Chapter 11
Privatization and Foreign Direct Investment

The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least amount of hissing.
Colbert

Learning Outcomes

By the end of this section, you would understand:

- *Privatization's theoretical function*
- *Privatization as a strategic goal of the state and the initiatives taken*
- *Public and private sector partnerships (PPP)*
- *Privatization results to date and consequences*
- *Foreign direct investment (FDI) as a principal tool of economic reform*
- *The positive and negative effects of FDI*
- *FDI flows to the Kingdom by source and sector*

Introduction

There is a consensus amongst Saudi economic observers and practitioners that the Kingdom truly needs to make economic reforms work and it can only do so by strengthening the private sector, finding other sources of investment and encouraging repatriation of Saudi capital in viable domestic projects. What then are the obstacles? It is not that Saudi Arabia lacks good intentions or has not set the proper priorities. Rather, there is *no matching consensus* as to how much action is needed and how quickly it should act. While different economists and government planners might assign different priorities and values to the urgency of the effort needed, most would agree that success will depend on far more progress being made in the following areas:

- Privatizing key public assets
- Attracting more effective foreign direct investment (FDI)

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- Strengthening the private sector in a meaningful manner
- Repatriating Saudi capital into domestic projects
- Creating meaningful and value-added jobs for the Saudi economy

Some have argued that implementing some or all of the objectives can no longer be postponed (Cordesman, 2003), due to a multitude of challenges faced by the Kingdom. Amongst these are a wide range of external forces that shape the value of the Kingdom's petroleum revenues in ways it cannot control. These forces include serious problems in planning budgets and 5-year plans, because of an inability to predict cash flow. There also has been low productivity in many subsidized and sheltered sectors. In addition, the pace of structural change has been slow, so that despite all the measures of diversification away from oil, the private sector still only accounts for a base of around 35% of the GDP. Diversification efforts have also had a limited productive impact, and the economy has neither generated sufficient number of jobs for Saudis nor induced a "knowledge-based" society.

Taking the First Steps for Privatization

Until it announced its wide-scale privatization programme in late 2002, the Saudi government had run core services itself or through the private sector via operation contract method, whereby government services are carried out on a contract basis by the private sector. The decision to privatize government services and transfer them wholly to the private sector is an implicit acknowledgement that both the operation contract method and the use of direct government services have failed. This failure can be traced back to the government's inability to deliver on its commitments in the face of increased domestic demand, and to the inherent conflict of interest created by the fact that the government was judging its *own* performance.

Countries worldwide are redefining the roles of government and the private sector. As they rely more on the private sector for the provision of infrastructure and public utility services, which in many cases are exposed in the short and medium term to little or no competition, there is also a need for economic regulation.

Economic regulation is required to protect consumers from monopoly or from the abuses of limited competition and, at the same time, to give the private sector the necessary incentives for short- and long-term efficiency. On the other hand, there is some evidence to indicate that, in their zeal for regulation, this could have an adverse effect on economic growth (Speakman, 2002).

Regulators must therefore play the important role of an independent and impartial referee who balances the interests of government, consumers and private sector providers of infrastructure and services. For most countries that do not have a regulatory tradition, the establishment of entities that are responsible for economic regulation poses major challenges, as is the case for Saudi Arabia.

While there are some disagreements on approaches to be taken, most experts would agree that "good" economic regulation should aim to maximize the overall welfare of societies, otherwise changes will only add to confusion and lack of direction (Saravia, 2002). The key tasks are the design of regulatory institutions and

of processes that are seen to be independent and accountable, as well as transparent and consistent.

To its credit, the Saudi Arabian government is aware of all these issues. Despite the then Crown Prince Abdullah's declaration in 2000 that privatization is a strategic choice for the Saudi economy, the Supreme Economic Council, which has been mandated to implement economic policies, has attributed the slow progress on privatization to the nature of structural changes that are required (Saudi Press Agency, 2002). The council has focused its efforts on developing the regulatory environment, without which the outcome and direction of the new economic liberalization will be beneficial in terms of sustained structural economic diversification.

Privatization: Key Concepts

Since its first appearance in England in the late 1970s under Prime Minister Thatcher, privatization has been, by far, the most controversial instrument of economic policy of the past two decades. Economics, politics and ideology have punctuated the debate on privatization and have polarized opinion, but do not diminish the importance of privatization as a policy instrument and as a process shaping the economics of the twenty-first century. As we highlighted earlier, the rulers of Saudi Arabia have publicly stated that privatization is a strategic goal of the state and which has been reiterated in the latest Ninth Five-Year Plan.

Privatization is an instrument of economic policy through which there is a transfer of property or control of assets, usually owned by the state, to the private sector. Thus, in its purest form, privatization encompasses the privatization of management and ownership.

A broader definition describes privatization as the abolition of barriers to private sector provision of services or to the infrastructure necessary for their delivery. This broad definition usually applies to privatization of a sector (telecommunications, electricity, gas, water, etc.) and it often requires a restructuring of the whole sector rather than just one firm. It also requires legal and regulatory mechanisms to ensure that private providers do not overlook the public dimensions and responsibilities of the services they are licensed to deliver, and to ensure they meet the pre-agreed upon targets and policy objectives, such as coverage to certain areas and access for the public. It is this issue – the regulatory framework – that has kept the Saudi privatization process from advancing more rapidly than hoped for, given the political statements of support.

Different economies and countries have adopted privatization for different ends. Thus, for example, the former Socialist economies of Eastern Europe used privatization to increase the role of the private sector in the economy. Some Arab economies going through transition and change, like Egypt and Algeria, are striving to move from a state-controlled and dominated economy to a market-based economy where the private sector plays a much greater role.

The oil-rich countries of the Gulf Cooperation Council (GCC) have used privatization as a means of diversifying their economic base, moving away from

