efficient manner in situations where a regular market fails to operate (Rugman, 1981a; 1981b; 1983). Buckley & Casson (1976) claim that MNEs internalize their intermediate markets and production processes to reduce market imperfections and uncertainty. Similarly, Rugman (1983) argues that the failure of markets and, in certain cases government restrictions (taxes and regulation) on the use of the market necessitate the need for a firm to use an internal market to monitor and control the use of its firm-specific assets.

Dunning's eclectic theory or Ownership - Location - Internalization (OLI) paradigm of FDI is the most comprehensive and accepted (Eden and Potter, 1993). Ownership advantages refer to firm-specific characteristics (marketing skills, finance, and organization) that may allow a firm to overcome production constraints in a foreign country. Internalization refers to the ability of the firm to manage and coordinate activities internally in the value added chain. Location advantages refer to the host-country factors that lower cost of production, including tax incentives and a skilled and cheap source of labor. The OLI model is therefore a synthesis of many theories based on market imperfection or market failures which seek to identify and evaluate the factors that influence why and where MNEs would want to invest or produce abroad. Such investment could be natural or resource-seeking, market-seeking, efficiency-seeking; or assetseeking (Dunning, 2002; UNCTAD, 1998, 2001).

The main thrust of the FDI theories, as noted by Sethi et al. (2003) is that a firm's knowledge and skills constitute tacit ownership advantages which take time to evolve; however, MNEs are able to manipulate these advantages by leveraging them through worldwide investments. It is important to note, however, that the various theories taken independently do not fully explain the incidence of FDI inflows (Buckley, 1988). For example,

ownership advantages do not by themselves justify foreign production; they only suggest that a firm commands a competitive edge that can be exploited in several ways other than through establishment of foreign subsidiaries (Ancharaz, 2003). Consequently, locational or ownership advantages by themselves are necessary but insufficient condition for attracting FDI (UNCTAD, 1992).

Robock and Simmonds (1989) critique internalization theory, indicating that it focuses on the internal motives of the firm and gives little attention to external factors such as government policies that may affect the benefits and costs of internalization. On the other hand, Casson (1983) argues that internalization theory is a general theory of why firms exist and that without additional assumptions it is almost tautological. Casson therefore suggests that to make it a theory of the multinational enterprise, it is necessary to specify assumptions about transaction costs for particular products and for trade between particular locations.

While this review of the theoretical literature is not meant to be a comprehensive comparison and critique of the various of theoretical assumptions of FDI, it does indicate that many economic, social, political and institutional factors have an effect on the location of FDI (See Sethi et al. 2003; Gastanaga et al 1998 and Dunning, 2002 for a detailed review). Many empirical studies have been conducted to give support to the theoretical basis of FDI. A few of the empirical studies on the determinants of FDI are discussed in the next section.

Empirical Review

Over the past four decades, many cross-country empirical studies have been conducted on the determinants of FDI. These studies' samples usually include developing and developed countries, developing countries from all regions of the world, or countries from particular regions of the world. Because the focus of the current study is SSA, only those developing country and regional studies on Africa are reviewed here.

Developing country studies.

Studies on the determinants of FDI in developing countries are many and varied (Kobrin, 2005; Crenshaw, 1991; Nunnenkamp, 2002). The results of these studies are inconsistent. For example, whereas Nunnenkamp (2002) and Kobrin (2005) find that traditional market-related determinants (population, GDP growth, and GDP per capita) are still dominant determinants of FDI, Crenshaw (1991) makes claims to the contrary. Nunnenkamp (2002) employed a correlation analysis to study the determinants of FDI in 28 developing countries between 1988 and 1999. Nunnenkamp (2002) reports that traditional market determinants were the most important of FDI inflows for the four periods of the study (1987, 1992, 1996, and 1999). Nunnenkamp further reports that human capital was significant at the 5% level only in the last period (1999). Consequently, he argues that the study provides little support to the view that nontraditional determinants of FDI have gained prominence in developing countries.

Similar to Nunnenkamp's study, Kobrin (2005) in a cross-sectional study of the investment climate of 116 developing countries between 1992 and 2001, reports that market size is the single most important determinant of a country's FDI inflows. In light of the inconsistencies regarding the determinants of FDI, many authors advocate for regional studies to reduce any bias in sample selection and consequently in the regression analysis. A few of the studies that focused on Africa are discussed next.

