

Factors Affecting Foreign Direct Investment Location in the Petrochemicals Industry: The case of Saudi Arabia

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Foreign Direct Investment (FDI) is an important source of capital and economic growth in developing countries. It provides a package of new technologies, management techniques, finance and market access for the production of goods and services. However, attracting FDI is a major challenge for most host countries as they face the challenge of identifying the major factors that motivate and affect the FDI location decision. This study fills the research gap by examining the relative importance of major FDI location factors in Saudi Arabia's Petrochemicals industry. The paper concludes that the most important major location factors for FDI inflows into the Petrochemicals industry are cost factors followed by infrastructural and technological factors, political and legal factors, market factors and social and cultural factors.

INTRODUCTION

With the world's largest proven oil reserves and a strategic location at the centre of east-west trade, Saudi Arabia is set to become a strategic hub for the expanding petrochemical industry. Newer, large-scale facilities, particularly the ones with competitive feedstock supplies are expected to gain a competitive edge over their rivals. A number of highly integrated refining and petrochemical investments are also expected to leverage Saudi Arabia's national competitive advantages in the coming years. As result of the ready availability of natural gas associated with the production of crude oil, and the Government's desire to encourage the industrialization drive, Saudi Arabia has the lowest natural gas prices in the world. This favourable differential has clear benefits for in- Kingdom consumers of natural gas feedstock such as the petrochemicals industry, where about 60% of the integrated cash costs are hydrocarbon based. The petrochemicals sector is the largest and most important non-oil industrial sector in the Kingdom. Overall, Saudi Arabia is the 11th largest supplier of petrochemicals globally producing 7-8% of world supply, and the Kingdom has ambitious plans to increase this to 13-14% of world supply by 2010. The Saudi Arabia's petrochemicals sector has successfully developed a robust industry in the past 25 years that has been underpinned by two critical success factors. The first is the feedstock advantage and the second non-feedstock operational excellence.

Saudi Arabia attracted FDI in the petrochemicals industry for a variety of reasons. Attractively priced gas and liquid feedstock in a highly competitive petrochemical infrastructure offers attractive project economics; long-term feedstock supply security is unparalleled. Strategically located to serve vast markets in both Europe and Asia; World Trade Organisation (WTO) membership allows free access to new export markets for Saudi's petrochemicals producers. Developing rapidly petrochemicals cluster creates significant business opportunities for support services' providers. The country does not only enjoy a world-class infrastructure but it also undergoes continuous upgrade. Additional supply and diversification of petrochemicals derivatives create new value chains and attractive opportunities for value-added industries downstream (Saudi Arabia Investment Authority (SAGIA) 2008). The main purpose of this research is to examine the relative importance of major FDI location factors in the Saudi Arabia's Petrochemicals industry. In order to satisfy the research aim the following hypotheses were tested:

*H0: The relative importance of location factors vary significantly in Saudi's Petrochemicals industry.
Alternatively H0 is not true.*

*H1: The relative importance of cost factors vary significantly in Saudi's Petrochemicals industry.
Alternatively H1 is not true.*

*H2: The relative importance of market factors vary significantly in Saudi's Petrochemicals industry.
Alternatively H2 is not true.*

H3: The relative importance of infrastructure and technological factors vary significantly in Saudi's Petrochemicals industry.

Alternatively H3 is not true.

H4: The relative importance of political and legal factors vary significantly in Saudi's Petrochemicals industry.

Alternatively H4 is not true.

H5: The relative importance of social and cultural factors vary significantly in Saudi's Petrochemicals industry.

Alternatively H5 is not true.

There is a startling gap between current studies on the relative importance of location factors between countries and industries. This study narrows this gap by making use of comprehensive survey data to identify the relative importance of FDI location factors in the Petrochemicals industry in Saudi Arabia. As far as, the authors are aware, this study is the first of its kind in Saudi Arabia and therefore it is hoped that this study would provide some useful insights, policy implications and recommendations for the country and the international business community.

REVIEW OF THE RELEVANT LITERATURE

There has been a considerable literature on the determinants of location factors for multinational Corporations (MNCs) when they choose their foreign market location, but very little on the relative importance of the location factors for FDI in a specific country and industry.