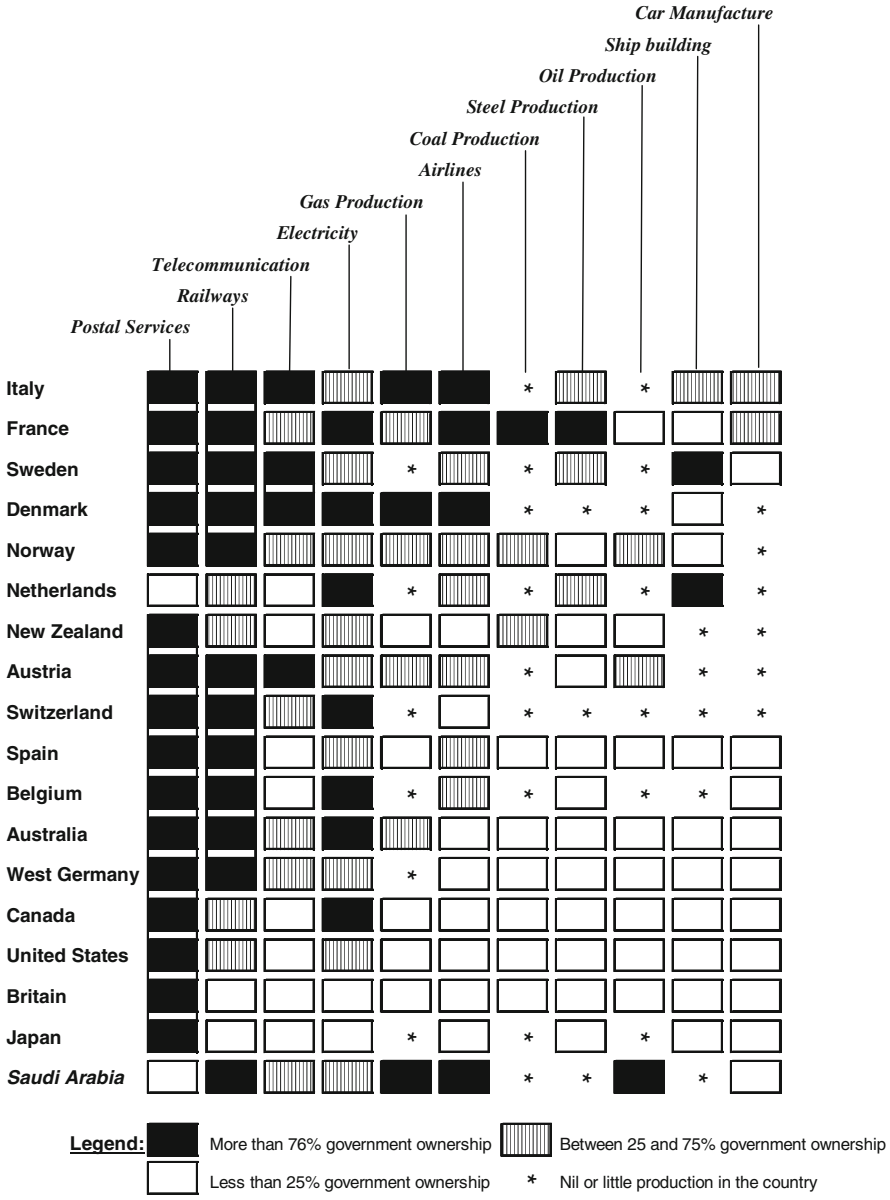

Fig. 11.1 Privatization pattern – industry ownership in selected OECD countries and Saudi Arabia (1998) (Source: Adapted by Author from OECD Privatization Database, 2000)

a heavy reliance on the oil sector (Al Bazai, 2002, Seznec, 2002). It is also fortunate that the earlier adoption of privatization in many countries will make it possible for Saudi Arabia and others in the GCC to learn from these experiences and to draw important lessons that are relevant to their own economic structures.

Figure 11.1 compares the status of Saudi privatization with those of selected Organisation for Economic Co-operation and Development (OECD) countries in 1998. It is interesting to note that, with the exception of Britain, Japan and the USA, the majority of OECD countries have yet to privatize many state industries. It is worthwhile noting that Saudi Arabia's nascent car manufacturing industry is entirely in private sector hands, like all other OECD countries (with the exception of Italy and France). Saudi car production, though, is more of an assembly line operation for trucks, buses and other specialized cargo vehicles carried out through a Saudi–German partnership of the Jeddah-based *Juffali* group with Mercedes Benz and the Riyadh-based *Al Jomaih* group with General Motors.

Routes to Privatization

Privatization follows many different routes, from a minimal or low level of private ownership to total private ownership, as Fig. 11.2 illustrates.

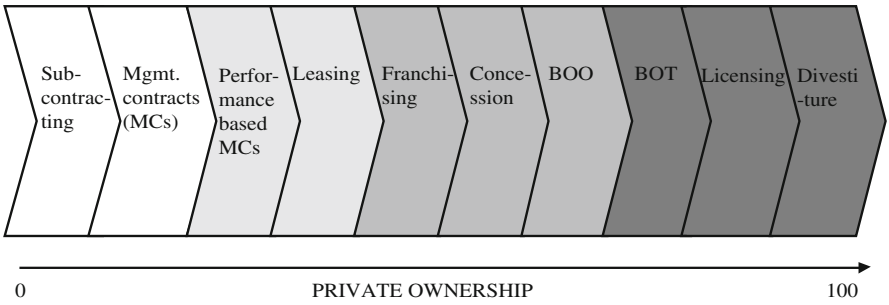

Fig. 11.2 Privatization scales

Each public–private partnership noted here entails a different set of agreed commercial and operational elements, as well as a specified period for the privatization. The subcontracting and management contracts (MCs) are of shorter duration than the leasing contracts, franchising, etc., until total divestiture (sale) of the public asset. As discussed in earlier chapters, the MCs and subcontracting have been the main methods of operation of the Saudi government to date in involving the private sector. Other countries in the region, especially Turkey, pioneered the concepts of build-operate-transfer (B-O-T) and build-own-operate (B-O-O) as part of their privatization strategy.

The political push for privatization as a strategic choice is necessitated by the forecasted capital expenditure needs of the Kingdom in key areas. Current estimates of such capital expenditures over the next 20 years are around $540 billion or SR 2,025 billion for education, electricity, oil, gas, mining, water and agricultural projects (National Commercial Bank, 2003). The government cannot meet these needs, so it must either borrow or turn over key sectors to the private sector to operate on a profitable and cost-efficient basis.

In November 2002, the Saudi Arabian government announced plans to privatize 20 economic sectors, including telecommunications, civil aviation, desalination, highway management, railways, sports clubs, health services, municipality services, water and sewage, highway construction, airport services, postal services, grain and flour silos, hotels, seaport services and industrial city services. Privatization would also cover state share sales in the Saudi Electricity Company (SEC) and the Saudi Arabian Mineral Company (*Maaden)*, as well as local petroleum refineries. Both SEC and *Maaden* have been partially privatized since the announcements.

It was a staggering list in both size and diversity, and one of the most ambitious privatization announcements of any country in the world over the past few decades.

Experiences of privatization elsewhere, including pioneering Britain, showed that government revenue maximization through privatization is not necessarily the best option. It is the method and quality of privatization that is of more importance, specifically the management and technical capabilities of those new operating owners who will be answerable to shareholders. The checks and balances through independent industry regulators are also important, especially for utilities such as water, electricity and gas.

Because privatization can take many forms, governments around the world have used different methods to achieve their objectives, and the most common methods to implement privatization programmes have been as follows (Dagdeviren, 2006, Clarke 1994, Clarke et al., 1995):

- *Share issue privatization,* whereby the government sells part or all its shares on the local or international stock market
- *Asset sale privatization,* whereby the government sells the entire corporation or part of it to a strategic investor, usually by public auction
- *Voucher privatization,* whereby the shares of ownership are distributed to all citizens, usually free or at very low prices

Share issue privatization is the most common type of privatization and is the route taken by Saudi Arabia. The benefit of such an approach of share issuance is that it can broaden and deepen domestic capital markets, boosting liquidity and potential economic growth (Kemp, 2007, Clarke, 2005), and this was evidenced when STC and SABIC shares were listed on the Saudi stock market. Sometimes developing countries adopt the asset sale privatization route for strategic reason that involves international foreign partners to capitalize on their expertise, R&D and efficiency gains. Voucher privatization has been rare, but has been used in the transition economies of Central and Eastern Europe, such as Russia, Poland, the Czech Republic and Slovakia (Dagdeviren, 2006).

As noted earlier, privatization raises opposing arguments, and the key arguments are summarized in Table 11.1.

As noted from the various arguments for and against privatization, there is no clear consensus as both sides have some valid arguments. The decision to undertake a privatization programme is not an easy one for any government, given the opposition it generates primarily based on “social justice” and equity as opposed to

Table 11.1 Arguments for and against privatization

For	Against
• Private market factors can deliver goals and services more efficiently owing to market competition, leading to lower prices, improved quality, more choice and quicker delivery. Governments have few incentives to ensure enterprises are well run. Lack of benchmark comparison with state monopolies • State-run industries tend to be bureaucratic and changes only happen when they become politically sensitive • Managers of privately owned companies are accountable to stakeholders and consumers while managers of public enterprises are accountable to political stakeholders • Investment decisions are governed by market interest rates instead of cross-subsidizing of government entities with overall credit risk of the country • Governments may bail out poorly run state businesses often due to sensitivity of job losses when economically it may be better if such enterprises are curtailed • Successful market-led enterprises generate new jobs, stimulate R&D and create wealth for society. As such subsidies are reduced, and fewer taxes are raised by governments to maintain state corporations	• Governments are proxy owners of state enterprises and as such they are answerable to the people and will lose elections or popularity if state enterprises are not managed well • Society should be sheltered from some elements of more "ruthless" market forces that do not take into consideration social responsible services such as health and education • The government mission is for social support whose primary aim is delivering affordable and quality services to society • Governments can raise funds in the financial markets more cheaply than private companies and re-lend to state-owned enterprises • Governments have chosen to keep certain sectors or companies under public ownership because of their strategic or national interest and which cannot be turned over to the private sector to manage • Government-owned companies in essential utilities such as water or electricity provide such services to all regions and would not cut off regions or households less able to pay • Government corporations often take a long-term view of their operation unlike a short-term conflict between profitability and service level of private companies

efficiency. For Saudi Arabia, the decision to privatize has been based on efficiency criteria as the critical factors explored below show.

