

FOREIGN DIRECT INVESTMENT AND DEVELOPMENT OF SMALL AND MEDIUM SCALE ENTERPRISES IN NIGERIA

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ABSTRACT

Despite the significance attached to inflow of foreign direct investment (FDI) and the development of small and medium scale enterprises (SMEs) as essential driving forces for economic growth, the extent to which SMEs have developed in response to this inflow has remained an issue of concern given Nigeria's poor economic predicament. Thus this paper investigates the extent to which FDI influences SME development in Nigeria. This paper extends beyond the existing literature given the cross-sectoral analysis of the Nigerian economy in addition to the analysis of FDI and SME development through the use of ordinary least square. Hence, compared to the level of generalization in the literature, result from this study is more precise while at the same time addresses small and medium scale businesses in different sectors of the Nigerian economy with respect to FDI.

Keywords: Foreign direct investment, small and medium scale enterprise, economic growth, Nigeria

JEL Classifications: F21, L26, O14, O17

I. INTRODUCTION

Given the critical role of entrepreneurship in economic growth of any nation and considering the absence of adequate technology in developing countries, it is essential to seek for technology transfer. More so, market and access to expertise are crucial to the survival and growth of small and medium enterprises (SMEs) in developing countries. Access to expertise allows SMEs to undertake productive

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investments efficiently and to acquire the latest technologies, thus ensuring their competitiveness and that of the nation as a whole. As opined by Dutse (2008), these latest technologies can be attained through the spill-over effects of FDI. This is because FDI is one of the major channels for transferring new scientific knowledge and related technological innovations.

From a priori FDI is therefore an essential impetus to small and medium scale entrepreneurship development in the country. In this regard, FDI facilitates access to markets, access to expertise and most of all access to technology. However the willingness of Multinational Corporations to open their global value chains to local firms has not really metamorphosed into meaningful SMEs development. This therefore raises the question of why the abysmal performance of the SMEs in Nigeria?

Furthermore, the pattern of the FDI inflow is often skewed towards extractive industries, meaning that the monumental rate of FDI inflow into Nigeria has been adduced to natural resources, although the size of the local market may also be a consideration (Asiedu, 2001). Invariably there is very little hope of economic development and growth for the country due to problems of socio-economic, political and religious factors.

Historically Nigeria is one of the economies in Africa with enormous demand for goods and services and has attracted some FDI over the years. The amount of FDI inflow into Nigeria has reached US\$2.23 billion in 2003 and it rose to US\$5.31 billion in 2004, this figure rose again to US\$9.92 billion in 2005. The volume however turns down vaguely to US\$9.44 billion in 2006 (CBN, 2009). The question that comes to mind is do these FDIs essentially contribute to small and medium scale business development in Nigeria? If FDI effectively contributes to growth, then the sustainability of FDI is a worthwhile action and a way of achieving its sustainability is by identifying those factors contributing to its growth with a view to ensuring its enhancement. Again, most studies on FDI and growth are cross-country studies. However, FDI and growth debates are country specific. Earlier studies (for instance, Otepolo, 2002; Oyejide, 2005; Akinlo, 2004) examine only the importance of FDI on growth and the channels through which it may be benefiting the economy. This study however examines the contributions of FDI to Small and Medium scale businesses with much emphasis on agriculture and transportation sector from 1981 to 2009.

II. REVIEW OF RELEVANT LITERATURE

Agreement in the literature supported by several empirical evidences seems to be that foreign firms through FDI do transfer technology to their affiliates; a process that can equally allow spill over to unaffiliated firms in the host economy which in turn augments growth through productivity and efficiency gains by local firms (see Ayanwale and Bamire, 2001; Girma, et. al, 2001 and Ayanwale, 2007). In Dutse (2008) opinion, FDI facilitates productivity in Nigeria by generating both technological and efficiency spill over to local firms, encouraging innovation in the small and medium scale businesses, allowing technology adoption and developing human capital. In addition to this, Ayanwale and Bamire (2001) report a positive

spill over of foreign firms on domestic firms' productivity that are dominated by the small and medium scale businesses.

