Foreign Investment, Oil Curse, and Democratization: A Comparison of Azerbaijan and Russia

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Abstract

The rentier-state literature pays little attention to the initial political conditions that shape the way an oil-rich country develops its resources. One of the key causal mechanisms linking oil wealth and regime type is the relationship between foreign investors and host governments. Especially in the developing countries that depend on international financing and expertise, the role of foreign capital in fashioning the balance of power in the political system and thereby the distribution of oil wealth becomes ever more important. As the experiences of Azerbaijan and Russia in the 1990s demonstrate, among oil-rich states in the developing world, those with authoritarian regimes tend to fare better in terms of attracting FDI in the oil sector than states with democratizing (or hybrid regimes). The durability of some authoritarian regimes in the developing world is partly a function of this external legitimation from foreign investors.

KEYWORDS: foreign investment, globalization, oil contracts, democratization, Azerbaijan, Russia

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**Introduction**

The relationship between oil and democracy has long attracted scholarly attention. The literature on rentier states contends that oil rents reinforce authoritarian tendencies and create obstacles for political change.\(^1\) As Michael Ross aptly states, there are three general explanations for why oil has antidemocratic effects. A “rentier effect,” which suggests that resource-rich governments use low tax rates and patronage to relieve pressures for greater accountability; a “repression effect,” which demonstrates that resource wealth retards democratization by enabling governments to boost their funding for internal security; and a “modernization effect,” which holds that growth based on the export of oil and minerals fails to bring about the social and cultural changes that tend to produce democratic government.\(^2\)

This literature, however, is primarily concerned with the negative effects of oil resource wealth once the inflow has begun and as such fails to address the initial conditions under which the oil wealth is created. Especially in the oil-rich countries of the developing world, the role of foreign investment in generating economic rents cannot be ignored. Even the countries that were once closed to foreign investment\(^3\) are today courting foreign capital in order to share the risks and costs of exploration, as well as to benefit from the market advantages of powerful multinational corporations. Given the increasing competition among the developing countries for international financing and expertise, the relationship between foreign oil companies and host governments is particularly important in understanding the connection between oil wealth and authoritarianism. The alliance between foreign investors and state elites can render democratic transition and consolidation problematic by providing new economic resources for the state and by legitimizing undemocratic governing elites.

These anti-democratic properties of foreign capital have been emphasized by dependency theorists.\(^4\) They have demonstrated that dependent development creates a particular transnational class coalition, which reinforces tendencies toward authoritarianism and inequality. Since the local elites’ position of social dominance is guaranteed by the support of its multinational ally, it has little incentive to institute reform to improve the conditions of the masses. Yet despite the continuing importance of attracting foreign capital to oil-rich countries today, students of the rentier state literature are overlooking this prior link between foreign capital, oil wealth, and democratization.

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1. See for instance, Mahdavy (1970); Delacroix (1980); Gelb (1986); Shafer (1994); Chaudry (1997); Karl (1997); Ross (2001); Wantchekon (2002); Jensen and Wantchekon (2004).
3. Among such countries are Algeria, Vietnam, Iran, Brazil, Venezuela, and Saudi Arabia.
4. See for instance, Cardoso (1973); Evans (1978); Bennett & Sharpe (1983).
In order to understand this link, we need to first address the initial conditions under which foreign capital is attracted. Even when oil-rich states need and want foreign capital, not all of them can easily attract it. What, then, explains the variation in the ability to attract foreign investment? I argue here that given the economic attractiveness of the resources, the type of political regime helps to explain why and how governments can attract foreign direct investment (FDI) in the first place. I use regime type as a proxy to capture two political variables: the level of political competition between opponents and proponents of FDI, and the strength of political institutions that can resolve disagreements over investment policy. Investment stability can be created and sustained only if the opposition—those who lose from globalization—is either co-opted into or excluded from the decision-making process. I argue that among oil-rich states in the developing world, those with authoritarian regimes where political competition is limited, fare better in terms of attracting FDI in the oil sector than democratizing states (or hybrid regimes) that allow for some degree of competition over investment policies in the absence of strong institutions to mediate between competing interests. The decision-making structure that is created to attract foreign investment can reveal a great deal about how the oil wealth will be developed and used later on. This argument essentially is in line with the critics of the rentier-state literature who posit that prior political structures have a significant effect on how natural resource wealth affects political outcomes.5

