Assessing the role of family business in promoting economic growth: perspectives from Saudi Arabia

Mohamed A. Ramady

Department of Finance and Economics
King Fahd University of Petroleum and Minerals
P.O. Box 5075, Dhahran 31261, Saudi Arabia
E-mail: ramadyma@kfupm.edu.sa

M. Sadiq Sohail*

Department of Management and Marketing
College of Industrial Management
King Fahd University of Petroleum and Minerals
P.O. Box 210, Dhahran 31261, Saudi Arabia
E-mail: ssohail@kfupm.edu.sa
*Corresponding author

Abstract: Family businesses play an important role in economic development across the globe, whether in developed or developing nations. Despite its importance, research on family business has attracted the attention of scholars only during the last two decades. This paper attempts to contribute to existing research in the stream of family business. The paper assesses the role of family businesses in Saudi Arabia by examining the current corporate structure and identifies the need for reforms. The paper puts forth a case for listing of family businesses and its likely consequences to the Saudi economy. Finally, the paper concludes with some policy recommendations.

Keywords: family business; economic growth; economic reform; business structural changes; Saudi Arabia; globalisation; new listings.

Reference to this paper should be made as follows: Ramady, M.A. and Sohail, M.S. (2010) 'Assessing the role of family business in promoting economic growth: perspectives from Saudi Arabia', *Int. J. Entrepreneurship and Small Business*, Vol. 10, No. 4, pp.447–459.

Biographical notes: Dr. Mohamed A. Ramady obtained his PhD in Economics at the University of Leicester, UK 1977. Currently he is a Visiting Associate Professor in Finance and Economics at King Fahd University of Petroleum and Minerals (KFUPM). He specialises in regional and Saudi economy, as well as money and banking, globalisation, and WTO. Dr. Ramady has also over 25 years of non-academic senior-level professional experience in the field of international banking, finance, and investment with leading financial institutions. He was a Vice President with Citibank and was seconded to the Saudi American Bank. He also served as Vice President with Chase Manhattan, First City Texas BankCorp and Qatar National Banks, and was Senior Advisor to the Chairman of Qatar International Islamic Bank.

Dr. M. Sadiq Sohail is presently an Associate Professor of Marketing at the Department of Management and Marketing, College of Industrial Management, King Fahd University of Petroleum and Minerals, Saudi Arabia. He is currently serving as a Vice President for the Academy for Global Business Advancement (AGBA). Dr. Sohail also currently serves as the Managing Editor of the *Journal of International Business and Entrepreneurship Development*. He also serves in the editorial board of eight other international journals. Dr. Sohail's prime research interests are on international marketing, marketing in developing countries, services marketing, tourism marketing, bank marketing, consumer behaviour issues and e-commerce. He has published over 60 papers in refereed journals. He has likewise presented research papers in a number of countries. He is also the co-author of case books in the field of marketing and international business.

1 Introduction

Family businesses provide a critical infrastructure for economic activity and wealth creation (Poutziouris *et al.*, 2004). Family businesses have played an important role in the economic development across the globe. A study estimated that over two-thirds of all worldwide businesses are owned or managed by families' enterprises and account for about half of GDP-economic activity (Shanker and Astrachan, 1996). About 90% of all the businesses in the USA and Canada are estimated to be family-owned (Ibrahim *et al.*, 2004); while in Australia, about half of all businesses are reported to be family businesses (Getz and Carlson, 2000). Family businesses also play an important role in economic progress of developing countries like India (Basu, 1998).

Despite the importance of family business, research in the area of family business has attracted the attention of academicians only since the 1990s (Brockhaus, 1994; Dyer and Handler, 1994). Being a relatively new field of study, developments have been somewhat limited by a series of factors including the failure of scholars and practitioners to establish a consensus on what constitutes a family business as well as the adoption of theoretically rigorous research methodologies, which lack robust survey designs and sound statistical analyses (Poutziouris *et al.*, 2004).