Saudi Arabia's Basic Privatization Objectives

In June, 2002, the Supreme Economic Council (SEC), under the Chairmanship of the then Crown Prince Abdullah bin Abdulaziz, approved the privatization strategy for Saudi Arabia (Saudi Press Agency, June 2002). The strategy consists of eight basic objectives, each of which requires the adoption of a number of policies. These are as follows:

Objective 1: Improving the capacity of the national economy and enhancing its ability to meet the challenges of regional and international competition.

Objective 2: Encouraging private sector investment and effective participation in the national economy and increasing its share of domestic production to achieve growth in the national economy.
Objective 3: Expanding the ownership of productive assets by Saudi citizens.
Objective 4: Encouraging local investments of domestic and foreign capital.
Objective 5: Increasing employment opportunities, optimizing the use of the national workforce and thus ensuring the equitable increase of individual income.
Objective 6: Providing services to citizens and investors in a timely and cost-efficient manner.
Objective 7: Rationalizing public expenditure and reducing the burden of the government budget by giving the private sector opportunities to finance, to operate and to maintain certain services that it is able to provide.
Objective 8: Increasing government revenues from returns on the sale of assets to be transferred to the private sector.

While these are laudable objectives for any government to pursue, the Supreme Economic Council also recognized when setting these objectives that, in order for them to be successful, a regulatory framework had to be in place for the privatized industries. In addition, they needed to prepare and restructure the sectors and public enterprises to be privatized. They also indicated that one option was to pursue foreign strategic partners to provide capital, share risks provide advanced technical and management expertise and assist in creating a suitable climate for a successful privatization programme. What have been the accomplishments to date?

Privatization Efforts by Sector: Mixed Results

The Saudi government's actions to date have been partly characterized as market-driven and partly as an effort to shift current and future investment burden away from the government. They do not seem like a serious effort to privatize functions now operated by the state sector on a commercial basis. The eight broad privatization objectives set out so clearly by the Supreme Economic Council seem to intuitively recognize that privatization, in the Saudi Arabian context, can only have the required impact on growth and reform if it means conversion of state-held functions to truly competitive private enterprises. These enterprises can charge market prices and, by extension, reduce labour and overhead costs so as to become more productive and profitable.

Until recently, the economic regulation of infrastructure and utility services was not an issue in the Kingdom, as most of these services were provided directly by government entities (Al Bazai, 2002, Khemani, 2002). As such, issues related to policy, ownership and operation of assets for the provision of the services were interconnected and any regulation that existed was primarily in the form of self-regulation. To date, the government of Saudi Arabia has not (with the exception

of the postal services) totally privatized – and therefore economically regulated – any major sector of services or industry. It has only sold part of its shareholding to the public in companies such as the Saudi Arabian Basic Industries Corporation (SABIC), Saudi Telecom Company (STC) and Saudi Arabia Mining Company (*Maaden*).

Recognizing the need for such a regulatory framework, the Saudi government approved the Telecommunications Regulations in 2001 and, in the same year, established the Saudi Telecommunications Authority. This built upon the experience of the Electricity Services Regulation Authority set up in 1998 (SAMA, 2003).

From 2006, however, the pace of privatization-led initiatives has picked up in Saudi Arabia, no doubt assisted by the favourable turnaround in the Kingdom's fiscal position due to high oil revenues as explored in earlier chapters. The key initiatives are summarized below by sector.

The Saudi Basic Industries Corporation (SABIC): SABIC is one of the pillars of Saudi industrialization policies and represents the Middle East's largest non-oil hydrocarbon-based industrial company. The government currently owns 70% of SABIC, and 30% is owned by the private sector. SABIC shares are actively traded on the Saudi stock market. To date, there has been no sign of further government sales of SABIC shares to the public, despite a cabinet approval in principle to sell three-quarters of its 70% share. The success of SABIC's share flotation and Saudi Arabia's relative comparative advantage in petrochemical products has encouraged other private sector companies to enter the petrochemical field, and this would not have been done at the level of investment undertaken if the government had not partially privatized SABIC.

The Saudi Electricity Company (SEC): SEC is the merger of the previous four separate Saudi Electricity Companies (SCECO) in the east, west, centre and south. These supplied around 85% of the Saudi power supplies, and in 2000 the various SCECOs and ten private power companies were all merged into the SEC. The government share in SEC is 74.15% and the private sector holds the remainder. The restructuring of the SCECO system was intended to lead to a more efficient streamlining of the Saudi power sector base, with the expectation that SEC would develop three separate sector companies for generation, transmission and distribution. The government has established an Electricity Services Regulation Authority to assist with the privatization programme and is considering alternative forms of private sector participation in this sector through BOO, BOT and even build-own-operate-transfer (BOOT) schemes. According to SAMA, the financial requirement for the power sector through 2023 is estimated at SR 341 billion or $90.9 billion (SAMA, 2009).

The partial privatization of SEC encouraged the company to initiate some public and private sector partnerships (PPPs) with the aim of attracting investors in the area of power generation for several mega projects including *Rabegh*, a project with a capacity of 1,200 MW to be operational in 2012, and *Alqariah*, a 2,000 MW project to be operational in 2014.

SEC also participated on a 50/50 basis with the Saline Water Conversion Corporation (SWCC) in establishing the Water and Electricity Limited Company,

provided that SEC would be the sole buyer of water and electricity; production projects were awarded on the basis of BOO principle.

Saudi Telecom Company (STC): A 30% stake of STC was sold to the private sector in December 2002, in one of the largest government sales of shares; it raised around SR 15 billion or $4 billion. Following the sale, the STC became the Saudi stock market's second largest listed company in terms of capitalization, after SABIC. Work has progressed to create a specialized body with the administrative and financial autonomy to organize the telecommunications sector and provide rules and regulations to ensure fair competition amongst private firms. Following STC's partial privatization, and the Kingdom's accession to the WTO in 2005, several other telecom providers have entered the Saudi market, notably *Mobily* in 2006 and *Zain* in 2008, creating competition with STC for its mobile and Internet services. According to STC, Saudi Arabia has 21 million mobile users generating annual profits of around SR 14 billion and STC holds 85% of the market share, with *Mobily* at 10% and *Zain*, the new entrant, the remaining market share. Due to the competition it faced following partial privatization, STC has diversified its portfolio, targeting specific segments of society, mainly youth between 18 and 25 years old. New third-generation (3GP) services offered by STC include mobile TV, Internet access over mobile and video calls. Some argue that all this would not have occurred without privatization competition.

Saudi Arabian Airlines (Saudia): The first pronouncements on privatizing the national airline Saudia were mooted as early as 1994. In 2000, SAUDIA's board of directors invited investment banks to prepare bids for the privatization of the company. Some significant developments have taken place since those days and by 2010, the following actions were taken: a privatization implementation programme was approved by the Supreme Economic Council (SEC) in 2006 to convert Saudia's non-basic sectors into commercial units in the catering, ground services, cargo, aviation academy and real estate divisions. At the same time, the privatization directive of the SEC was to restructure the basic core sector of aviation and convert it into a strategic unit. These Saudia privatization initiatives prompted some new entrants to compete against Saudia in its core aviation business. New Saudi private airlines, SAMA (literally meaning to "rise high") and NAS were granted licences in 2006 and 2007 to compete on domestic routes, operating on the global model of budget or low-cost airlines. Once again, the strategic intent for privatization attracted private sector entrants, and Saudi consumers now enjoy alternative choices for domestic flights, especially on the more lucrative Riyadh and Jeddah routes; Saudia is still studying the partial flotation of its core aviation business. In March 2010, the Director General of SAUDIA, Mr. Khaled Al Molhelm, announced that the organization's core aviation unit would be privatized within 2 years and that the privatization of the maintenance service unit would be completed by 2011. Financial observers believe that SAUDIA's financial position has improved, given the taking over of virtually all its debt by the Public Investment Fund, to allow for a successful privatization.