In the next section, I discuss the empirical puzzle that the two former Soviet republics, Azerbaijan and Russia, pose for the literature. These two cases best illustrate the differences between authoritarian and hybrid regimes in creating an attractive investment environment. After comparing the investment relationship between host governments and foreign companies in Azerbaijan and Russia as a function of their political regimes, I discuss the experience of another oil producing country, Norway, to emphasize the differences between a consolidated democracy and a hybrid regime in attracting oil investments. I conclude with the political effects of FDI and how this analysis contributes to the rentier-state literature.

5 For instance, Terry Lynn Karl (1997) emphasizes the importance of institutional settings prior to the development of oil resources. She argues that “stateness” is a crucial determinant of how oil rents will be distributed and used. Similarly, Pauline Jones Luong & Erika Weinthal (2001) argue that how and why a state initially decides to develop its resources determine the extent of the resource curse.
Foreign Investment in the Former Soviet Union

Especially in the oil-rich states of the former Soviet Union, the role of oil wealth in promoting or hindering democracy greatly hinges on the relationship between FDI and host governments. With 4.6 percent of the world’s proven oil resources, the region is considered a viable alternative to the countries of the volatile Middle East and accordingly an attractive destination for foreign investment. Since the beginning of the 1990s, many foreign oil companies have been eager to start projects in the five oil and gas rich countries of the region: Russia, Azerbaijan, Kazakhstan, Turkmenistan, and Uzbekistan. Even though foreign capital was not initially sought by each government with the same intensity and urgency, doing so became a necessity for most in generating revenues to jump-start their economies.

The experiences of Azerbaijan and Russia, two of the region’s five energy-rich states, best illustrate the variation in the degree of democratization as well as the extent of foreign investment in the region in the 1990s. While Russia has been a typical example of a hybrid regime with “partly free” rankings by the Freedom House, Azerbaijan is more representative of authoritarian regimes in the region with mostly “not free” rankings. Moreover, according to the FDI performance index rankings of 140 countries, which takes the ratio of a country’s share in Global FDI flows to its share in Global GDP, Azerbaijan was the 3rd highest from 1994 to 1996 and 8th highest from 1998 to 2000; while Russia was 108th and 104th highest respectively. Between 1994 and 2002, even though Azerbaijan had about 1/6th of Russia’s oil resources, it received at least 7 times more FDI per barrel of its proven oil reserves than Russia (see Table 1).

While Azerbaijan was becoming the “showcase for the art of doing business” and a “frontier of global capitalism” for foreign investors, Russia suffered greatly from lack of investment that was very much needed and sought by the government. Even though there are some positive signs of increasing

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6 Freedom House country ratings 2004 (www.freedomhouse.org). Individual countries are evaluated based on a checklist of questions regarding political rights and civil liberties that are derived in large measure from the Universal Declaration of Human Rights. Each country is assigned a rating for political rights and a rating for civil liberties based on a scale of 1 to 7, with 1 representing the highest degree of freedom present and seven the lowest level of freedom. The combined average of each country’s political rights and civil liberties ratings determines an overall status of Free, Partly Free, or Not Free.


9 Russian authorities, including President Yeltsin himself, repeatedly emphasized the need for external sources, especially in the form of foreign direct investments (FDI) from international oil companies. In 1993, Yeltsin used a presidential decree to propose legislation to facilitate the flow of foreign capital into oil extraction and development projects. While it is true that many Russian oil companies have had alternative sources of financing for developing existing oil fields and thus
foreign investment in Russia today, there is still suspicion and hesitation on the part of investors related to making long-term commitments. This variation presents us with a set of striking empirical puzzles. First, how was Azerbaijan able to attract significant amounts of oil FDI, while Russia was not? Second, how does the success or failure in attracting FDI affect regime trajectories in these countries? Given the variation in their political regimes and their ability to attract foreign capital in a region that has such huge energy potential, an analysis of these two cases provides a unique opportunity to test the relationship between foreign investment, oil and regime type.