Ayanwale (2007) results suggest that the determinants of FDI in Nigeria are market size, infrastructure development and stable macroeconomic policy. But out of these determinants only the market size slightly induced FDI into Nigeria since the others are lacking. FDI in Nigeria contributes positively to economic growth but its overall effect on small and medium scale businesses has not been that significant due to lack of infrastructure and unstable macroeconomic policies.

UNCTAD (2000) maintains that FDI contributes to economic growth through technology transfer with the multinational firms transferring technology either directly to their foreign owned enterprises or indirectly to domestically owned and controlled firms in the host country. Following Lucas (1988) argument, FDI spurs long-run growth through such variables as research and development (R&D) and human capital. It is suggested that through technology transfer to their affiliates and technological spill-over to unaffiliated firms in the host economy, foreign companies can speed up the development of new intermediate product varieties, raise product quality, facilitate international collaboration on R&D, and introduce new forms of human capital.

Other empirical studies conclude that FDI contributes to total factor productivity and income growth in host economies, over and above what domestic investments would trigger (Keller, 2003). The studies found out that policies that promote indigenous technological capability, such as education, technical training, and R&D, increase the aggregate rate of technology transfer from FDI and that export promoting trade regimes are also important prerequisites for positive FDI impact that would reduce the technology gap existing between developed wealthy and undeveloped poor nations.

Moreover, there are other related observed evidences on positive direct technology transfer from a foreign firm to its local affiliates in terms of higher productivity levels and growth in developed as well as developing countries (Girma, et. al, 2001; Saggi, 2003).

Further study suggests that technical change and technological leaning are main determinants of growth either of SMEs or other sector of the economy. Ikiara (2003) opines that foreign firm may allow local firms to appropriate its technology if this guarantees it access into some of the benefits available in the host country such as access to valuable local technology and possibility of receiving commercial advantages.

Nunnenkamp and Spatz (2003) however criticize the view that developing countries should draw on FDI to create economic development. The authors conclude that the growth impacts of FDI are ambiguous because of highly aggregated FDI data. By disaggregating FDI and considering the compatibility of different types of FDI on economic conditions prevailing in the host country, the positive growth effects of FDI are doubtful. Host country and industry characteristics as well as the interplay between both sets of characteristics determine the growth impact of FDI in developing nations. Alfaro *et. al.* (2003) analyze the role of local financial markets in enabling FDI to promote growth through backward

linkages. They assert that to operate intermediate firms in the goods sector, the entrepreneurs require upfront capital investments. The more developed the local financial markets is, the easier it is for credit constrained firms to operate. The increase in the varieties and quantities of intermediate goods leads to positive spill-over to the final goods sector. Due to this, the financial markets guarantee the backward linkages between foreign and domestic firms to turn into FDI spill-over. Their calibration results indicate that holding foreign presence constant, financially well developed economies perform almost as twice as economies with poor financial markets in term of growth. FDI contributes more in an economy with well developed financial system than in an economy with less developed financial system. Lastly, local conditions such as market structure, human capital are also important to generate a positive effect of FDI on economic growth.

Nigeria as a country, given her natural resource base and large market size, qualifies to be a major recipient of FDI in Africa and indeed is one of the top three leading African countries that consistently received FDI in the past decade. However, the level of FDI attracted by Nigeria is very low compared to its resource base and potential need (Asiedu, 2001). Also, the empirical linkage between FDI and economic growth in Nigeria is yet unclear despite the numerous studies that have examined the influence of FDI on Nigeria's economic growth with varying outcomes (Adelegan, 2000; Akinlo, 2004).

Carkovic and Levine (2002) further note that the economic rationale for offering special incentives to attract FDI frequently derives from the belief that foreign investment produces externalities in the form of technology transfers and spill-over.

In another vein, De Gregorio (2003) notes that FDI may allow a country to bring in technologies and knowledge that are not readily available to domestic enterprises and in this way increases their productivity throughout the economy.

Corroborating these submissions, Jerome and Ogunkola (2004) assess the magnitude, direction and prospects of FDI in Nigeria. They observed that while the FDI regime in Nigeria was generally improving, some serious deficiencies are yet to be resolved. These deficiencies are mainly in the area of the corporate environment (such as corporate law, bankruptcy, labour law, etc.) and institutional uncertainty, as well as the rule of law. In line with this Akinlo (2004) discovers that foreign capital has a small and not statistically significant effect on economic growth in Nigeria.