Early research on family businesses in Saudi Arabia and the Arabian Gulf, has been largely in the domain of practitioners highlighting the significant economic impact of such family businesses on domestic alliances in terms of investment, employment, international agency alliances and capital flows (Field, 1985; Fahim, 1995; Netton, 1986; Carter, 1984). Recent research has stressed on the problems faced by such family businesses, and the need to transform them into joint stock companies to enable them to survive global competitive pressures and liberalisation moves by the national government (Azzam, 2002; Speakman, 2002; Barrak, 2004). However, transforming into joint stock company has its own advantages and disadvantages. The advantages include access to new finance sources, externalities, and international expansion (Pagano, 1993; Jain and Kini, 1994). Offering shares to public gives owners the liquidity to diversify their investments and the possibility of offering employees shareholding incentives to change the management structure and reduce principal agent problems. Companies become more transparent in their operations (Barrak, 2004). However, going public may be seen as having some disadvantages such as fear of losing control, being no longer involved in prime decision making (Zingales, 1995; Pagano, 1993), as well as the prospects of large direct costs associated with an Initial Public Offering (IPO).

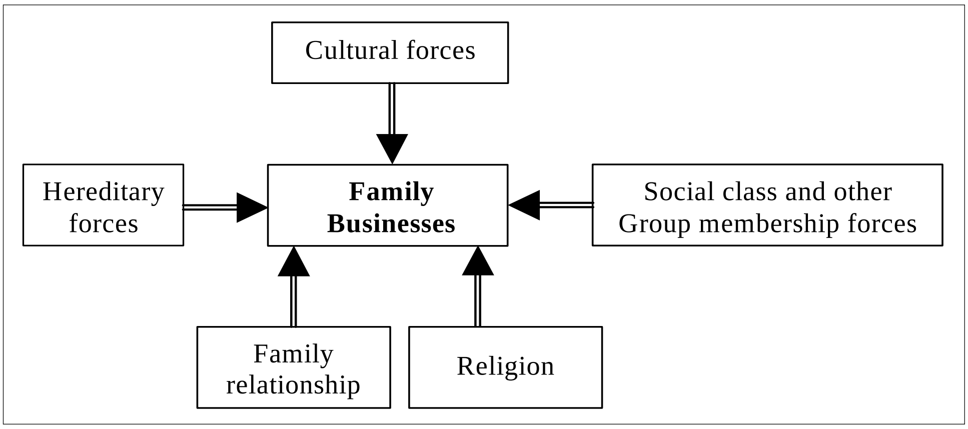
This paper will address the impact of the role of the family businesses in Saudi Arabia by examining the current corporate structure in Part 2, and the need for reform in Part 3. In Part 4 we will examine the impact of family businesses going public on the Saudi stock market and its likely consequences on the Saudi economy. Part 5 will quantify the likely effects on the Saudi stock market by an additional listing of 137 new companies. Part 6 will set out some policy conclusions and recommendations.

2 Saudi family businesses: current setting

In Saudi Arabia, family businesses operate in all spheres of economic activity and the majority of franchises and agencies are owned by no more than 100 of the top family businesses (Ramady, 2005). Given this prominent impact on the nations' economy, the Saudi government has encouraged family businesses to examine their current structure and try to address potential problems that might affect the family business and the national economy. Issues such as succession, or more precisely *competent* succession, have now become areas of concern following some high profile cases of family business break-ups because of succession problems.

Mergers and acquisitions are options for Saudi family businesses, but these have been rare in a society where they imply social and managerial failures. As such, there is a reluctance to sell to 'outsiders', leaving some family businesses to operate despite significant financial losses. The preferred option is for 'informal' family-related alliances through marriage or bloodline (Field, 1985; Wright, 1996). Such alliances could influence the efficient management of family businesses, whereby decision making could be constrained by hereditary and other ethical considerations on whether to act independently or in line with external socially driven factors (Morris *et al.*, 1996). A model depicting the major forces influencing family businesses is shown in Figure 1.

Figure 1 Major forces influencing family business in Saudi Arabia



Source: Model developed for this study based on an adaptation from Gibson *et al.* (1988)

Building on a model developed by Gibson *et al.* (1988), a model was developed specifically for this purpose. This model illustrates the forces influencing family businesses in Saudi Arabia (see Figure 1). As can be seen from Figure 1, we identify five forces that influence decision making in family business in the Kingdom of Saudi Arabia. An overwhelming majority of the population of the Kingdom are Arabs who adhere to Islam. Islam as a religion governs every aspect of a Muslim's life, and also permeates every aspect of the KSA including family business conduct. Arabian culture is often described as detail-orientated, whereby emphasis is placed on ethics and expected social behaviour such as generosity, respect, and solidarity. These cultural forces also infiltrate family businesses and affect the way decision making is handled. Family influences and personal connections are also factors that take precedence in decision making by family business firms.