It is widely believed that the trend towards globalized production and marketing has major implications for developing countries' attractiveness to FDI inflows. The boom of FDI flows to developing countries since the early 1990s indicates that multinational enterprises have increasingly considered these host countries to be profitable investment locations. At the same time, various experts argue that the determinants of and motivations for FDI in developing countries have changed in the process of globalization. As a consequence, it would no longer be sufficient to offer promising markets in order to induce FDI inflows. Policymakers would face rather complex challenges in striving for location attractiveness to FDI (Kokko, 2002).

The relative importance of FDI location determinants have changed. Even though, traditional determinants and the types of FDI associated with them have not disappeared with globalization, however, their importance are said to be on the decline. More specifically, "one of the most important traditional FDI determinants, the size of national markets, has decreased in importance. At the same time, cost differences between locations, the quality of infrastructure, the ease of doing business and the availability of skills have become more important" (UNCTAD 1996). Likewise, Dunning (1999) argues that the motives for, and the determinants of FDI have changed. According to Dunning, FDI in developing countries has shifted from market-seeking and resource-seeking FDI to more (vertical) efficiency-seeking FDI. It would have important policy implications if globalization had changed the rules of the game in competing for FDI. The policy challenge may become fairly complex; host country governments would have "to provide and publicize a unique set of immobile assets, pertinent to the types of economic activity they wish to attract and retain, vis-à-vis those offered by other countries" Dunning (1999). Arguably, policymakers can no longer rely on the previous empirical literature stressing the overriding role of some clearly defined factors shaping the distribution of FDI.

Location specific factors are key components of the overall competitiveness of an economy. Yet Location specific factors, despite being key components of Dunning's eclectic paradigm, would appear to have been neglected factors in international business (IB) research, particularly as far as the impact on foreign direct investment (FDI) and multinational enterprise (MNE) activity is concerned (Dunning, 1998). Ricart, Enright, Ghemawat, Hart, and Khanna (2004,) suggest that understanding locations, or in their term 'places', is very complex and that 'distinctions among nations remain peripheral to much of the strategy literature and strategy practice, which is perhaps one reason why firms seem to be blindsided by differences in markets and business practices, public policies, macroeconomics, and institutional frameworks'.

Buckley and Ghauri (2004) point to the limited attention researchers have given to the FDI location factors in the literature. They suggest that international business strategy is distinct from mainstream, or single country, business strategy only because of differences between locations. Hence, location specificity is essential to the possibility of international strategy having a distinctive content. They too suggest that a focus on locations, and possibly the question of why locations differ, could be a response to the issue of what forms the next 'big question' in international business research. Dunning (2008) suggests that the more recent lack of attention to location by IB scholars could have arisen from an assumption that the location decision principles are the same for both international as well as domestic locations. Thus, scholars were either satisfied with existing explanations or as Dunning (1998) points out '*maybe they were just not interested*'.

In attempting to determine the relevant set of location factors, Michael Porter's (1990) work cited in Hodgetts (1993) offers a valuable starting point. Porter postulates that success for a given industry in international competition depends on the relative strength of that industry with regards to a set of business-related features or 'drivers' of competitiveness, namely 'factor conditions'; 'demand conditions'; 'related and supporting industries'; and 'firm strategy, structure, and rivalry'. 'Government' and 'chance' are viewed as influencing competitiveness through their impact on the above four basic drivers. This framework, or drivers of competitiveness have been used in a number of studies of industries and of individual economies. Porter's competitiveness framework has been the subject of major criticisms. First, Paul Krugman (1994) specifically criticized the idea that nations, or locations, compete in the same way as firms do, and his wide-ranging critique attacks this concept. Also, the empirical evidence for national competitiveness and the policies that follow are what Krugman (1994) describes as 'a dangerous obsession'. A second criticism is that Porter places government involvement in international business outside of the core determinants. Third, many authors have claimed that Porter's framework pays insufficient attention to relevant specific location factors such as globalization (Dunning, 1993), multinational companies (Dunning, 1993; Rugman & Verbeke, 1993), technology (Narula, 1993). Several authors have questioned the validity of the model, and the conclusions drawn from the model, for countries such as Austria (Bellak & Weiss, 1993), Canada (Rugman & d'Cruz, 1993), Hong Kong (Redding, 1994) and Mexico (Hodgetts, 1993).