Olayiwola and Okodua (2005) further reveal that a unidirectional causality runs from FDI to non-oil exports. Responses of the economic growth, non-oil export and FDI to one standard deviation innovations were on the average, found to be dormant in the early stages of the out-of-sample forecast period but all demonstrated more pronounced responses after about seven years into the forecast period.

III. DATA AND METHODOLOGY

A. Data Collection

The data obtained for this study were from secondary source. This includes the Central Bank of Nigeria Statistical Bulletin where data on volumes and values of exports and imports, manufacturing, agriculture, transportation and trading output,

foreign direct investment, and fixed capital formation were obtained. The contributions of the SMEs were also extracted from these aforementioned sectors. The data covers the period from 1981 to 2009 while using ordinary least square regression to analyze the data.

B. Model Specification

The analytical framework draws from financial intermediation theories that place greater emphasis on the importance of finance to business enterprise (see Salihu, 2011). And as it was rightly pointed out in Subair and salihu (2010), there are two main sources of finance to small and medium scale business in Nigeria, among which are personal savings and commercial bank loan. However due to non availability of data, personal savings was dropped and an inclusion of Foreign Direct investment and inflation was made from the work of Faras and Ghali (2009). Given the heterogeneous nature of small and medium scale business in terms of output, it is disintegrated into two sub sectors as follows: transport and agriculture. In this regard foreign Direct Investment in each of the sector is expected to boost the activities of the sector in the host country.

The GLM multiple regression equations was adopted given the variability in the agricultural and transportation business. After which the overall regression equation for the small and medium scale business is estimated. In view of this argument, the following output functions that incorporate four explanatory variables for estimation purpose are specified as follows:

Agricultural Business

The equation one below modeled the performance of small and medium scale farmers.

$$LAGR_t = \beta_0 + \beta_1 LFDI_t + \beta_2 LGEX_t + \beta_3 LCBL_t + \beta_4 INF_t + \mu_t \text{-----}1$$

Where AGR is Revenue to agric as a percentage of GDP measured Performance of small scale farmers, FDI is Foreign direct investment to agriculture as percentage of GDP, GEX is growth rate in government expenditure, CBL, Commercial bank loan percentage of GDP and INF is the inflation rate in the economy.

Transportation Business

The second equation modeled the performance of small and medium scale transport business.

$$TRANS_t = \partial_0 + \partial_1 FDI_t + \partial_2 GEX_t + \partial_3 CBL_t + \partial_4 INF_t + \mu_t \text{-----}2$$

Where TRANS measure the performance of transport business in terms of Revenue to transportation as a percentage of GDP, FDI is Foreign Direct Investment to transportation business as percentage of GDP while GEX, CBL and INF is the same as above.

Small Scale Business

There after the small and medium scale performance was proxy as the combination of the conditions of both farmers and transporters operating on small and medium scale. Thus the expression is shown in the equation 3 below.

$$SME_t = \alpha_0 + \alpha_1 MS_t + \alpha_2 FDIG_t + \alpha_3 CBL_t + \mu_t \text{-----3}$$

Government expenditure and inflation are excluded in this equation follow the preliminary study by authors, which show that the impact of the two variables is immaterial to the overall SMEs performance. However an additional variable namely Margin of Safety (Return on investment minus Interest rate) is included. The study explored only the above data resources that covered the period of 1981-2007; the choice of this period was governed by data availability.

The theoretical expectations are the coefficients of equations (1), (2) and (3) and these are as follows: β_0, \dots, β_4 ; $\partial_0, \dots, \partial_4$; $\alpha_0, \dots, \alpha_3$. All these technical coefficients are expected to be positive such that SMEs performance is positively related to the independent variables except being negative with respect to inflation (INF_t).