In Saudi Arabia, the government has not yet reached the stage where regulations are imposed on family-run businesses, preferring instead internal reforms of family groupings. This situation, however, might not last forever given the pressure on the Saudi private sector to assume a greater role in the economy. Moreover, Saudi Arabia needs to diversify its economic base to ensure that it does not depend on one major source of revenue from oil and also to meet globalisation challenges (SAMA, 2007; Abdelkerim, 1999; Cordesman, 2003; Ramady and Mansour, 2005). In the final analysis, if inefficient family business conduct and behaviour conflicts with the larger interests of the country, then increased government regulations will result (Ostapski *et al*., 1996). The likelihood of such pressure in the future has not gone unnoticed by the Saudi family businesses. During the period 2005–2007 there was a flurry of announcements on the intentions of some prominent Saudi family businesses to partially float their companies, and the number of initial public offerings rose from 2 in 2005 to 10 in 2006 and a further 12 in 2007 (SAMA, 2007).

Table 1 Companies operating in Saudi Arabia by type and capital (2006)

Type of company	*Number*	*Capital (SR million)*	*Average capital per company (SR million)*
1 Joint stock companies	208	263,117.3	1264.9
2 Limited liability partnerships	12 194	137,319.1	11.26
Saudi	9592	73,871.3	
Joint venture	2151	54,679	
Non-Saudi	451	8,764.8	
3 Joint-liability partnerships	2955	4,446.4	1.50
Saudi	2920	4,414.2	
Joint venture	34	27.2	
Non-Saudi	1	5	
4 Mixed-liability partnerships	1153	9,811.1	8.5
Saudi	1143	9,774.0	
Joint venture	8	21.9	
Non-Saudi	2	15.2	
5 Mixed liability partnership by shares	4	2.9	0.72
Totals	16 514	414,697	25.11

Source: SAMA (2007, p.252)

The current structure of Saudi corporations is overwhelmingly private limited companies, followed by joint-liability partnerships, and mixed liability partnerships. The number of joint stock companies represents around 1% of the total companies operating in Saudi Arabia as illustrated in Table 1.

While joint stock companies represent around 1.2% of the total number of companies, they account for around 63% of total capitalisation, with an average capital of SR 1,264 million per company (US$337 million), compared to SR 11.3 million for limited liability companies and around SR 8 million for partnerships.

Table 1 also illustrates that, in general, the joint venture and foreign-owned companies tend to be higher capitalised than the wholly owned Saudi companies are. This is to be expected, given the preference for foreign investors in the more capital-intensive petrochemical-related industries.

Foreign Direct Investment (FDI) has been, until the Saudi government eased on regulations for foreign ownership, effected through joint ventures (Ramady, 2005; Malik, 2004). Foreign companies brought with them modern management practices and much coveted technology transfer. Evidence from around the world indicates that the relationship between ownership structure and firms' performances varies by the holder's identity. In a study of Saudi Arabian publicly traded companies, empirical results suggest that corporate ownership structure has a significant effect on firms' performance, using Return on Equity (ROE) as a proxy for firms' performance. The studies showed that foreign ownership has a statistically significant impact on economic performance as measured by ROE (Yakubu and Al-Elg, 2004). While it is outside the scope of this paper, globalisation and World Trade Organization (WTO) membership will allow fully owned foreign corporations to operate in Saudi Arabia, creating an added impetus for Saudi family businesses to carry out structural reforms (Ramady and Mansour, 2005).

An analysis of the top 100 companies in Saudi Arabia by legal structure reveals a large number of limited liability and sole ownership structures of these largest corporations (54%). This is illustrated in Table 2. The table reveals a consistent pattern of such a legal structure for all the major sectors of the economy.