General Railway Organization (GRO): Currently, the GRO operates a railway system connecting the Eastern Province with Riyadh. Saudi Arabia has always sought

to expand this railway network by linking Riyadh to *Makkah, Madina and Jeddah*. Other plans call for establishing a rail network to link the mining regions in the north-west of the Kingdom to Riyadh, and to continue on to the *Jubail* industrial port. The World Bank was asked to make detailed studies, the results of which were submitted to the Supreme Economic Council, and, according to SAMA, "the project of expanding the railway network will be put out for execution by floating a tender to specialized companies on the basis of BOT." Bids were invited in late 2009 on that basis. To date the private sector has executed a number of projects and services for the GRO in engineering, maintaining the rail network and developing the electronic booking system, as well as operating and managing the dry ports of Riyadh and *Al-Dammam*.

Saudi Post Corporation: This sector is one of the most advanced in terms of privatization, with just under 95 private sector operating agencies providing a full range of postal delivery services by the end of 2008. Express mail was separated from mail parcels sector and a general directorate for this sector was formed as a preliminary step for its complete privatization in the future. Work is under way to convert the Saudi Post Corporation into a holding company with a number of subsidiaries operating in the post services sector in the Kingdom.

General Port Authority: The Saudi government started to involve the private sector by granting 10-year lease contracts to operate general port services on an income-sharing basis, through which the port assets are owned by the state but are operated by the private sector. Besides the shorter-term contracts, some 20-year contracts were also awarded. All eight Saudi ports have such private sector involvement ranging from general goods to containers, bulk grain, roll-on cargo, chilled and frozen food.

Grain Silos and Flour Mills Organization (GSFMO): In 2002, the Council of Ministers approved a list of targets for GSFMO to make conversion of the organization into a private enterprise on a commercial basis. External consultants were hired to propose alternative options, and these were finalized in 2009 and included converting the organization into a fully commercial enterprise, or separating all silos from mills while bringing together silos in a company subsidiary to the state. The final decision of the Supreme Economic Council is awaited.

Saline Water Conversion Corporation (SWCC): Demand for water in the Gulf has grown exponentially fuelled by energy revenues and consumer and industrial demand. This increased demand has necessitated countries in arid regions such as Saudi Arabia to embark on ambitious plans to achieve self-sufficiency in water production through desalination projects, often at great cost because of subsidized water distribution. The GCC accounts for around 50% of the world's desalination plants and Saudi Arabia has the largest share at round 41% of the GCC total. Saudi Arabia has 30 desalination plants of varying ages and technologies, operating either on thermal or membrance processes with a daily production of more than 3 million m^3 and generating 5,000 MW of electricity, as some plants are dual use. These provide about 70% of the daily drinking water supplies and 20% of the power generation of Saudi Arabia (SWCC, 2009). It has been forecasted that around $24 billion will be required by 2020 in both capital and operating expenditure for the existing

plants and six new major projects. As such, the Kingdom has decided to privatize SWCC as a central strategy to meet both the funding and efficient supply distribution challenges.

It is estimated by the Water Ministry that Saudi consumers on average use 221–250 L of water a day, compared to between 150 and 200 L a day internationally. Wastage is also significant, with an estimated 20% of water production wasted through spillage in the Kingdom.

The privatization strategy hinges on transforming the SWCC into a state-owned joint stock holding company that has multiple subsidiaries consisting of current and future planned production companies. The aim is to invite private sector investors and developers to tender for the production companies.

The Saudi privatization plans are novel; they consist of separating production from transmission, and maintaining these as well as older operating plants and the Research and Desalination Technology Institute under the holding company. This is different from the "full" water privatization models adopted by other countries.

Under Saudi privatization plans, private sector investors and developers will not bear the burden of transmission, which is exorbitant given the huge landmass of Saudi Arabia that has to be covered to deliver water from coastal desalination plants. The percentage of the private sector's participation in each of the newly proposed production affiliates to the holding company shall be in accordance with the investment attractiveness, provided that the private sector's participation is no less than 60% in each production subsidiary. At the same time, costly research and development will be assumed by the new SWCC holding company. Hopefully, what emerges is a more realistic but "tiered" water tariff level to consumers, compared with current subsidized pricing that induces waste on a massive scale.

SWCC has now completed its strategic privatization studies and submitted its findings based on expert consultant advice, and is awaiting the final implementation decision from the Supreme Economic Council to initiate the SWCC conversion into a joint stock holding company fully owned by the state with an option to float shares at a later stage.

Saudi Arabian Mining Company (Maaden): *Maaden* offered 50% of its shares for an IPO which was oversubscribed 200% and which injected SR 10.956 billion to the company in 2008. This will help to assist *Maaden's* strategic expansion plans to open up the Saudi mining sector to private investments. Encouraged by the public's response to the first IPO, *Maaden* has sought approval from the Council of Ministers to increase its capital to SR 9.25 billion with 50% again being offered for public subscription.

Privatization of education services: During 2008, the Saudi Ministry of Education made several initiatives in privatizing some educational support services such as leasing of its unused land for private developers, signing contracts for recycling of paper waste and unused school books, school transportation, school cafeterias and canteens and allowing the private sector to bid for the building of new schools and maintaining current schools.

Besides the above key privatization initiatives, the Saudi Arabian government has also signalled its willingness to enter into a public and private partnership (PPP) to

encourage the private sector to participate in the development and construction of the "mega cities" being established in the Kingdom. Four such mega cities are being constructed in Saudi Arabia, and Table 11.2 summarizes the major characteristics of these projects with the aim of establishing a reinvigorated regional economic diversification and more equitable wealth creation for Saudi citizens.

By 2020, it is expected that the major phases of the economic cities will have been completed and the forecasted impact on the Saudi economy are far-reaching. According to the Saudi Arabian General Investment Authority (SAGIA), some 1.3 million new jobs will be created, with the economic cities adding $150 billion to the Saudi GDP. They will attract over $100 billion of new investments domestically and from abroad, and their population will be three times that of Dubai, with an area four times that of Hong Kong. The Government of Saudi Arabia is forecasting that

Table 11.2 Saudi economic cities: major characteristics

Characteristic	King Abdullah Economic City	Prince Abdulaziz bin Mousaed Economic City	Knowledge Economic City	Jazan Economic City
Location	Rabigh, Red Sea coast, north of Jeddah	Hail, Northern Saudi Arabia	Madinah	Jazan, Southern Saudi Arabia
Project size ($ billion)	80	23	7	30
Project area (million m^2)	168	156	8	110
Project details	Largest Saudi private sector development	30,000 residential units	Focus on knowledge-based industries	Heavy industries (aluminium, refinery, steel, power)
	260,000 apartments and 56,000 villas	180,000 residents	30,000 housing units	Secondary industries (fisheries, pharmaceuticals, tech parks)
	To generate 1 million new jobs	New airport	20,000 new jobs	500,000 new jobs
	Promoting energy- and transportation-related industries	250,000 new jobs	150,000 residents	
	Seaport of 13.8 million m^2 handling 300,000 pilgrims	Agro-industry and mineral exploitation services	4,000 multipurpose commercial units and hotels	
Expected completion date	2020	2018	2020	2013 Phase 1; 2023 Phase 2; 2037 completion

a staggering $800 billion will be invested in these economic zones and other mega projects, including those by Saudi Aramco and SABIC over the next 20 years.

We can see that progress has taken place and that there is the political will to pursue a meaningful privatization programme. This political will is made doubly urgent by the forecasted estimates of future investment costs and capital needs if privatization is ignored or delayed.

Obstacles to Privatization

Within the Saudi Arabian context, there has been some debate amongst economists on the various problems and impediments that might arise out of the current desire to privatize a large element of government entities, and some of these potential obstacles are highlighted in Table 11.3.