A large body of research interested in providing the determining factors for FDI location decisions are seen to be made by managers. Some of the major studies are the following (Dunning, 2000): theories of risk diversification (Rugman, 1979); agglomeration theories (Krugman, 1993; Porter, 1994, 1996); theories related to government-induced incentives (Loree and Guisinger, 1995); and theories of location (Dunning, 1997). All these new theories are certainly insightful, but they are all context specific, and interested solely in stressing the relevance of certain factors to the detriment of others that may be equally significant. None of them yet provides a satisfactory explanation of the relative importance of specific factors that lead managers to locate their investments via FDI in a specific country and industry (Dunning, 2008).

Dunning (2008), believes that “it is not possible to formulate a single operationally testable theory that can explain all forms of foreign-owned production any more than it is possible to construct a generalized theory to explain all forms of trade or the behaviour of all kinds of firms.” Cohen (2007) believes that location factors for a specific location and industry that affect the location decision are based on the perceptions of a small group of senior managers, not a scientific formula. Furthermore, Buckley *et al* (2007) argue that studying a single firm or group of firms in the same industry is the best way to identify the most important factors because firms in the same industry usually follow a systematic process for location choices, therefore, they look for certain location factors priority as they become more internationally matured.

Cohen (2007) argues, “No standard set of attributes, each with an assigned relative weight of importance, exists in the many lists of what matters in location published by business groups, international organizations, and scholars. Determining where to invest is a case-by-case decision”. Cohen (2007) also suggests that no single formula exists because specific strengths and weaknesses of a country or region might receive high priority by one team of corporate evaluators and can be ignored by another, depending on what kind of investment is contemplated, which in turn will determine a subsidiary's objectives and operational needs. Furthermore, individual corporate cultures will assign different relative importance to what attributes they require in a country, what they would like to see, what negatives they can work around, and what is unequivocally unacceptable. Calculating trade-offs between positive and negative country characteristics is an art, not a science.

RESEARCH METHODOLOGY

In the planning and design of the research methodology for this study, an empirical survey was constructed based on the previous location factors, and distributed to senior managers working in petrochemicals FDI in Saudi Arabia. The manager must be in high managerial level in the firm such as the President, the Chief Executive Officer (CEO), the Vice-President or other managers who are engaged directly on the location decision for the firm when they choose Saudi Arabia as their investment location. The respondents were first asked to rate the importance of each of the location factors for the location decision on a five-point Likert scale (with 1 = very unimportant, 2 = unimportant, 3= neutral, 4 = important, 5= very important). Then, the respondents were asked to rate the attractiveness of Saudi Arabia, relative to its main competitors in the region, on each of the factors, again on a five point Likert scale (with 1= much worse, 2= worse, 3 = same, 4 = better, 5= much better). The survey instrument which was handed over to senior managers of the petrochemicals industry in Saudi Arabia was organised by the Saudi General Investment Authority (SAGIA) and by professional industrial associations. The response rate was 60%.

The methodology used in this study improves upon previous studies on FDI location factors in three important ways. First, previous studies have considerable benefit of its simplicity, but it does not capture the full complexity of the determinants of a location's attractiveness in a particular industry. However, in this study, a much larger range of potential location factors are considered. Second, previous studies have a major drawback at the operational level in that they do not provide any mechanism for prioritizing the location factors on the relative importance of the location decision of FDI. Third, on a conceptual level, most studies of the location factors assumed that the importance of location factors could only be applied to other countries and industries. In this study we identify that the importance of location factors vary significantly from one industry and country to another.