**Investment Environment and Political Regime**

The flow of foreign investment into countries with significant natural resources should not be taken as a given. Foreign investors prefer that such countries also have stable and predictable investment environments that provide general standards of treatment and have predictable legislative and regulatory frameworks in which channels of negotiation are clear. Absent an enforceable framework defining ownership, taxation, dispute settlement, and regulation, they fear expropriation, onerous administrative intervention, and unpredictable laws and regulations.\(^\text{10}\) Especially in the oil industry, where there are high political risks for investors, governments provide stability through laws that establish the terms of the investment relationship and by setting up an administrative apparatus that oversees implementation.

Terms of an investment relationship are not shaped in a vacuum. Their formulation and implementation involve a political process in which winners and losers from foreign investment confront one another. Therefore, I argue that the stability and attractive attributes of the investment environment and, in consequence, the ability to attract foreign capital depends on two political variables: the degree of political competition and the strength of political institutions to mediate and resolve conflicts among competing groups.

The first variable, the degree of political competition, as measured by the number and strength of veto players, demonstrates the constraints imposed on the executive. Veto players are defined by George Tsebelis as “individual or collective actors whose agreement is necessary for a change of the status quo.”\(^\text{11}\)

\(^{10}\) United Nations Conference on Trade and Development (2003).

Veto players can include chambers of the legislature, various government ministries, military officials, courts, and regional administrative units. Depending on number and strength, they can oppose government policies and act as barriers to the formulation and implementation of investment terms. Tsebelis, for instance, finds that significant legislation is introduced in countries with one or few veto players more frequently than it is introduced in countries with many veto players. Applying a similar logic to natural resource development policies, Pauline Jones Luong and Erika Weinthal argue that the degree and form of international participation in an oil-rich country is particularly constrained by the level of ‘political contestation’ in the system.\textsuperscript{12}

\textbf{TABLE 1: FDI statistics for Azerbaijan and Russia}

<table>
<thead>
<tr>
<th></th>
<th>Total FDI\textsuperscript{1} (millions of $)</th>
<th>World FDI Rankings\textsuperscript{2} (out of 140 nations)</th>
<th>FDI in Oil\textsuperscript{3} (millions of $)</th>
<th>FDI in Oil / Proven Reserves\textsuperscript{4} ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AZERBAIJAN</td>
<td>3,787</td>
<td>3\textsuperscript{rd}</td>
<td>8\textsuperscript{th}</td>
<td>3,029</td>
</tr>
<tr>
<td>RUSSIA</td>
<td>21,524</td>
<td>108\textsuperscript{th}</td>
<td>104\textsuperscript{th}</td>
<td>3,228</td>
</tr>
</tbody>
</table>

\textbf{Sources:}
1. FDI Figures from UNCTAD 2002 Handbook of Statistics
2. This ranking is based on the FDI Performance Index (by UNCTAD World Investment Report 2001), which is the ratio of a country’s share in Global FDI Flows to its share in Global GDP. This ratio for Azerbaijan is 9.2 for 1994-1996 and 3.3 for 1998-2000. For Russia these ratios are 0.3 and 0.9 respectively.
3. Calculations based on the percentage of oil investment in the overall FDI provided by U.S. Energy Information Administration (EIA) Azerbaijan Country Report, and Foreign Investment Promotion Center under the Russian Ministry of Economy.

One missing element in both Tsebelis’s analysis of veto players and in Luong and Weinthal’s analysis of political contestation is the role of institutions

\textsuperscript{12} Luong and Weinthal (2001).
in structuring the interaction among veto players. Neither more veto players nor more political contestation necessarily means less policy stability or flexibility. In many “consolidated” democracies, political competition does not lead to unstable policy outcomes. Therefore, we also need to look at a second variable, the strength of mediating institutions, to understand the potential effects of veto players on policy making. Governments that need and favor FDI are faced with the task of managing opposition to their policies that regulate the financial, regulatory, and legal relations with the foreign investors. A stable and attractive investment environment depends on the degree of political competition in the system as well as the ability of a government to build and sustain bases of support (co-optation) and/or to cut opponents out of the policy-making process (exclusion).