Table 11.3 Saudi privatization: possible obstacles

Obstacles	Rationale
1. Fair book value for public assets	• A wide gap could arise between the fair book value and the market price. There could be limited availability of information concerning government operations and future risk factors, thus affecting the valuation method
2. Rigid pay structure	• Government employee pay scales are higher than in the private sector, and sometimes are not related to productivity. There is the problem of adjusting wages and reducing employment numbers, and of allowing the private sector to strike a balance between wages and productivity expectations
3. Government subsidies	• The removal of government subsidies on basic services such as utilities or health care could cause social problems. At the same time, artificially imposing low price levels will affect the most efficient allocation of private sector resources. Other forms of income support for those who are less well-off will have to be found
4. Lack of regulatory framework	• The government needs to address this major concern to ensure consumer protection and a degree of competition after privatization. Major progress has been made since the privatization process picked pace and experience has been gained
5. Updating public sector accounting standards	• These need to be updated so as to allow prospective investors to evaluate the true worth of these privatized public corporations
6. Financial resources	• There is a lack of depth in the current capital market structure that will make it more difficult to transfer public to private ownership. However, the growth in the numbers of new IPOs as well as their size indicates that this might not be such a critical impediment • Domestic banks have an aversion to long-term risk capital and there is an uncertain commercial/legal framework
7. Employment	• Potential unemployment becomes an issue, as the government faces pressure to reduce current unemployment levels

The list of possible obstacles to privatization in Saudi Arabia highlights one fundamental point that structural reform should precede privatization and that the benefits accruing from privatization are most sustainable when competition is free, the economy stable and the regulatory sector strong. Privatization remains more of a politically driven goal, albeit driven by a fear of the unknowable consequences of selling strategic state companies that have been supported for years by government assistance and protection. For those countries that have embarked on this unknown journey, the results have, in general, been more positive for industries and services after privatization than before. Studies for both industrialized and developing countries (Bourbakri, 1997, D'Souza and Megginson, 1998, Megginson et al., 1994) have indicated that, on average, there are improvements on all counts of productivity and efficiency measures as set out in Table 11.4.

What is interesting to note from the empirical studies carried out and documented above is that employment considerations post-privatization were not as bad as feared by some opponents of privatization. They worried that the policies would contribute to a greater level of unemployment in the long run, as highlighted earlier in Table 11.3.

Table 11.4 Consequences of privatization

Concept	Measure	Countries	Source	Median 3 years before sale	Median 3 years after sale
Profitability	Net income/sales	(IC)	= MNR	5.5%	8.0%
		(DC)	= BC	4.3%	11.0%
		(IC)	= DM	14.0%	17.0%
Efficiency	Sales/number of employees[a]	(IC)	= MNR	0.96[a]	1.06[a]
		(DC)	= BC	0.92[a]	1.17[a]
		(IC)	= DM	1.02[a]	1.23[a]
Investment	Capital expenditure/ Sales	(IC)	= MNR	12.0%	17.0%
		(DC)	= BC	11.0%	24.0%
		(IC)	= DM	18%	17.0%
Output	Sales adjusted by CPI	(IC)	= MNR	0.90[a]	1.14[a]
		(DC)	= BC	0.97[a]	1.22[a]
		(IC)	= DM	0.93[a]	2.70[a]
Employment	Number of employees	(IC)	= MNR	40,850	43,200
		(DC)	= BC	10,672	10,811
		(IC)	= DM	22,941	22,136
Leverage	Debt/assets	(IC)	= MNR	66%	64%
		(DC)	= BC	55%	50%
		(IC)	= DM	29%	23%
Dividends	Dividends/sales	(IC)	= MNR	1.3%	3.0%
		(DC)	= BC	2.8%	5.3%
		(IC)	= DM	1.5%	4.0%

[a]Ratio in year of sale set to 1.00 to avoid large differences among industries
IC = Industrialized countries; DC = Developing countries; MNR – Source: Megginson, Nash and Van Randerborgh (1994); BC – Source: Bourbakri and Cosset (1997); DM – Source: D'Souza and Megginson (1999)

Foreign Direct Investment (FDI): Theoretical Basis

Foreign direct investment (FDI) is an investment of foreign assets into domestic structures, equipment and organizations. It does not include foreign investment into the stock markets. FDI is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially "hot money" which can leave at the first sign of trouble, while FDI is durable and generally useful whether the economy is doing well or badly (Aitken et al., 1997, Liu et al., 2000). An example of this is the 1988/1989 Asian financial crisis that resulted in a deficiency of short-term debt finance, but did not have a significant impact on the level of foreign direct investment in the Asian region. Also, the return to direct investment is dependent on profitability, unlike debt finance where the capital and interest must generally be repaid, regardless of performance (Helpman et al., 2004).

When analysing FDI, it is important to know what the strategic drivers are for organizations to invest in other markets. According to some analysts, there are two main patterns of internationalization, the first being firms who want to move production to foreign countries in order to reduce their overall production costs. This type of FDI is referred to as vertical FDI and is generally influenced by differences in labour costs (Buch et al., 2005). Vertical FDI is beneficial to the organization investing by achieving a reduction in costs but also beneficial to the country receiving the investment. Not only is there infrastructure and capital being invested into the economy of the developing country, but more importantly there are specialist skills and knowledge that the organization must transfer to their local workforce that will spill over to be shared within and between industries in the local market (Kugler, 2006).

The second type of FDI identified by Buch, Kleinert, Lippioner and Toubal is horizontal FDI, and this is where organizations invest in other countries as a means to gain better access to foreign markets, get closer customers and avoid trade costs. The majority of FDI between developed nations is predominantly some form of horizontal FDI in order for multinational organizations to operate efficiently in a global context (Buch et al., 2005).

There are also political factors that can influence a firm's decision to invest as FDI, including the avoidance of trade barriers as well as economic development incentives that may be available from governments wishing to build up infrastructure in their country (Fisher et al., 2006).

Foreign direct investment is a major component of today's global business environment and a clear way for large multinational companies to achieve strategic advantages. This can occur through vertical FDI, where the benefits are mainly reduced costs, or horizontal FDI, where the benefits are mainly access to new markets. There is evidence to show that FDI into a nation has a wide array of benefits for both the organization and the country being invested in, which also equates to knowledge and productivity spillovers (Aitken et al., 1997, Harrison, 1997).

The global financial crisis of 2008/2009 has affected net private capital flows, but with different aspects as illustrated in Table 11.5 for the period 2006–2009.

Table 11.5 Net capital flows to emerging and developing markets 2006–2009 ($ billions)

Region	2006	2007	2008	2009
Africa: Total	35.2	33.4	24.2	30.2
Net direct investment	23.4	32.1	32.4	27.6
Net portfolio investment	17.6	9.9	–15.8	0.9
Other net investments (outflows)	–5.7	8.3	7.9	1.8
Middle East: Total	–50.0	11.0	–120.9	–29.5
Net direct investment	14.9	4.0	11.4	17.6
Net portfolio investment	–25.7	–31.0	–12.3	–14.4
Other net investments	–39.2	38.0	–120.1	–32.7
Emerging Asia: Total	31.8	164.8	127.9	–46.9
Net direct investment	94.3	138.5	222.6	161.6
Net portfolio investment	–107.2	11.2	–65.9	–192.1
Other net investments	44.6	15.2	–28.7	–16.3
Commonwealth of Independent States	55.1	127.2	–127.4	–119.0
Net direct investment	20.7	26.6	44.4	17.3
Net portfolio investment	12.9	14.5	–36.8	1.6
Other net investments	21.5	86.1	–135.1	–137.9

Source: SAMA, IMF, World Economic Outlook

An analysis of Table 11.5 seems to confirm the volatility of portfolio capital flows discussed earlier, compared with the relative stability of net direct foreign investment. “Other net investment” flows in the above table relate to residents’ investment outflows to other markets and their inflows to their home markets. Given the significance of such global investment flows, what measures has the Kingdom adopted to attract FDI and what have been the results to date?

Saudi FDI: Establishing the Operational Framework

Saudi Arabia’s WTO accession in 2005 helped to bring changes to the Kingdom’s investment environment under the Agreement on Trade Related Investment Measures (TRIMs). However, prior to WTO accession, the Kingdom had been taking some measures to attract FDI and a new Foreign Investment Law was enacted in 2000 to replace and liberalize the 1979 Foreign Investment Law. The 2000 law established the Saudi Arabian General Investment Authority (SAGIA) as responsible for approving foreign investment projects; SAGIA also serves as the enquiry point on laws, regulations and procedures relating to foreign investment, and the Governor of SAGIA, currently Dr. Amr Al Dabbagh, holds the status of a cabinet minister.