Table 2 Saudi Top 100 Companies – legal structure (2007)

Sector	*Limited liability companies*	*Sole owner*	*Partnership*	*Limited partnerships*	*Joint stock company*	*Government owned*
Agriculture	1				5	
Contracting and real estate	3				3	
Finance and investment	3				12	1
Services	2	2		2	2	
Diversified trading	10	3	3	2	5	
Industry, oil and related industries	13	5	2	3	18	1
Total	32	10	5	7	44	
Percentage (%) of total	32	10	50	7	44	2

Source: Arab News (2007)

Table 2 also illustrates that some key economic sectors such as contracting, services, and trading have a high concentration of ownership in the partnership and limited partnership categories. By contrast, the more capital-intensive oil and industry sector had 18% in the joint stock ownership category. The economic significance and potential impact of such a large family-owned concentration pattern in these economic sectors are emphasised by their contribution in terms of total revenue generated, the number of employees, and their level of productivity. This is illustrated in Table 3.

Table 3 Saudi Top 100 Companies – revenue, employees and productivity (2007)

Sector	*Total revenue (million)*	*Percentage (%)*	*Employees*	*Percentage (%)*	*Productivity per employee (SR),000*
Agriculture	16,691	4.9	36 671	11.5	455
Contracting	3,742	1.0	43 183	13.9	80
Financing	79,707	23.5	30 210	9.8	2,638
Services	8,947	2.6	9209	2.9	971
Diversified trading	26,313	7.6	68 044	22	386
Industry oil and related industries	204,077	60.4	121 820	39.6	1,675
Total	339,157	100	309 137	100	–

Source: Arab News (2007)

Table 3 indicates that while the agriculture sector had around 12% of employees, they contributed around 5% of the total Top 100 Company revenue, but that they were still better in terms of productivity per employee compared with contracting, which only contributed around SR 80,000 ($21,300) per employee. In terms of overall productivity, financing and the oil/industrial sectors outperformed the others, taking advantage of capital investments, international joint venture alliances, and positioning post WTO accession for the petrochemical industries. The implication from the productivity analysis is that some room exists for a more efficient corporate restructuring in some Saudi economic sectors.

3 Saudi family businesses: the need for reform

To face future challenges, the Saudi family business management structure has to change. A centralised decision-making ‘power-culture’, in which tasks are assigned downward by the chief executive or owner, and strict hierarchy is transferred by heavy doses of paternalism, is not the way forward (Azzam, 2002). A wide range of literature exists to show that many societies have gone through transformations of such power-cultures successfully, albeit aided by a transparent legal and capital market structure that allowed family businesses to go public (Deal and Kennedy, 1982; Allen and Porter, 1983; Gibson *et al.*, 1988; Miner, 1982).

Under current Saudi Arabian family business decision-making processes, family companies are more likely to provide clients with the kind of goods that are already available, rather than customised goods that meet clients' needs. Obsession with balance sheet size, rather than size and growth of market share, has become a feature, which explains the enormous interest shown by Saudi family businesses in being included in the 'Saudi Top 100 Companies' surveys. While some companies do provide data on assets, turnover and sales, as well as capital and employee numbers, they give little information on the profitability and market share of these companies (Fadhel, 2004). Table 4 outlines areas of changing management structure to which some Saudi family businesses are adapting. Others will need to address such structure issues soon.

Table 4 Family businesses: changing management operating structures

Characteristic	*Current structure*	*New structure*
Organisation	Pyramid, strict hierarchy	Horizontal, delegation
Focus	Balance sheet growth, agencies and franchises	Profitability, maximising shareholder value, production
Ownership	Family, affiliated groups	Publicly listed joint stocks
Financial structure	Internal raising of capital	External funding, IPOs
Resources	Physical assets	Human capital
Competition	Between family groups	Between brands, services and products
Expansion	Using influence, family alliances and 'Wasta'	Productivity and achievement
Financials	Internal, annual, not audited	Quarterly, audited
Leadership style	Top down, paternalistic, dogmatic	Bottom up, inspirational
Worker	Mere employees	Shareholders, participatory, critical
Job expectation	Look for security, obedience	Personal growth, satisfaction

Source: Adapted from Azzam (2002, p.18)

Table 4 reveals how the Saudi family businesses need a fundamental a shift in mindset in order to proceed into the next 'new-structure' age. Above all, the paternalistic leadership style has to change from top-down to bottom-up inspirational leadership approach, which might still remain in the hands of the younger, educated, and technically proficient family members, aided by independent professional managers with a stake in the family business. Instead of having employee's with a civil service attitude, only mindful of rank and title and rewarded for obedience to the family hierarchy, true empowerment of professional talent would be emphasised (Barrak, 2004; Malik, 2004).