I define such mediating institutions as political parties, interest group associations, and bureaucratic organizations that can aggregate different interests, form enduring coalitions, reconcile differences among veto players through negotiation, and reach compromise policy outcomes that ensure a stable investment environment. In addition to providing links between state and society, highly institutionalized political parties and interest groups serve integrative functions between branches of government and between central and regional/local governments. Not only do they provide formal channels of communication between veto players, they also facilitate bargaining and negotiation among them. These mediating institutions enable decision makers to co-opt veto groups into supporting government policies by creating new opportunities and incentives for them. Similarly, a centralized, hierarchical, and coherent bureaucracy can overcome divisions related to government policies by mediating between the branches of government, as well as between central and regional administrations. A strong and cohesive bureaucratic organization can also build coalitions among legislators and interest groups and provide decision makers with institutional mechanisms to reach policy equilibria. In sum, the strength of these mediating institutions is indicative of the capacity of the state to govern effectively at the intersection of domestic and international pressures.

Winners of FDI in the Developing World: Authoritarian or Democratizing Regimes?

The distinction between authoritarian and democratizing/hybrid regimes, in terms of level of political competition and strength of mediating institutions, is crucial in understanding the variation in the ability of oil-rich developing states to create a stable investment environment and thereby attract FDI. The characteristic that is common to all authoritarian regimes is limited political competition in the
Authoritarianism is a political regime characterized by a small number of individuals—either one leader/family, or one party—exercising power over the state but not simultaneously being constitutionally responsible to the public. There are essentially no veto players in the system to challenge the authority and policies of the rulers. This circumstance gives political leaders in authoritarian systems much greater insulation and leeway than their counterparts in democratic systems to develop policies to be imposed on the rest of the society. Especially when these leaders want/desire foreign capital, there is essentially no one who can stand between them and foreign investors. The groups in society who could oppose investment terms that disproportionately benefit foreign capital are either excluded from the decision-making process by force or are co-opted into government policies through specific benefits and rents.

On the other hand, hybrid regimes that are in the process of democratizing or are permanently stuck between authoritarianism and consolidated democracy can have numerous veto players who can challenge investment policies of the government. The lack of strong mediating institutions, however, leaves this kind of pluralism unchecked and unconstrained. The rulers are insecure because the electoral arena is a genuine battleground for power. Legislatures occasionally become focal points of opposition activity. In some cases, veto players are not limited to the legislature but are also seen in regional administrative units and bureaucratic agencies that pose significant challenges to government policies. In these settings, the weakness of conciliatory institutions is a detriment to coherent policy making and to working relations between the executive and legislative branches. Decision makers cannot overcome the opposition of the veto players by totally excluding them because the challenges tend to be both formally legal and widely perceived as legitimate. Moreover, decision makers cannot easily co-opt these veto groups because they do not possess the institutional mechanisms to build enduring coalitions and to facilitate negotiation and bargaining. Oftentimes the result is policy instability, deadlock, and— in most cases— chaos in the investment environment. Investors face arbitrary, conflictual, and aggressive investment terms that drive them away.

The emphasis on democratizing (hybrid) regimes as a distinct category from consolidated democracies reveals the qualitative differences among democracies in attracting foreign investment. Unlike hybrid regimes, where competition among veto players is unbounded and unchecked, consolidated democracies provide strong mediating institutions that can aggregate different interests into policy coalitions and establish mechanisms of negotiation and

14 For a further discussion on hybrid regimes, see for instance, Diamond (2002); Levitsky & Way (2002); Carothers (2002); Schedler (2002).
bargaining among them. The result is a stable investment environment in which investors feel that their investment contracts are sufficiently secure.

*Icon of Stability in Oil Investments: Production Sharing Agreement Regime*

Azerbaijan and Russia demonstrate that given similar attractiveness of resources and need for foreign investment, authoritarian regimes tend to be more capable than democratizing regimes in overcoming the veto power of opposition groups and creating an attractive investment environment. Their experience with the formulation and implementation of a specific oil-contract regime, production sharing agreement (PSA), best illustrates the role of political regimes in attracting FDI.