Table 1: Summary of Dataset Used

Variables	Description	Units measured	Source
AGRI	Revenue to agric as a percentage of GDP measured Performance of small scale farmers	Percentage rate	Central Bank of Nigeria (statistical Bulletin, 2009)
GEX	Government Expenditure	Billions of Naira	Central Bank of Nigeria (statistical Bulletin, 2009)
FDIG	Foreign direct investment to sector as percentage of GDP	Percentage rate	Central Bank of Nigeria (statistical Bulletin, 2009)
CBL	Commercial bank loan percentage of GDP	Percentage rate	Central Bank of Nigeria (statistical Bulletin, 2009)
INF	Inflation rate	Rate	Central Bank of Nigeria (statistical Bulletin, 2009)
TRANS	Revenue to transportation as a percentage of GDP measured Performance of small scale transporter	Percentage rate	Central Bank of Nigeria (statistical Bulletin, 2009)
SME	Small and medium Business performance measured by Asset to SMEs	Percentage change	Central Bank of Nigeria (statistical Bulletin, 2006)
MS	Margin of Safety (Return on investment minus Interest rate)	Rate	Central Bank of Nigeria (statistical Bulletin, 2006)

The study explored only the above data resources that covered the period of 1981-2007; the choice of this period was governed by data availability.

IV. EMPIRICAL RESULTS

The percentage average of sectoral distribution of foreign direct investment and growth rate in various sectors are illustrated in Table 2. Mining and quarrying received the highest percentage of FDI in Nigeria in 1970s with an average of 39%, followed by manufacturing and trading sectors with transport sector having lowest growth rate of 6.25%. Though Mining sector has the largest share of the FDI, the growth rate in the sector is similar to what is obtainable in Agricultural sector.

Table 2: Average FDI and Sectoral Growth (%)

Sectors	1970/1980		1981/1990		1991/2000		2001/2010		1970/2009 (Over all average)	
	FDI (%)	Growth rate	FDI (%)	Growth rate						
Mining and quarrying	38.97	8	15.84	10.94	35.99	11.49	35.71	11.73	30.07	10.45
Manufacturing and processing	29.92	6.92	38.71	9.31	29.9	9.57	30.63	9.96	33.06	8.83
Agriculture	1.85	8.3	1.95	10.86	1.38	11.51	1.44	12.31	1.49	10.61
Transportation & Communication	1.22	6.25	1.37	8.53	0.9	8.82	0.94	10	1.27	8.22
Building & construction	4.67	7.77	6.33	8.4	3.29	8.59	3.38	9.14	4.26	8.19
Trading Business services	18.68	7.08	30.65	10.16	2.45	10.61	5.27	11.24	16.15	9.8
Miscellaneous	4.65	----	5.18	-----	23.07	-----	22.66	-----	13.72	-----

Source: Central Bank of Nigeria

Considerably the statistics is different in 1980s partially as a result of structural adjustment programme. Despite the drastic fall in FDI to mining sector during this period, its growth rate stands at 10.98% which was the highest for the period. Hence aside mining and manufacturing sector, FDI improvement in transport, trading and business service and building and construction were followed with expected increase in their growth rate or contribution to economic growth. Though FDI to the service sector was very low, indications from the table show that increase in foreign direct investment are mostly followed by improvement in only the service sector during SAP era.

Similar trend was observed in 1990s and 2000s except that FDI to mining increases during the eras. The transport sector in 1990s received the ever low percentage of total FDI (0.9%) in history. This support the fact that majority of development in transport is financed locally since the sector is traditionally dominated by the small and medium entrepreneurs.

However, average value for the entire period shows that manufacturing sector has the highest share of FDI. And as shown in the Table 2, agricultural sector is the fastest growing sector within the Nigeria economy but poorly financed even by foreign investors. This supports the previous evidence in literature that agriculture is predominantly dominated by the peasant farmers. And that despite the recognition of the financial problem of small and medium scale businesses by some Multinational Corporations (MNCs) especially Shell in Nigeria, the perennial financial constraints to small and medium scale farmers still persist. As one can rightly guess, when firms failed to get financing loans in an atmosphere of escalating liberalization under the aegis of structural adjustments, it is expected that most of them would face stiff competition from MNCs and perhaps fold up. This has actually been the case and when they hang on, most of them remain static without the capability of developing due to poor performance. This results in low profit, reduced working capital and most at times unable to meet debt obligations. As a result, many MNCs prefer either to import, purchase from other MNCs subsidiaries, or produce in-house rather than investing in local SMEs linkages.