Only in the past decade have researchers began to empirically examine the determinants of FDI inflows in Africa (Morisett, 2000; Basu and Srinivasn, 2002; Bende-Nabende, 2002; Asiedu, 2002, 2006). Bende-Nabende (2002) used a co-integration analysis to examine the long-run determinants of FDI in 19 SSA countries between 1970 and 2000, and reports that market growth, market size, and export orientation were significantly positively correlated with FDI inflows. Morisett's (2000) study is more comprehensive (examines both

political and institutional variables) in analyzing the impact of business climate on FDI inflows in 29 SSA countries between 1990 and 1997. The study's results show that GDP growth rate and trade openness are significant and positively correlated with the investment climate in Africa. However, he finds that none of the social or political-institutional variables is significantly correlated with FDI.

Similarly, Asiedu (2002) finds that political instability was negative but insignificantly correlated with FDI inflows to SSA between 1988 and 1997. Further, the author finds that a large share of the variation in FDI rate (60%) was explained by the degree of openness, infrastructure development, and the return on investment. However, in a later study with a longer time frame (1984-2000), Asiedu (2006) finds that institutional quality and political stability have a positive significant effect on FDI inflows. What none of the studies on SSA has done is to assess the changes over time in FDI determinants. This is the gap that this paper seeks to fill. The data and methodology employed in the analysis are discussed next.

Data and Methodology

The study analyzes the determinants of FDI inflows in 38 SSA countries using data from the period 1971-2000. The study was divided into three sub periods (1971-1980, 1981-1990, and 1991-2000) to identify any changes in the factors that are determinative of FDI inflows to SSA. The variables used, their symbols and sources of data collection are summarized in Table 1.

Dependent Variable

The dependent variable is the FDI share in GDP as used in Gastanaga et al. (1998), Globerman and Shapiro (2003) and Kobeissi (2005). Table 2 summarizes the data on FDI inflows between 1971 and 2000.

Independent Variables

The independent variables are classified into four groups: economic; social; political; and institutional factors. The macroeconomic variables used in the study are the rate of inflation and GDP growth. GDP growth is used to measure the rate of expansion and dynamic nature of the market (Morisset, 2000; Torissi, 1985) and the rate of inflation is a proxy for macroeconomic instability (Taylor, 2000).

Table 1: Description and Sources of Data

Variable	Symbol	Source of Data
FDI share in GDP	FDI/GDP	Global Development Network Growth Database and UNCTAD FDI database online
Real Gross Domestic Product	RGDP	World Economic Outlook (2000)
Real GDP growth rate	GROWTH	World Economic Outlook (2000) and Global Development Network Growth Database
Inflation rate	INFLA	World Economic Outlook (2000)
Urbanization	URBAN	Global Development Network Growth Database
Governance	GOV	Kaufmann et al. (2005)
Democracy	DEM	Freedom House (2005)
Trade share in GDP	OPEN	Global Development Network Growth Database
Telephone main lines per 1,000 population	TEL	Global Development Network Growth Database
Natural Resources	NAT	African Development Indicators (2004)
Human development report	HDI	Human Development Report (2005)

Table 2: SSA Foreign Direct Investment Share in GDP (FDI/GDP), 1971-2000.

Country	1971	1981	1991
	1980	1990	2000
Angola	0.00	-3.26	7.68
Benin	0.31	1.77	4.64
Botswana	10.50	5.38	0.44
Burkina Faso	0.00	0.07	0.45
Burundi	0.50	0.63	0.90
Cameroon	1.92	0.38	0.12
Cape Verde	0.00	0.07	3.34
Central African Rep	0.66	0.44	-0.13
Chad	0.00	0.27	4.28
Congo, Rep	2.34	1.17	3.18
Cote d'Ivoire	0.93	0.42	1.18
Ethiopia	0.00	0.07	1.06
Gabon	0.74	1.32	-0.94
Gambia	0.00	0.52	6.78
Ghana	0.35	0.32	1.82
Guinea	0.00	0.63	0.81
Guinea Bissau	0.00	0.41	0.57
Kenya	1.09	0.44	0.73
Lesotho	1.04	1.94	7.40
Madagascar	-0.02	0.35	1.33
Malawi	0.77	0.66	0.11
Mali	0.13	0.24	1.72
Mauritania	3.82	1.15	2.23
Mauritius	0.10	0.89	3.31
Mozambique	0.00	0.19	2.34
Niger	1.96	0.68	0.58
Nigeria	-1.15	1.48	2.40
Rwanda	1.40	0.83	0.35
Senegal	0.48	1.19	0.75
Seychelles	6.45	6.02	4.57
Sierra Leone	-1.70	2.83	0.00
South Africa	0.00	-0.03	0.48
Sudan	0.00	0.00	1.61
Swaziland	4.86	4.99	7.95
Tanzania	0.00	0.00	1.60
Togo	3.76	1.09	1.78
Uganda	0.00	0.00	1.38
Zambia	1.59	2.60	2.39
Zimbabwe	0.00	-0.04	0.47