Reflecting the impact of WTO negotiations on Saudi legislation over the past several years, Saudi Arabia confirmed to the WTO that the 2000 Foreign Investment Law is fully consistent with the WTO Agreement on TRIMs and that Saudi Arabia would not apply any measures prohibited by that agreement.

This agreement recognizes that certain investment measures can have trade-restrictive and distorting effects. TRIMs state that no WTO member shall apply a measure that is prohibited by the provisions of GATT Article III (regarding national treatment) or Article XI (regarding quantitative restrictions). An example of inconsistent measures includes local content requirements. The agreement contains transitional arrangements allowing members to maintain TRIMs for a limited time following the entry into force of the WTO (2 years in the case of developed country members, 5 years for developing country members and 7 years for least-developed country members). The agreement also establishes a committee on TRIMs to monitor the operation and implementation of these commitments (SAMBA, 2006). Table 11.6 summarizes the main features of the new law and the old law it replaced.

As can be noted from Table 11.6, the 2000 law and other subsequent actions made considerable changes to the Kingdom's foreign investment regime in order to make the country more business-friendly and open to FD1. The old law favoured joint ventures over 100% foreign-owned projects. Under the new law, foreign investors are no longer required to take local partners. The new law provides equal treatment for non-Saudi firms. The repatriation of profits and capital are guaranteed. It offers foreign licensed companies the right to buy property for the purposes of the company and allows them to sponsor their own non-Saudi employees, previously denied. The new law streamlined the investment process by committing to respond within a specified amount of time to an investment application from the date of receipt.

Other related laws and regulations in the past have added to the more liberal environment. Saudi Arabia also reduced the maximum income tax rate for foreign firms to 30% (from 45%) in April 2000, and in January 2004 a new tax law reduced the rate to 20%. Business travel into the Kingdom has become more relaxed with less onerous requirements for business visas.

Table 11.6 Comparisons of main features of the new and old Saudi foreign investment laws

Feature	New law	Previous law
Tax holiday	• No reference is made to tax holidays and dividend taxes	• If the Saudi share in the company is greater or equal to 25%, foreign investors will not pay taxes during the first 10 years for industrial projects, or 5 years for services and agricultural projects
Taxing scheme	• If the corporate profits of a company are: • less than SR 10,000; they are taxed at the rate of 20%; the rate rises to 30% if corporate profits are more than SR 100,000. The new law reduced the tax brackets from four to just two	• If the corporate profits of a joint venture company are: – less than SR 100,000, the tax rate is 25% – more that SR 100,000, but less than SR 500,000, the tax rate is 35% – more than SR 500,000, but less than SR 1,000,000, the tax rate is 40% – more than SR 1,000,000, the tax rate is 45%

Table 11.6 (continued)

Feature	New law	Previous law
Financial losses	• There is no limitation on the number of future years that financial losses can be allocated to	• Financial losses can only be allocated to next year's operations
Loans from the Saudi Industrial Development Funds (SIDF)	• Companies fully or partially owned by foreigners can apply for subsidized loans from SIDF and can now enjoy all of the incentives and privileges offered to local projects	• For company to apply for SIDF loans, the Saudi share in equity has to be at least 25%
Real estate ownership	• Full ownership of the project is granted to the licensed firm (including land, buildings and housing for employees)	• There must be a Saudi partner/sponsor who would own the land • Foreign ownership prohibited
Sponsorship	• No Saudi sponsor is needed for the foreign investor. The licensed company will be the sponsor for the expatriate workers	• The Saudi partner will be the sponsor for the foreign investor and for expatriates working in the joint venture company
Investment guarantees	• Foreign investor has the right to transfer his share derived from selling his equity or profits out of Saudi Arabia. Not subject to expropriation (nationalization) except in public interest and in exchange for equitable compensation	• None were specified
Penalties for violation	• A petition against any penalty may be brought by foreign investor before Board of Grievance. Possible penalties include: withholding incentives, imposing fines not exceeding SR 500,000 and cancelling a licence	• Kingdom could cancel licence or deny incentive after investor received warning from Ministry of Industry and Electricity to correct violation within a certain period. Investors could appeal to Board of Grievances within 30 days
Administration	• SAGIA Investor Services (one-stop shop) was focal point for investors and comprises representatives of nine investment-related ministries	• Several ministries and government agencies
Type of investments	• 100% foreign-owned project in addition to joint ventures	• Favoured joint ventures over 100% foreign
Period of approval of licences	• Maximum 30 days	• Not specified
Investment fields open to investors	• All fields open for investments except those on "negative list"	• To be approved under national development plan
Possibility of more than one licence	• More than one licence allowed in different fields	• Restricted and had to be in the same field

Source: SAGIA

To ensure compatibility with WTO rules, in April 2005 Saudi Arabia removed the minimum foreign requirements for foreign investors, which had been SR 25 million for agricultural projects, SR 5 million for industrial projects and SR 2 million for services businesses. Technology transfer was not a condition for investment under the new law.

However, as Table 11.6 also indicates, there are still some restrictions placed by the new FDI law on certain investment fields that foreigners can enter, the so-called "negative list."

Since 2000, the number of activities prohibited to foreign investors has been reduced to exploration, drilling and production of petroleum, manufacturing of military equipment and uniforms and civilian explosives. In the service sector, foreigners are not allowed to invest in military catering, security or real estate in *Makkah* and *Madina* nor can they invest in real estate brokerage television and radio stations, advertising and public relations, recruitment and employment services and transport.

Excluding the negative list, all sectors are now open to foreign investment in Saudi Arabia, including the lucrative insurance services, wholesale and retail trade, air and train transport and communication services, including satellite transmission services.

Saudi FDI: A Score Sheet

By all accounts, FDI can be a critically important ingredient to *long-term* sustainable growth for developing countries, especially if the FDI is channelled into neglected productive sectors, or internationally underperforming, but potentially profitable sectors. FDI can play an important "spillover" effect as demonstrated by other countries' experiences (Aitken et al., 1997). Table 11.7 examines an FDI "score sheet" of positive and potential negative factors and their Saudi Arabian applicability in light of the new FDI law and the recent structural and economic changes that have taken place in the Kingdom.

As Table 11.7 illustrates, there seems to be little reason for concern as far as potential large-scale negative factors affecting Saudi Arabia from encouraging more FDI are concerned. This is due to the large and varied industrial and manufacturing base that has been recently built up, most of which is of a new technology and on par with international standards, unlike other developing countries which often see foreign "enclave economies" arise through FDI investments.

Saudi FDI Flows: On the Rise

After many years of languishing at the lower end of Middle East FDI league tables, Saudi Arabia is fast becoming the attraction of both Arab and non-Arab FDI destination. For example, FDI by the UAE in the Kingdom stood at nearly $5.8 billion in

Table 11.7 Foreign direct investment: Saudi Arabia score sheet

FDI factors	Analysis	Saudi Arabia applicability
Positive factors		
1. Capital formation	• This is more stable than other forms of investments. Essentially it is an equity investment – profits are repatriated when projects yield returns and part of the profits is reinvested in the host country • Risks are borne by foreign shareholders • FDI will not lead to debt crises (like bank lending) that require bailouts	• Applicable: In Saudi Arabia investments are in either Saudi majority-owned companies, or, now, 100% foreign-owned companies
2. Productivity growth	• A new understanding of the growth process treats technological changes as endogenous growth. This also involves the "soft" side of technological advances (organizational structure, managerial practices, etc.) that contribute to productivity growth • Rather than reinvent technological advances, developing countries can benefit from best practices in standards, embodied technology and markets of parent company	• Applicable: This is the main reason why SABIC established international joint venture affiliates as examples as well as entry of new telecom companies such as Mobily and Zain
3. Economic linkages	• The impact of FDI on domestic economic growth depends on spreading out best practices through backward linkages with local producers and distributors, horizontal linkages with local competitors and linkages with local institutions such as universities and research institutes	• Applicable: Local sourcing is an important stimulant to domestic companies. Linkages to universities are also important (e.g. science parks) • More is needed on backward linkages with local suppliers, but this varies with the industry
4. Employment and labour standards	• Employment can be created via three areas: (a) direct employment in operations, (b) backward and forward linkages in enterprises that are suppliers, subcontractors and service providers and (c) employment in sectors not directly related to FDI projects • Quality of labour standards is improved in the domestic economy, through good labour practices, superior working conditions and positive career prospects • Adopting international global labour management practices that are different from host country and ensuring that practices are of international standards	• Applicable: The quality of labour employment and the creation of best employment practices have been more important to date than the quantitative aspect of employment and Saudi companies are adapting best HR practices from leading international companies now operating in Saudi Arabia
5. Environmental standards	• FDI can lead to higher environmental controls and procedures	• Applicable: Saudi Arabia insists on the latest environmental-friendly technology