THE PILOT STUDY

A questionnaire was developed based on the factors and sub-factors presented in this section. It was first pre-tested with a number of colleagues to check for clarity and consistency and appropriate changes were made. It was then reviewed by and discussed with several academics. It was subsequently reviewed by the top executives of two firms who are working at foreign Petrochemicals firms in Saudi Arabia to provide

comments and feedback. This process led to an improvement in the questionnaire content, design, wording and clarity, thus making completion of the questionnaire easier and more attractive. A proper pilot study was conducted by distributing questionnaires to 12 senior managers who had engaged on the location decision for their firms. After reviewing the related literature on FDI location factors and studying the Saudi Petrochemicals industry, we chose the following five major location factors and sub-factors:

The major FDI location factors and sub-factors:

1. **Cost factors:** (F1: Labour costs, F2: Transportation/logistic cost, F3: Low cost of raw materials, F4: Return on investment, F5: Energy costs)
2. **Market factors:** (F6: Large size of host markets, F7: Demand in host country, F8: Level of competition in host market, F9: Economic stability)
3. **Infrastructure and technological factors:** (F10: Level of infrastructure, F11: High industrial concentration (Clustering), F12: Availability of well qualified work force, F13: Access to reliable and corporative suppliers)
4. **Political and legal factors:** (F14: Political stability, F15: International trade agreements, F16: Tax reduction in host country, F17: Benign environmental legislation towards FDI)
5. **Social & Cultural factors:** (F18: Cultural distance, F19: Attitude of the local community toward the firm).

RESULTS AND FINDINGS

In the first part of the questionnaire, the participants were asked to rate the relative importance of sub-locating factors of their decision to locate in Saudi Arabia. After calculating the average rating of the sub factors, the ranking of the major location factors are in decreasing order of their importance: **(a) Cost factors** (including sub-factors such as return on investment, ranked 1; energy costs, ranked 2; low cost of raw materials, ranked 3, transportation/logistic cost, ranked 9; labour costs, ranked 12); **(b) Infrastructure and technological factors** (including sub-factors such as access to reliable and corporative suppliers, ranked 4; level of infrastructure ranked 6; high industrial concentration, ranked 6; availability of well qualified workforce, ranked 14); **(c) Political and legal factors** (including sub-factors such as political stability, ranked 5; benign environmental legislation towards FDI, ranked 8; tax reduction in host country, ranked 10; international trade agreements, ranked 11); **(d) Market factors** (including sub-factors such as economic stability, ranked 13; level of competition in host market ranked 15; large size of host markets, ranked 16; demand in host country, ranked 18); and **(e) Social and cultural factors** (including sub-factors such as attitude of the local community towards the firm, ranked 17; cultural distance, ranked 19) (see Table 1). Cost factors, infrastructure and technological factors and political and legal factors are rated relatively high among other major location factors. The market factors, social and cultural factors are rated relatively low among other major location factors.

All sub-factors identified from the list of each of the major factors were ranked according to their average scores in table 1. From the analysis of all the sub-factors, and average rating above 3.0 was considered an important location factors in Saudi's petrochemicals industry. The top ten sub-factors identified according to their relative importance on location decision among other location factors listed below are in decreasing order of importance: (1) Return on investment; (2) Energy costs; (3) Low cost of raw materials; (4) Access to reliable and corporative suppliers; (5) Political stability; (6) Level of infrastructure; (7) High industrial concentration (Clustering); (8) Benign environmental legislation towards FDI; (9) Transportation/ logistic cost; (10) Tax reduction in host country. Table 1 below shows the relative importance of location factors in the Petrochemical industry.

Table 1. The Relative Importance of Location Factors in the Petrochemicals Industry