4 Economic influence of Saudi family businesses reform

Notwithstanding the free-market ideology stated in all Saudi development plans, the Saudi government regulates the marketplace to some extent by intervening to regulate both safety in the workplace and environmental effects of production. The government is still the regulator in terms of establishing the overall commercial and legal regime within which the private sector can operate. To its credit, the Saudi government has gone to great lengths to meet some of the challenges and issues raised by the private sector, including its requests for a less burdensome bureaucracy, more predictability of regulations, and a legal system conducive to business, which adapts to deal with the realities of modern international business (Malik, 2004).

The accession of Saudi Arabia to the WTO in late 2005 also provided an urgent impetus for the Saudi government to ensure that it established a more transparent regulatory regime in the commercial and judicial sectors, which could benefit Saudi family businesses opting to go public.

One area for a large potential impact on the domestic economy, if family businesses carry out the necessary reforms and go public, is the Saudi capital market. The Saudi capital market took off during the 1990s, with the beginning of domestic economic reforms in the fields of privatisation and liberalisation, especially when the country opened up to the outside world for inward investment. However, the current number of Saudi listed companies and their narrow sectoral basis cannot be sustained. Like any other stock market in the world, the Saudi Composite Stock Market Index masks sectoral differences and does not accurately reflect the composition of the overall economy. Between them, the banking sector and telecommunications accounted for slightly under 48% of total market capitalisation. The service sector, which account for around 18% of current Gross Domestic Product (GDP) in 2006, accounted for 5.7% of stock market capitalisation, while agriculture with 3.0% of GDP contributed less than 1% to Saudi stock market capitalisation (SAMA, 2007). Share price movements for key players in the heavily concentrated market sectors will undoubtedly influence the rest of the market.

However, over the period 2004–2007, there has been an acceleration in the number of new listings across a wide variety of economic sectors in Saudi Arabia, such as Sahara Petrochemicals, Ittihad Itisalat, Saudi Telecommunications Company, Al Bilad Bank, Jabal Omar, Sipchem, Mobily, Kayan Petrochemicals, *etc*. The sharp rise in share prices seen in the Saudi market, especially in 2006 when the market index reached a record of 20 900 in February of that year, from opening levels of 16 700, has created a 'wealth effect' in the Saudi economy, adding a considerable amount of additional wealth to individuals and corporations. Some have calculated this additional wealth effect to be as high as 32.3% of nominal GDP (NCB, 2003). However, it still remains to be seen whether this 'wealth effect' will start to penetrate into the local economy by way of creating real businesses and jobs, or if it will continue to be used in speculative share purchases. The current number of listed companies and their narrow sectoral basis cannot be sustained.

4.1 From where can the new family business listings come?

Research carried out among the Top 1000 Saudi non-listed companies revealed that around 137 new companies could be listed in the Saudi market using the current Ministry of Commerce joint-stock company benchmarks. The results are set out in Table 5.

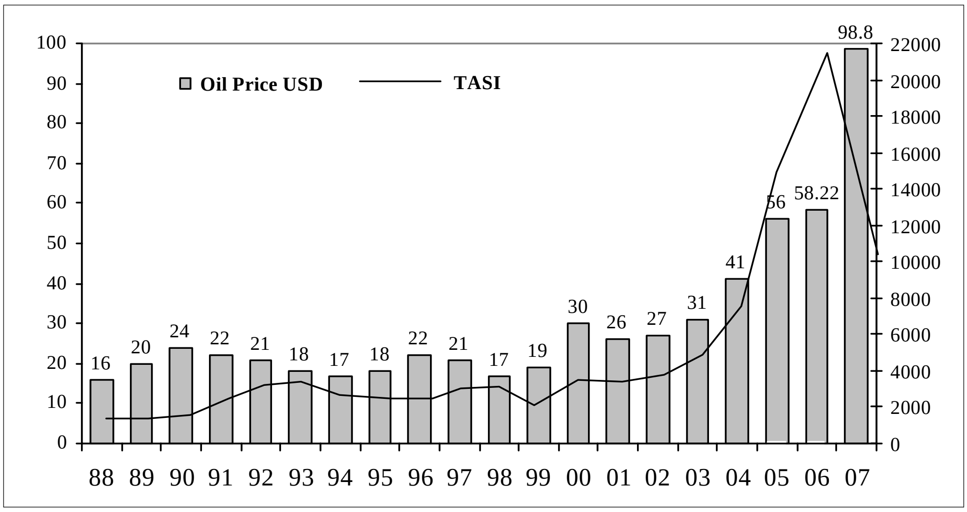
Table 5 Projected increase in current Saudi stock market through new listings by sectors and capitalisation (2007)