Table 11.7 (continued)

FDI factor	Analysis	Saudi Arabia applicability
Negative factors		
1. "Crowding-out" effect	• FDI may remove investment opportunities of the domestic firms and drive them out of business (e.g. in financial markets) • If FDI borrows locally, interest rates could rise if there are scarce resources, making borrowing for local firms uncompetitive • FDI could pre-empt entry into the market of some types of production, especially if the foreign company employs aggressive marketing practices	• There is not yet any evidence of this in Saudi Arabia, as most FDI has been capital-intensive and the joint venture majority is Saudi-owned
2. Balance of payments problem	• FDI profits could be repatriated, constituting financial outflows to be set against net annual FDI inflow. This is important for countries with exchange controls	• This is not an issue for Saudi Arabia as no exchange control regime exists
3. "Enclave economies"	• FDI investments could be narrowly based with a limited overall impact on domestic economy and benefiting only a small group of population. Examples are in mining natural resource extraction or "export processing zones," whereas if mining is only for exports, then it will not generate secondary industry employment. Neither would repackaging of goods in a duty-free "export processing zone"	• Not applicable as oil sector is in state hands and no foreign-owned exclusive zones exist

2008, the largest FDI flow by an Arab country, as per figures released by the Inter-Arab Guarantee Corporation (IAIGC). The UAE investment in Saudi Arabia was more than double the total FDI channelled by the UAE into other Arab countries in 2008, and nearly 45% of the total investments received by Saudi Arabia from other Arab League nations.

Until 2005, the Kingdom had not seemed to match inward investments with its undoubted economic size and potential compared to other Arab and Islamic countries. The reasons were obvious – sluggish bureaucracy, uncompetitive incentives and taxation regime, multiple layers of governmental approvals and seeming inflexible labour and sponsorship laws. The general feeling in Saudi Arabia was that the domestic market had ample surplus liquidity, unlike other "capital-poor" Arab countries. Continued government spending on mega projects would make up for any capital shortfall. This rosy picture could not last forever in the face of persistent budget deficits during the period 1983–2001, the advent of privatization as a strategic tool for private sector participation and the Kingdom's accession to the World Trade Organization (WTO) in 2005. The time for change had arrived and a fresh perspective had to be found to attract foreign investors.

From 2005, the Kingdom's FDI took off as illustrated in Fig. 11.3, with inflows of $12.1 billion recorded in that year, compared with a meagre $245 million on

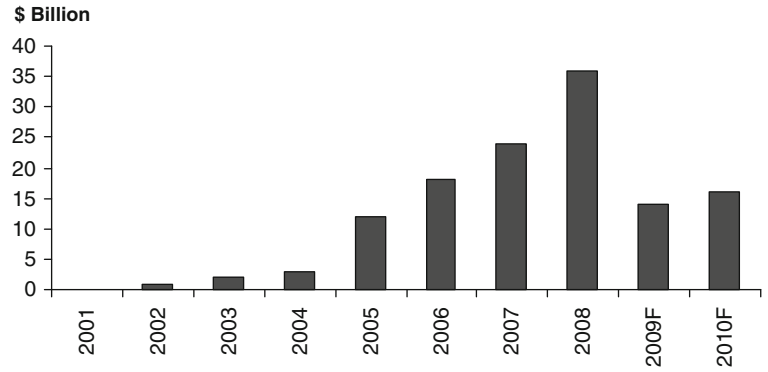

Fig. 11.3 Saudi FDI inflows (2001–2010) (Source: UNCTAD) ("F" stands for "forecast")

average per year for the period 1990–2000. By 2008, the net inflow had reached $38.2 billion as illustrated in Fig. 11.3.

In line with global trends seen earlier in Table 11.5 the net FDI inflow to Saudi Arabia was forecasted to fall to around $15 billion in 2009, but is forecasted to rise in 2010 on the basis of higher oil prices for the region (averaging at more than $70 p.b.). According to UNCTAD however, Saudi Arabia came eighth among the top 10 recipients of FDI in 2009 with inflow of $36 billion, making Saudi Arabia the tob Middle East FDI destination. What is also significant is that FDI is now making a larger impact on the national economy and the relative size of FDI to GDP has been rising as illustrated in Fig. 11.4.

In 2007, Saudi Arabia's inward FDI flow as a ratio to GDP was 6.4%, but this had risen to 8.1% in 2008, despite the record oil revenues of that year which saw GDP rise to $465 billion levels. An analysis of FDI flows into the Kingdom by country of origin reveals that the top-ranked investing countries are primarily non-Arab,

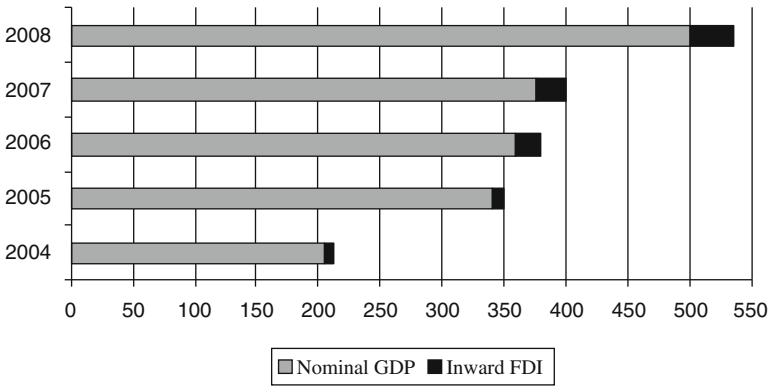

Fig. 11.4 Saudi Arabia's FDI vs. GDP (US$ bn) (Source: SAMBA, UNCTAD, World Investment Report, 2008)

Table 11.8 Net cumulative FDI flows into Saudi Arabia – top 10 countries 1999–2005

Country	1999 ($Million)	Country	2005 ($Million)
1. USA	2,252.5	1. Japan	12,906
2. Japan	576.8	2. USA	4,979
3. Bermuda	312.3	3. France	4,035
4. Netherlands Antilles	219.9	4. UAE	3,930
5. Jordan	214.7	5. Germany	3,351
6. France	198.3	6. Lebanon	1,292
7. UK	147.1	7. Canada	1,069
8. Panama	107.6	8. Bermuda	1,043
9. Italy	100.7	9. Cayman Islands	981
10. Switzerland	97.1	10. UK	780

Source: National Centre for Economic and Financial Information, 1999, SAGIA, 2006

with the recent exception of the UAE's investment into Saudi Arabia, especially in the mega economic city projects. Table 11.8 illustrates this by analysing the top 10 cumulative FDI contributors by country of origin for 1999 and 2005.

From Table 11.8, we note that while the USA was the largest equity investment partner in 1999, it had been overtaken by Japan in 2005 in a significant way, with the large petrochemical joint projects at *Petro Rabigh* on the Red Sea Coast of the Kingdom accounting for a large portion of the investment by the Japanese Sumitomo Corporation. In both 1999 and 2005, countries such as Bermuda, Netherlands Antilles, Panama and Cayman Islands appear on the FDI list, but the countries of origins of those registering in these offshore tax havens are not known. They represented a significant portion of investment source in 1999 but less so by 2005, probably due to stricter "know-your client" rules by the Kingdom, especially following the September 11, 2001 events and tighter international control over finance movements.