Major and Sub-Location Factors	Average Rating	Important Ranking
<i>1. Cost factors</i>	4.08	1
F1: Labour costs	2.67	12
F2: Transportation/ logistic cost	3.83	9
F3: Low cost of raw materials	4.5	3
F4: Return on investment	4.83	1
F5: Energy costs	4.58	2
<i>2. Market factors</i>	2.08	4
F6: Large size of host markets	1.83	16
F7: Demand in host country	1.75	18
F8: Level of competition in host market	2.33	15
F9: Economic stability	2.42	13
<i>3. Infrastructure and technological factors</i>	3.77	2
F10: Level of infrastructure	4.25	6
F11: High industrial concentration (Clustering)	4.00	7
F12: Availability of well qualified work force	2.42	14
F13: Access to reliable and corporate suppliers	4.42	4
<i>4. Political and legal factors</i>	3.60	3
F14: Political stability	4.33	5
F15: International trade agreements	2.75	11
F16: Tax reduction in host country	3.33	10
F17: Benign environmental legislation towards FDI	4.00	8
<i>5. Social & Cultural factors</i>	1.58	5
F18: Cultural distance	1.33	19
F19: Attitude of the local community toward the firm	1.83	17

In the second part of the questionnaire, the participants were asked to rate the competitiveness of Saudi Arabia compared to other locations in the region in the petrochemical industry. Table 2 below displays Saudi Arabia's competitiveness compared to other locations in the petrochemicals industry in the region. After calculating the average rating for all sub-factors, the measure of major location factors in competitiveness of Saudi Arabia compared to other locations in the region are ranked in order of competitiveness: (1) Cost factors; (2) Infrastructure and technological factors; (3) Political and legal factors; (4) Market factors; (5) Social and cultural factors (see Table 2). The results also show that the factors that are rated relatively much better among other major location factors were cost factors, infrastructure and technological factors and political and legal factors. Whereas market factors, social and cultural factors were rated relatively low among other major location factors (see Table 2)

. Table 2. Saudi Arabia Competitiveness Compare To Other Location in the Petrochemicals Industry

Major and Sub-Location Factors	Average Rating	Competitiveness Ranking
<i>1. Cost factors</i>	3.88	1
F1: Labour costs	2.25	14
F2: Transportation/ logistic cost	3.08	10
F3: Low cost of raw materials	4.50	3
F4: Return on investment	4.50	2
F5: Energy costs	4.83	1
<i>2. Market factors</i>	2.27	4
F6: Large size of host markets	1.58	18
F7: Demand in host country	1.67	17
F8: Level of competition in host market	2.58	13
F9: Economic stability	3.25	9
<i>3. Infrastructure and technological factors</i>	3.46	2
F10: Level of infrastructure	3.42	8
F11: High industrial concentration (Clustering)	4.17	5
F12: Availability of well qualify of work force	1.92	16
F13: Access to reliable and corporative suppliers	4.33	4
<i>4. Political and legal factors</i>	3.18	3
F14: Political stability	3.83	6
F15: International trade agreements	2.67	12
F16: Tax reduction in host country	2.75	11
F17: Benign environmental legislation towards FDI	3.50	7
<i>5. Social & Cultural factors</i>	1.17	5
F18: Cultural distance	1.17	19
F19: Attitude of the local community toward the firm	2.25	15

Evidence in Table 2 also demonstrates the competitiveness of all sub-location factors in Saudi Arabia compared to other locations in the region. After studying the ranking of the competitiveness of the sub-location factors, an average rating approximately 3.0 was considered a relatively high competitive factor for Saudi Arabia compared to other locations in the petrochemicals industry. The top ten sub-factors identified were rated high in respect of Saudi Arabia's competitiveness and they are listed below in decreasing order of importance: (1) Energy costs; (2) Return on investment; (3) Low cost of raw materials; (4) Access to reliable and corporative suppliers; (5) High industrial concentration (Clustering); (6) Political stability; (7) Benign environmental legislation towards FDI; (8) Level of infrastructure; (9) Economic stability; (10) Transportation/ logistic cost

DISCUSSION

It is quite evident that cost factors are the most important factors found in this study. Unfortunately, for a highly automated industry such as the petrochemicals, labour cost received the lowest rate of importance among the sub-cost factors. Return on investment factor received the highest rating among all location sub-factors, reflecting that the industry strives to locate their business in location where they receive the highest profit on their investment. Energy cost is the second most important factor in the petrochemicals industry, which was affected by the industry's operational cost mostly driven by the recent energy cost. Cost factors received the highest rating of Saudi Arabia's competitiveness compared to other locations in the region, giving support to the above findings when a direct reference is made to its relative importance.