Table 3: Correlation Matrix

Variables	Manufacturing growth rate	Agricultural growth rate	Trade and services growth rate	Transportation growth rate
Manufacturing growth rate	1.000000	-0.031611	0.987396	0.974738
Agricultural growth rate	-0.031611	1.000000	0.088886	0.152551
Trade and services growth rate	0.987396	0.088886	1.000000	0.994045
Transportation growth rate	0.974738	0.152551	0.994045	1.000000

Source: Authors' Computation

The output of the correlation matrix in table 3 above shows the degree of association between variables of interest. This suggests that at an average, the relationship between development in agriculture (AGR) and manufacturing sector growth (MAN) is negative 3%. This suggests further that development of manufacturing sector leads to migration of labour force from agriculture to manufacturing. This is properly explained in rural-urban labour migration that has a negative implication on Nigeria agricultural sector thus reducing the contribution of the small and medium scale farmers to economic growth.

However manufacturing sector, trading and business service and transport and communication sector exhibit a very strong positive correlation with one

another. Furthermore there is a weak correlation of 9% between agriculture and trading. The relationship between transportation/communication (TRANS) and agriculture (AGR) is 15%, suggesting that the problem of small and medium scale farmers is not majorly transportation.

Table 4: Result of Agricultural Sector

Dependent Variable: LAGR

Method: Least Squares

Sample: 1981-2007

Included observations: 27

Variable	Coefficient	Std. Error	t-Statistic	Prob.
LFDI	0.750763	0.123979	6.055541	0.0000
LGEX	0.014461	0.038963	0.371150	0.7141
LCBL	0.300346	0.099829	3.008613	0.0065
INF	-0.007858	0.002752	-2.855737	0.0092
C	-0.735863	0.547971	-1.342886	0.1930
R ²	0.986078	Mean dependent var	10.21519	
Adjusted R ²	0.983547	S.D. dependent var	1.904146	
S.E. of regression	0.244244	Akaike info criterion	0.184277	
Sum squared resid.	1.312412	Schwarz criterion	0.424247	
Log likelihood	2.512257	F-statistic	389.5630	
Durbin-Watson stat	1.012864	Prob(F-statistic)	0.000000	

Source: Authors' Computation

Government recurrent expenditure exerts the strongest positive impact on the small and medium scale businesses specifically in agricultural sector. This impact is

confirmed to be significant at 5%. Commercial bank loan to agricultural sector has weak impact on the small and medium scale farmers though significant at 5% level. Hence, 100% increase in commercial bank loan to small and medium scale farmers only leads to 30% increases in agricultural output.

The positive impact of income on agricultural output exhibited in the output above suggests that increase in the standard of living through increase in income results to increase in the output of small and medium scale farmers. Furthermore, the extent of foreign direct investment into the country is confirmed to have significant positive relationship with small scale farmers' output in Nigeria only at 10% level of significant. More so, the impact of inflation rate and lending rate is immaterial. This might probably be attributed to less reliance of the small scale farmers on the commercial banks for loan.

The high coefficient of determination value suggests that the regressors determined 99% of the variation in the output of small and medium scale farmers. Durbin Watson value of 1.01 implies that there is no sufficient information to accept the existence of autocorrelation. And the estimated F- statistic of 389.56 is significant, suggesting that the regression or model is significant, hence, it can be used for forecasting.

Table 5: Result of Transport Sector

Dependent Variable: TRANS

Method: Least Squares

Sample: 1981-2006

Included observations: 26

Variable	Coefficient	Std. Error	t-Statistic	Prob.
GEX	0.005327	0.000910	5.850725	0.0000
FDIT	-303.6885	54.32490	-5.590226	0.0000
INF	-33.06766	10.76963	-3.070456	0.0058
LOAN	0.001781	9.64E-05	18.47715	0.0000
C	4211.385	673.1448	6.256284	0.0000
R ²	0.984307	Mean dependent	5195.787	
Adjusted R ²	0.981317	S.D. dependent var	6890.822	
S.E. of regression	941.8669	Akaike info	16.70465	

criterion			
Sum squared resid	18629377	Schwarz criterion	16.94659
Log likelihood	-212.1604	F-statistic	329.2861
Durbin-Watson stat	1.813335	Prob(F-statistic)	0.000000

Source: Authors' Computation

The result of the transport sector equation indicates that government expenditure is positively related with performance in the transportation sector. Increase in government expenditure increases the performance of transportation by 5 units. This was found to be significant at 5% level of significant due to various poverty alleviation programmes established in the sector. As part of mass transit programme, the tricycle was introduced by various state governments while the federal government did same through the National Poverty Eradication Programme (NAPEP). This established the main reason why the sector is dominated by the small and medium scale transporters compared to FDI with negative coefficient.