A PSA outlines the regulatory, financial, organizational, legal, and compensatory relationship between the investor and host government and, as such, is a good proxy for measuring the stability and attractiveness of an investment environment for the oil industry. The PSA regime— the laws, governmental regulations, and terms of these contracts— are seen by foreign investors as the principal mechanism for attracting foreign investment, especially in developing countries where the rule of law and institutions that can protect property rights are weak.

The most attractive characteristic of a PSA regime is the stability and guarantees it provides to investors operating in otherwise unstable, unpredictable market and political conditions. In marked contrast to a licensing regime, which gives the state discretion to change investment terms, under a PSA, the state is bound by the contractual obligations to the investor and is liable for breach of contract. 15 This is the nature of a civil relationship, where the parties act more or less as equals in a commercial context. In addition to leveling the legal playing field, the PSA also provides a stand-alone tax regime, in which the investor enjoys a predictable tax liability, which is completely independent of the general tax regime of the state. Therefore, replacing the existing tax regime with the PSA secures for the investor the stability of the investment regime over the term of the contract’s validity as well as an individual approach to particular projects.

Oil and gas explorations require huge capital investments in projects that may become profitable only after five or more years. Because the assets cannot be easily moved, foreign oil companies simply will not risk investing unless they have a reasonable level of comfort that the rules of the game and their projected profits will not unexpectedly change. Hence, the sine qua non of this type of

15 See for instance, Blinn (1978); Smith, & Dzienkowski (1989); Johnston, (1994).
contractual arrangement is the establishment of fiscal and legal stabilization of host country obligations.

Based on in-depth interviews with investors in the oil business and public officials in Azerbaijan and Russia, as well as an analysis of government proposals, legislation, and numerous oil contracts, I argue that the PSA regime that Azerbaijan’s authoritarian government set up in 1994 opened the way for significant flows of international capital. Russia, on the other hand, has been unsuccessful to date in bringing an efficient PSA regime into being, despite the efforts of PSA proponents. As a result, in the 1990s, Russia was not able to attract the much-needed foreign investment to develop the new oil fields that are essential for its future oil production.

**Comparison of Investment Environments in Azerbaijan and Russia**

Opening its oil industry to international capital in 1994, Azerbaijan immediately established terms of investment that were favorable to foreign oil companies. The government uses production sharing agreements (PSAs) and employs a flexible strategy whereby each contract becomes a law of the state and prevails over any existing or future law or decree whose provisions are in conflict with the contract. Each contract contains detailed stability provisions, assuring that the contractor’s rights and interests under the contract would not be subject to any change, modification, or restriction without prior consent by the contractor. These contracts also contain detailed arbitration provisions generally accepted in international practice.

Additionally, as opposed to standard tax and royalty schemes, PSAs provide mechanisms for rendering to the Azerbaijani state its share of profits, while allowing foreign energy companies to recoup their investments. Foreign participants recover their capital and operating costs in the form of a share of crude production at the beginning of the production cycle. The remainder of a field’s oil output is then split between the state and its foreign partners according to a formula agreed upon for each individual PSA. The only tax levied on the contractor is the profits tax payable at a fixed rate for each PSA. The contractor is exempt from all other existing or future export and import duties or taxes. These characteristics of the PSA regime in Azerbaijan have provided foreign oil

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16 Before 1994, the first democratically elected president of Azerbaijan, Abulfaz Elchibey, was actively promoting foreign investment in the oil sector. However, due to the war with Armenia over Nagorno-Karabakh and several coup attempts, all investment projects were suspended until after Heydar Aliyev came to power.
companies with a clear set of investment terms and thus substantially reduced the political risks of investment.