Analysis of FDI by sector of investment reveals that the industrial and service sectors take the overwhelming bulk of investments, with agriculture being the least attractive either for fully foreign-owned licensed projects or for joint venture licensed projects. This is illustrated in Table 11.9, which sets out the cumulative FDI stock in Saudi Arabia by 2005.

Table 11.9 Total cumulative FDI finance by ownership and project sector 2005

	Fully foreign licensed		Joint venture licensed	2005 ($million)
Investment sector	Number	Value (SR billion)	Number	Value (SR billion)
• Industrial	782	21.392	464	100.057
• Services	1,271	22.19	586	7.898
• Agriculture	5	0.125	4	0.366
Total	2,058	43.707	1,054	108.321

Source: SAGIA

By 2005, the cumulative FDI stock was around $40 billion, but this had risen to $115 billion by 2008 for both fully foreign licensed and joint venture projects. To put the 2008 data in perspective, the total world FDI stock in 2008 was $14,909 billion and Saudi's share represented less than 1%. Similarly, Saudi Arabia's record inflow of $38.2 billion FDI inflow in 2008 represented around 2.2% of the world's total of $1,697 billion, according to the United Nations Conference on Trade and Development (UNCTAD).

Sometimes the driving force behind FDI is not new projects or joint venture projects but rather cross-border mergers and acquisitions of existing companies. In the developed world, mergers and acquisitions (M&As) have become the primary mode of entry of FDI, while in the developing world their importance is small but growing. In the developed countries, one regularly hears of mega deals such as the acquisition of Mannesmann of Germany by Vodafone (UK) for $200 billion in 2000 and of Voice Stream (USA) by Deutsche Telecom (Germany) for $24.6 billion in 2001 or the 2010 acquisition of the Asian subsidiary of AIG by the UK's Prudential for $35.5 billion in 2010.

Cross-border M&As in the Arab countries are very small in comparison. Table 11.10 sets out the ten largest deals during the period 1997–2010.

Table 11.10 The ten largest cross-border M&A deals in the League of Arab States, 1987–2010

Acquired company	Target country	Acquiring company	Acquiring country	Year	Value in million dollars
Zain	Kuwait	Bharti	India	2010	10,700.0
Telecommunication Corporation of Jordan	Jordan	Investor Group	France	2000	508.0
Assiut Cement	Egypt	Cemex	Mexico	1999	373.0
Societe Marocaine de L'Industrie	Morocco	Corral Petroleum Holding AB	Sweden	1997	372.5
Societe des Cimens de Gabes	Tunisia	Secil (Semapa – Sociedade)	Portugal	2000	251.0
Al Ameriya Cement Corporation	Egypt	Lafrage Titan	France	2000	249.0
Societes des Ciments de Jbel	Tunisia	Cimpor – Cimentos de Portugal EP	Portugal	1998	229.9
Alexandria Portland Cement (EG)	Egypt	Blue Circle Industries PLC	United Kingdom	2000	196.0
Al-Sharif Group	Egypt	Investor Group	Saudi Arabia	1993	177.3
Societes des Ciments d'Enfidha	Tunisia	Uniland Cementera SA	Spain	1998	169.1
Credit Libanais (Lebanon)	Lebanon	Investor	Saudi Arabia	1997	163.0

Source: UNCTAD, Cross-Border M&A Database, 2002

The low level of M&A activity could be due to several factors. One factor is the type of company structures in the Arab world, which often tend to be closed, family groupings with no intention of selling to outsiders. Another factor is the lack of suitable publicly listed corporations that meet foreign investors' criteria in terms of market share, profitability and management structure (Field, 1985, Fahim, 1995, Wright, 1996).

The ten largest M&A Arab deals highlight the fact that the majority of such large deals are carried out by *non-Arab investors*. Unspecified Saudi investors participated in two deals in Lebanon and Egypt. The largest deal was $10,700 million, with Indian investor interests acquiring Zain telecom of Kuwait in 2010. The table also illustrates that those Arab countries with the longest experience of privatization, such as Egypt, Tunisia and Morocco, have led the way in cross-border M&A deals. However, the key implication of this table is that Arab capital, by and large*, prefers to migrate to non-Arab opportunities*. The exception to this is the international Saudi investor Prince Al Waleed Bin Tallal Bin Abdulaziz, who has diversified his holdings in both Western and Arab countries, particularly in Egypt, Jordan, Lebanon and Syria (Abdulaziz, Al Waleed Bin Tallal, 2003).

Continuing investor perception of a lack of development in the Arab world's general legal framework governing foreign investment, such as labour laws, company laws, bankruptcy laws and intellectual property laws, is a contributory factor to this negligible Arab cross-border activity. Knowing that they are being left behind in the FDI race, most Arab countries are taking steps to amend existing legislation and laws and to introduce new ones that are more foreign investor-friendly.

The high oil prices and larger revenue flows to several Gulf Arab countries such as Saudi Arabia and the UAE during the periods 2006 and 2007 have led to some significant cross-border acquisitions for these countries, as illustrated in Table 11.11.

While other regions such as Asia were active in both cross-border sales and purchases/acquisitions, other countries such as Turkey were more active in sales but not in acquisitions, unlike the Arab Gulf countries such as Saudi Arabia and the

Table 11.11 Cross-border merger and acquisition overview, 1990–2008 (millions of dollars)

Region/ economy	Sales (net)				Purchases (net)			
	1990–2000 (Annual average)	2006	2007	2008	1990–2000 (Annual average)	2006	2007	2008
Saudi Arabia	15	21	125	102	536	5,398	12,730	1,450
Turkey	78	15,340	16,415	11,628	42	356	767	1,313
United Arab Emirates	12	53	1,230	1,225	111	23,117	15,611	4,384
Asia and Oceania	8,970	65,130	68,538	64,730	10,488	70,714	91,250	89,006
Developing economies	25,860	89,028	96,998	100,862	13,900	114,119	139,677	99,805
World	257,070	635,940	1,031,100	873,214	257,070	635,940	1,031,100	673,214

Source: UNCTAD, World Investment Report, 2009

UAE who were more active in purchases and acquisitions than in sales. During 2006 and 2007, the UAE's purchases amounted to around $40 billion as compared to Saudi Arabia's $18.2 billion for the same period. However, while the majority of Saudi acquisitions were carried out by the private sector, the UAE's acquisitions were mostly the result of the country's Sovereign Wealth Funds such as Abu Dhabi Investment Authority (ADIA).

Conclusion

Most neutral observers commend the Kingdom's recent economic reforms, including the adoption of the new Foreign Investment Law allowing foreigners to own land, and the introduction of a comprehensive and inspiring privatization strategy. Most observers also agree that the pace of reform in the privatization and the FDI areas has been impressive, leading to tangible movement on both fronts, more so on the FDI sector where Saudi Arabia is now an attractive FDI destination. The Saudi WTO accession in 2005 has spurred this reform, but Saudi Arabia is also an attractive target for international investors which felt that the Kingdom had not been widely affected by the 2008/2009 international financial crisis and that the Arab world's largest economy and its ongoing mega projects were an attractive investment proposition.

Summary of Key Points

- *Privatization was officially launched in 2002, and planned to encompass all spheres of economic activities in the Kingdom. First steps have already been taken through the establishment of various regulatory agencies under which the privatized entities would operate.*
- *Privatization is an instrument of economic policy whereby there is a transfer of property or control of assets owned by the state to the private sector – both management and ownership. To date, Saudi Arabia has carried out "partial privatization" through the sale of shares of government-held corporations, such as SABIC, SCECO and SEC. More are being planned.*
- *Certain obstacles need to be overcome before privatization could become effective. These relate to assessing the fair book value of public assets, overcoming rigid pay structures of the privatized labour force, reduction of government subsidies and updating public sector accounting standards.*
- *Saudi Arabia has now been successful in attracting sizeable FDI to the Kingdom due to the size of its economy, market depth and more recent enhancements to the Foreign Investment Law, such as a reduction to 20% in foreign corporate profit tax. Cross-border mergers and acquisitions are still not common in the Middle East. Investor perception is that more is needed to enhance the legal and operating frameworks such as labour, company and bankruptcy laws.*