Note. Data are from Global Network Growth Database and World Economic Outlook (2000)

The social factors are the level of urbanization, proxied by the percentage of persons living in urban areas and the human development index (HDI), which is a measure of quality of life (an aggregate of three variables: health, human capital and level of development).

Many of the studies reviewed in this study used the level of democracy to measure how citizens are involved in their country's political process. Following Noorbakhsh et al. (2001) and Scully (1988), we use an aggregate measure of civil liberties and political rights as a proxy for democracy. Political rights are based on the degree to which individuals have control over those who govern. The civil liberties ranking measure the rights of the individual in terms of the independence of the judiciary or freedom of the press relative to the state. The two measures are all rated on a scale of 1 to 7, with 1 representing the most free or democratic and 7 being the least free or less democratic (Freedom House, 2005).

Kaufmann et al.'s (2005) governance indicators are used as measures of institutional quality. The indicators are government effectiveness, voice and accountability, political stability and absence of violence, rule of law, regulatory quality, and control of corruption. The scores of the six constructs lie between 2.5 and 2.5, with higher scores corresponding to better governance. The initial correlation matrix showed the six governance indicators to be highly correlated at the 1% level, with correlations ranging from $p = .61$ to $.89$. Consequently, following Gliberman and Shapiro (2003), we use a summary measure that is their first principal component, denoted as GOV.

Three other variables, natural resources endowment, trade openness, and the level infrastructure development are used as control variables. Natural resource (oil and minerals) endowment is used to control for the fact that FDI inflows have been resource-driven (Morissett,

2000). We use a dummy variable for natural resource endowment: 1 for countries that are resource rich and 0 for otherwise. Trade (exports plus imports) as a percentage of GDP represents the degree of openness of a country's economy and telephone main lines per 1,000 people is used as a proxy for the level of infrastructure development (Globerman and Shapiro, 2003; Lim, 2001; Taylor, 2000).

Analysis and Results

Statistical Analysis

Ordinary Least Squares (OLS) and Two Stage Least Squares (2SLS) regressions were used in the analysis. Following Loree & Guisinger (1995) and Nunnenkamp (2002), the study analyzed three time periods (1971-1980, 1981-1990, and 1991-2000) to examine how the factors that affect investors' locational decisions have changed in the context of SSA.

Findings

The results of the study indicate that openness had a significant positive effect on FDI inflows in all the three periods (columns 1, 2 and 3); consequently, two stage least squares (2SLS) regression was used to test for endogeneity between FDI inflows and openness to trade. Following Borensztein et al. (1998), we use the lagged values of trade share in GDP as instruments. Thus, the average trade share (1971-1980) was used as an instrument for the 1981-1990 openness variable and the average of the 1981-1990 used as an instrument for the 1991-2000 openness variable. The 2SLS regression results in Table 3 (columns 4 and 5) are qualitatively similar to the OLS regressions of the three periods (columns 1, 2, and 3). The 2SLS regressions show that trade openness is positive and significantly correlated with FDI at the 1% level indicating that trade openness did really contribute to FDI inflows to SSA.