Sector	*New company listing turnover (SR million)*	*Earnings ratio (%)*	*Earnings (SR million)*	*Sector average P/E ratio*	*Expected new company listings*	*2007 listed companies*	*Expected combined company listings*	*Expected additional market capitalisation (SR million)*	*2007 market capitalisation (SR million)*	*Expected total market capitalisation (SR million)*
Banks	5,111	6	307	15.9	1	10	11	4,907	354,169	359,076
Industry	12,221	12	1,467	17.2	20	36	56	25,224	436,371	461,595
Cement	–	–	–	–	–	8	8	–	53,420	53,420
Services	156,048	10	15,605	28.2	112	23	135	440,055	60,841	500,596
Electricity	–	–	–	–	–	1	1	–	47,916	47,916
Agriculture	3,359	4	134	18.02	4	9	13	2,415	8,377	10,792
Telecommunications	–	–	–	–	–	2	2	–	140,500	140,500
Total	176,739				137	89	226	472,601	1,112,025	1,573,895

Source: SAMA (2007)

Given limited public data for the major Saudi private companies, research on potential new listings has certain limitations, as the major variable used in calculating the potential increase in market capitalisation was the current average sector price-earnings ratios, along with the earnings for those sectors. What the findings from Table 5 indicated was a potential wider sectoral allocation from the new proposed company listings, especially in the industrial and service sectors, from where 132 of the proposed new listings would originate. Such new listings would break the cycle of sharp share-price fluctuations currently dominated by a few companies in a few sectors. Given the Saudi government's objective for economic diversification and its emphasis on the private sector's expansion of the economic base of the country, such an increase in the number of listed companies could help both stated government objectives. Secondly, Saudi market depth would rise significantly, taking the 2007 market capitalisation-to-constant GDP ratio to 190%, from below 50% levels in 2002/2003 (Ramady, 2005). The strong correlation between oil prices and Saudi stock market performance is striking, with high oil prices giving a boost to market prices. This is illustrated in Figure 2 below:

Figure 2 Oil prices and Saudi stock market performance (1985–2007)



Source: Brent and TASI (2007)

However, since October 2004, the Saudi stock market seemed to have risen at a faster pace than oil prices. This saw a modest correction in prices, while the Saudi share index, the Tadawul All Share Index (TASI), continued to rise sharply based on the speculative bubble that took the TASI to an all time high of 21 900 in February 2006, before plunging to 7900 at year end of 2006. During 2007, the TASI recovered to reach 11 000 levels again, assisted by capital market reforms and new listings. The benefits of the listings are not just economic diversification, however. Through transparency, investors will be able to see exactly what is going on inside listed companies; they will feel protected if they see their money is safeguarded from intermediaries and it will promote a climate for better reception of government-led privatisation sales.

Additional listings will also help to break the current cycle of sharp share-price fluctuations, dominated by a few companies in a few sectors, as illustrated by Figure 2, and help to bring share prices and current P/E ratios to more sustainable levels in line with actual company earnings and their future economic prospects.

5 Conclusions and recommendations

Family businesses can play both a positive and potential negative role in the Saudi Arabian economy. They are the backbone of the current private sector-driven diversification of the national economy, and account for the lion's share in terms of employment and the number of companies in operation. However, in the face of globalisation, Saudi Arabia's WTO entry and the greater need to expand the economic base on a more transparent footing, the role of the family businesses has to evolve into public-listed corporations for those entities that have the greatest economic impact in the long term. The Saudi government has, to-date adopted a policy of allowing the family businesses to evolve as they wished. However, this study indicates that there should be a more direct government role to encourage a greater number of family businesses to go public, as the decisions of the family businesses on investment, production and employment have great consequences on the whole national economy.

Acknowledgement

Both authors acknowledge the assistance provided by King Fahd University of Petroleum and Minerals, Saudi Arabia in the preparation of this paper.

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