Table 6: Aggregate Output Result

Dependent Variable: SME

Method: Least Squares

Sample: 1995 2006

Included observations: 12

Variable	Coefficient	Std. Error	t-Statistic	Prob.
MS	1.380506	0.505308	2.732009	0.0258
FDIG	-7.200767	2.554172	-2.819218	0.0225
CBL	1.908977	0.469353	4.067249	0.0036
C	18.02227	6.067193	2.970447	0.0179
R-squared	0.754580	Mean dependent var	15.21010	
Adjusted R-squared	0.662548	S.D. dependent var	11.37098	

S.E. of regression	6.605474	Akaike info criterion	6.874876
Sum squared resid	349.0583	Schwarz criterion	7.036512
Log likelihood	-37.24926	F-statistic	8.199069
Durbin-Watson stat	2.954095	Prob (F-statistic)	0.008001

Source: Authors' Computation

Evidence from the regression equation above shows that margin of safety (MS) has a significant positive relationship with the small and medium scale businesses. This implies that as the return on SME investment increases over the interest rate, SME performance improves. A 100% increase in margin of safety increases the performance of small and medium scale businesses (SME) by 138%. Furthermore this supports the quest for reduction in interest rate. However ratio of foreign direct investment to agriculture as percentage of GDP (FDI) is negatively related to small and medium scale businesses in Nigeria. Hence, as the ratio of FDI to GDP increases the performance of small and medium scale business declines.

Commercial bank loan (CBL) exerts significant influence on the small and medium scale businesses in Nigeria. It was found that an increase in the commercial bank loan to this set of entrepreneurs contribute meaningfully to SME growth, suggesting that if more loan is given to the sector, it will improve and facilitate SME development. This support the recent work of the authors (Subair and Salihu, 2010) that inadequate finance is one of the main factors that slow down the development of SME in Nigeria and if this constraint is eliminated, SME's will be on their path towards rapid growth and contribute meaningfully to Nigerian economic development as it was experienced by the leading economies in Asia.

Our model gives a very high coefficient of determination at 0.75. This implies that 75% of the variation in SME performance is explained by the safety margin, FDI and commercial bank loan. The F-statistic confirmed that the entire model or variable in the equation is significant. Durbin Watson value is an indication that there is no sufficient evidence to support existence of serial correlation in the model.

The entire diagnostic tests confirmed that the model is good fitting. The ARCH LM test suggests that the model is free of volatility and based on Brusch-Godfrey serial correlation LM test there is no sufficient information to accept the existence of serial correlation. The normal distribution of the model is confirmed by the Jarque Bera statistics. Assumption of homoscedacity is supported by the white heteroscedacity test. And finally the Ramsey reset test substantiates the fact that, the model is free of specification error. Given these, it is safe to conclude that the model is good for forecasting.

V. CONCLUSION AND POLICY OPTIONS

It is crystal clear that FDI on its own has contributed negatively to the development of small and medium scale enterprises in Nigeria through the MNCs. This has been attributed to low profit expectation in small and medium scale businesses and perhaps, the Multinational companies (MNCs) are more risk averse. In this respect many local industry specifically small scale businesses are relegated to the background despite their importance as a catalyst of economic growth. Having said this it is essential to state at this point that safety margin and finance are the major determinants of growth in small scale businesses. However the MNCs can still be convinced beyond reasonable doubt that small and medium scale businesses are lucrative if government provides enabling environment for their operation. This includes reorientation of the small and medium scale entrepreneurs in utilizing the loans granted them with the provision of infrastructures. Also, it is important that the power supply should be improved upon as most of the artisans dominate the small and medium scale businesses. In addition the interest rate or cost of loan should be reduced to the barest minimum while also improving the educational status of these entrepreneurs in order to tap the advantage of technological spill over from FDI.

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