The main finding of the study is that openness to trade had the greatest impact on FDI inflows to SSA over the past 30 years. An important observation of this study is that most of the results are sensitive to small alterations in the conditioning information set (preliminary results not shown here). Consequently, the

Table 3. Regression Coefficients for Determinants of FDI in SSA (1970-2000)

	OLS 1971- 1980	OLS 1981- 1990	OLS 1991- - 2000	2SLS 1981- 1990	2SLS 1991- 2000
	1	2	3	4	5
INF	-.163 (-.864)	.261 (1.456)	.233 (1.608)	.289 (1.568)	-.204 (1.147)
AGDP	.134 (.700)	.149 (.865)	-.308 (-2.63)	.120 (.674)	-.045 (-.286)
GDP	.076 (.227)	.135 (.572)	-.02 (-.193)	.130	.035 (.000)
URBAN	.060 (.235)	.103 (.495)	- .323** (-2.202)	-.0269 (-1.119)	-.266 (-1.516)
HDI	.014 (.057)	-.079 (-371)	-.079 (-371)	-.042 (-180)	-.360 (.722)
DEM	.346 (1.740)	.063 (.311)	.063 (.311)	.208 (1.004)	-.041 (-186)
OPEN	.459** (2.302)	.544*** (2.739)	.544*** (2.739)	.801*** (3.435)	.760*** (4.095)
NAT	.327 (1.539)	-.215 (-.981)	-.215 (-.981)	-.008 (-.038)	-.095 (-.481)
TEL	-.190 (-492)	-.140 (-611)	-.140 (-611)	-.212 (-888)	-.081 (-430)
GOV			.178 (.869)		.061 (.244)
N	26	35	38	31	31
R ²	.540	.28	.354	.432	.381

Note. *t* statistics in parentheses.

*Significant at the 10% level. **

Significant at the 5% level. ***Significant at the 1% level

paper finds evidence to support Chakrabarti (2001) and Morisset's (2000) assertion that openness to trade has a greater likelihood to be correlated with FDI inflows than any other variable. The lack of significance of the natural resource variable is surprising, because UNCTAD (1999) indicates that nearly 53.4% of SSA's FDI stock at the end of 1997 was in the primary sector. This might be due to the fact the dummy variable approach employed in this study may not be capturing the actual value of natural resources. The negative coefficient of

the urban population is also interesting in the sense that most other studies report either a positive relationship or a significant positive relationship between the two variables. For example, Crenshaw (1991) and Ioannatos (2001) find a significant positive impact of urban population on FDI inflows, but Morisett (2003) finds a positive but significant relationship between urbanization and FDI inflows. It is important to note, however, that unlike Morisett's (2003) work, which studied African countries, Crenshaw's (1991) study involved only developing countries and Ioannatos' (2001) study sample was made up of both developing and developed countries.

The governance variable is positive but not significantly correlated with FDI. In an earlier study, however, Asiedu (2002) reports that the low level of FDI inflows to Africa could be explained by the poor quality of institutions compared to other regions of the world. Unlike this study, however, Ancharaz (2003) in a study of 84 developing countries, reports that institutional quality was negatively correlated with FDI inflows to SSA. The inconsistency in the effect of governance on FDI inflows might be due to the difficulty in the operationalization of the governance measure. On the other hand, the lack of significance might suggest that most of the countries in the region have not reached the necessary threshold needed to impact positively on FDI inflows.

Finally, democracy was not found to be significant in any of the regression equations, and hence it can be argued that democracy has not been a key factor in FDI inflows to SSA. This finding supports Morisett's (2000) assertion that while trade openness is significantly correlated with FDI inflows to Africa, social, political and institutional variables have not had an appreciable impact on FDI inflows. The implications of the study are discussed next

Implications and Directions for Further Research

The study's finding that countries that open up their economies are more likely to attract FDI

should encourage policymakers to increase their participation in the globalization process as well as regional economic integration. However, the low level of FDI to SSA might mean that liberalization policies are necessary but not sufficient to attract FDI. Trade openness must be accompanied by proactive policies that encourage improvements in physical and governance infrastructure, human capital, and business climate to improve the region's chances of attracting more FDI (Dunning & Hamdani, 1997). This is especially important because MNEs are continuously examining how they can operate their production processes more efficiently (Dunning, 2002; UNCTAD, 1998, 2001).

UNCTAD's (2002) *World Investment Report*, notes that regionalism has become a dominant factor in investors' locational decisions. Further, Nyikuli (1999) claims that not only do regional blocs offer opportunities for investment and trade, but they are also a politically stabilizing factor. Consequently, policymakers in SSA must begin to examine how regional blocs like the Economic Community of West African States (ECOWAS) and the Common Market for Eastern and Southern Africa (COMESA) can be used to facilitate FDI inflows and promote the region's over all economic development.