Infrastructural and technological factors are the second most important factors among major location factors. The intensive competition in today's global business environment results in pressure to reduce the time to bring products to markets as well as demands by customers for higher levels of quality and improved delivery reliability. Therefore, the infrastructural factors become crucial in international operations. The existence, quality and reliability of modes of transportation, the quality and reliability of utilities and telecommunication systems are very important in today competitive petrochemicals industry. High industrial concentration (clustering) rated relatively high in the sub-factors. Petrochemicals firms usually cluster in a specific location to take advantage of spill-over effects from clustering such as exchange experience and closeness to supporting industries. Access to reliable and corporative suppliers are necessary to bring raw materials from suppliers to plants and to deliver products to markets as quickly and reliably as possible, enabling firms to reduce the total cycle time effectively. However, the importance of sub-factors may vary from one industry and country to another. For instance, availability of well qualified work force as a location factor received the least relative importance among infrastructure sub-factors because most firms in the petrochemicals industry bring their workers with them or the parent company send them skilled workers whenever they need them. Infrastructure and technological factors are rated high with regards to Saudi Arabia's competitiveness compared to other location factors in the region, which support our findings above for the relative importance of infrastructure and technological factors.

The relative importance of both political and legal factors was rated high among location factors. For a firm to be successful in foreign markets, political stability in host market is a crucial factor. Sudden changes in a business environment may affect profit and other aspects of business. Benign environmental legislation towards FDI is an important location factor which affects the development of the business. Tax reduction in host market also received a high rating as a location factor because it affects the profitability of the firm. However, the importance of sub-factors may vary significantly from one industry and country to another. For instance, international trade agreements received a low rating among the sub-location factors. Political and legal factors were rated high in the competitiveness of Saudi Arabia compared to other locations in the region. However, tax reduction in host country as a sub-factor was rated low among location sub-factors in the competitiveness of Saudi Arabia.

Market factors such as large size of host market, demand in host country, level of competition in host market, economic stability were considered to be the most important location factors for FDI. However, our study reveals that market factors are least important in the petrochemicals industry compared to other major location factors. Petrochemicals producers in Saudi Arabia are producing in capacity which far exceeds local demands. Therefore, the majority of the outputs sold globally may reflect the low rating for the market factors. Most of market factors were rated low in the competitiveness of Saudi Arabia compared to other locations in the region. However, economic stability was rated high among sub-location factors in the competitiveness of Saudi Arabia compared to other locations in the region. Social and cultural factors are the least important among location factors in the petrochemicals industry according to our findings. The interaction between petrochemical firms and local community are very low because most of the facilities of the petrochemicals industry are located near suppliers or the refineries or in low populated

areas. Also, the social and cultural factors were rated low in the competitiveness of Saudi Arabia compared to other locations in the region.

CONCLUSION

This study examined the relative importance of major location factors that affect FDI inflows into the Petrochemicals industry in Saudi Arabia. The findings of this study indicate that location factors and their importance vary significantly depending on the nature or type of business in which the location is being considered. In view of a small sample size, the findings of this study cannot be generalised as a representative in respect of the major factors affecting FDI location decision in all petrochemicals industries in the east-west region. In fact, it should be viewed more of a case study. Nevertheless, this case study provides a good example for other petrochemicals industries in the east-west region to follow. It is also the view of this study that each business sector should take into consideration when considering a location choice, the relative importance of factors that influence location decisions.

LIMITATIONS AND RECOMMENDATIONS

The research has limited geographical focus, as it focuses only on FDI located in Saudi Arabia. Therefore, it is likely that the findings may not apply to other countries in the region. Another limitation is that the survey samples may not represent every sector of FDI in Saudi Arabia. Therefore, the findings may not apply to FDI location factors in other sectors of Saudi Arabia's economy. Future research should focus on the depth of factors and their influence on the FDI location. This shows that there are still many unexplored areas of study. Given that this field of study has not been covered extensively in the past, the results and conclusions in this research thus contribute a significant platform for future researchers by giving them the opportunity to further extend the international business research on the priority of location factors for FDI location decision.

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