Obviously, the current regional developments including opening up their economies and implementing favorable policies to foreign investors have implications for MNEs. First, MNEs should not wait for the perfect environment to invest in SSA especially if they are looking for significant first-mover advantages. Clearly, first-mover advantages including the opportunity to build the MNEs' image and reputation, loyalty of first time buyers, best choice of local partners will enhance MNEs' profitability (Ramamurti & Poh, 2004). Second, MNEs should exploit the current favorable FDI policy environment to negotiate favorable terms of entry. As FDI-based development become a commonplace and the competition for FDI increases in SSA, the balance in bargaining shifts in favor of the

MNEs (Narula & Dunning, 2000). Third, the similar social, cultural and economic conditions create opportunities for MNEs planning to invest in SSA to apply standardization strategies to achieve economies of scale. Further, the establishment of investment promotion agencies across the region has not only resulted in competition for FDI but also convergence of regulations on MNEs, which can lower costs and uncertainty (Ramamurti, 2004).

Finally, an even more important reason for MNEs to consider SSA as FDI destination is that the economies of developing countries are gradually becoming linked to private investment (Trevino & Mixon, 2004). It has been shown that MNEs can enhance their own bottom line by investing in the poorest nations of the world (Prahalad & Hammond, 2002). The long term survival strategy for MNEs in the region, however, is to balance their profit expectations and the need to be socially responsible (Meyer, 2004). The impact of MNEs on their environment must be important to managers, as positive spillovers help build the image and bargaining position of the MNE with the host government (Woodward et al., 1995).

Accordingly, through FDI, MNEs can act as agents of social and institutional reforms in host countries, which in the long run might promote and enhance the profitability of the MNEs. Consequently, the way forward for MNEs seeking to invest in SSA is to be proactive and implement strategies that are not limited to their private goals of profit maximization but also promote policies that support the development of the region. Potential MNEs must have an agenda to invest in educational and technological infrastructure to increase the absorptive capacity of the local citizens and enhance the positive externalities that the MNEs bring to the local economy.

In discussing the results of the study it is worth mentioning a few of its limitations. The lack of consistent data across countries in SSA limited the analysis to a maximum of 38 of the 48

countries in the region. Further, the study examined the overall FDI inflows and hence does not give any information with respect to the sectoral distribution of FDI. The limitations and implications of this study offer some important areas for future research. First, the lack of consistent data across countries might mean that cross-country studies need to be complemented with country-specific studies to provide more information on the factors that affect the locational decisions of foreign investors in SSA. Second, the lack of a robust relationship between most of the explanatory variables and FDI suggests the need to employ both qualitative and quantitative methods to better understand the factors that promote FDI inflows. Third, there is a need for more empirical research on the role of MNEs and the linkages that are necessary to promote the growth and development of both the MNEs and the host countries in which they invest.

Conclusion

This study shows that the degree of openness has been the most important determinant of FDI inflows to SSA over the past 30 years. However, the lack of significant impact of the governance infrastructure and human development index on FDI inflows to SSA indicate that the study's results does not support the thesis that non-traditional determinants of FDI have gained prominence in SSA. This finding might explain the low level of FDI inflows to SSA, as most FDI to the developing world in the 1990s have been efficiency rather than natural resource or market seeking.

The main lesson of this paper is that trade liberalization by itself is not a sufficient condition for FDI inflows. Trade openness must be accompanied by policies that encourage improvements in physical and governance infrastructure, human capital, and business environments to improve the region's chances of attracting more FDI. Good governance is not only a prerequisite for growth but also a necessary factor for attracting FDI. On the other hand, MNEs need to exploit the favorable FDI environment to reap the benefits of being first-movers, but even more

important, MNEs must be upbeat and implement strategies that are not limited to their private goals of profit maximization but also enhance the positive externalities that the MNEs bring to the local economy. The argument of this paper is that governments' overall development policy matters if the region is to increase its share of global FDI inflows. However, MNEs willing to invest in the region need to complement the development effort for their own long term survival and growth.

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ABOUT THE AUTHOR

Dr. Samuel Adams is a lecturer at GIMPA and can be reached on the following:

Dr. Samuel Adams

Ghana Institute of Management and Public Administration

P.O. Box AH 50

Achimota

Email: sadamss2000@yahoo.com