In contrast to their experience in Azerbaijan, foreign investors have faced many difficulties in Russia throughout the past decade. The legal system governing oil activities has been fraught with complexity and ambiguity. For a very long time in the early 1990s, the only regulated form of investment in the Russian oil sector has been joint ventures, which had to be granted a license to carry out oil development. The licensing regime raised many concerns for investors. For instance, licenses were subject to state legislative action that resulted in unilateral changes and modifications, without granting the foreign investor any ability to prevent or influence this process. The rules for the length, operation, or termination of the licenses governed by many of the laws were contradictory and vague. These impediments literally paralyzed the operations of foreign investors. Moreover, the legal hierarchy established under the Constitution of 1993 was unclear as to the distribution of authority between the federation and the subjects of the federation in which oil reserves are located. Investors struggled with cumbersome and restrictive quota and licensing requirements, only to be plunged into confusion when the restrictions were lifted with no documented procedures for equal access to overburdened pipelines. As a result many of the joint ventures closed and some Western companies left Russia. No major new foreign investment in non-PSA energy projects has been made for a long time. As a joint-venture senior executive told Reuters in 1999, “[T]he Russian government absolutely strangled the life out of every nascent joint venture right at the beginning.”

Given these problems with the existing legal and fiscal framework, the preferred form of investment in the petroleum sector soon became the PSA. Indeed, Russia is a textbook setting for PSA use. Russia is rich in hydrocarbon resources but in the 1990s it did not possess the financial and technical means to develop them efficiently. Moreover, as discussed, its tax and legal regime has been too unpredictable and burdensome to attract large-scale, long-term investments. The PSA law was meant to jump-start the oil and gas investment process by immediately establishing a special legal regime for oil contracts in an attempt to insulate investors from these risks. Despite the immediate need for and the continuing insistence of foreign investors on PSAs, however, adoption of the PSA law and the regulations necessary for its implementation have not been fully completed, even to this day. In fact, the creation of a stable investment environment for oil investors has been one of the fiercest political struggles that the new state had to go through in its first decade of existence.

19 Hober (1997).
20 “Firms wait on laws in Russia’s black gold rush.” Russia Journal (June 5 2000), p.64.
As one analyst has put it, the PSA story in Russia reminds one of Samuel Beckett’s famous play *Waiting For Godot*. In fact, many have tabbed the PSA process, “Progress Stalled Again,” alluding to the hurdles along the way since the lawmakers first began making provisions for it before the breakup of the Soviet Union. PSA was again on the agenda when Yeltsin proposed it as a presidential decree on December 24, 1993, and called on the new Duma to pass a law structuring a PSA regime. After intense struggles among adherents of different versions of the law, the lower house of the parliament-- the State Duma--finally adopted a draft law on PSAs on February 24, 1995, only to see it rejected by the upper house --the Federation Council-- on October 3, 1995. Intense debate led to several revisions of the draft PSA law, which finally came into force in January 1996.

Despite the adoption of the PSA law, foreign investors still did not deem the investment environment stable enough to initiate projects. Exxon released a statement stating that the law “will not provide the stable foundation upon which the legal framework required to attract foreign investments can be developed.” A Texaco spokesman concurred, “[I]t is not a law that you can depend on in terms of your exports, your tax rates, your ability to gain a reasonable economic return.” The reasons for the stalemate were the shortcomings of the core PSA law, on one hand, and the conflicts between the law and various subsoil use, tax, customs, and foreign trade laws, on the other hand. The core PSA law was not consistent on key contractual issues, such as the priority of civil law arrangements, the transfer and pledge of PSA rights, and dispute resolution. A last-minute amendment to the draft PSA law that imposed broad legislative approval requirements also caused concern among foreign investors. Moreover, the provisions regulating the export of oil production and taxation significantly circumscribed the activities of foreign companies.

Given these drawbacks in the final version of the core PSA law-- except for the three PSAs that had been signed before adoption of the law and that were grandfathered in when the law took effect -- no other oil project gained any momentum. The investors demanded further amendments, including elimination or curtailment of the role of the legislature and resolution of fundamental conflicts with other laws. The investors also asked for detailed government regulations related to taxation, determination of recoverable costs, accounting, and other matters. It had taken almost three years and much arduous debate before the basic PSA Law became effective in January 1996. Even so, it was only a first step. Still ahead lay the task of providing the list of fields to be developed under PSAs as well as the amendments and enabling legislation that would allow the basic law to

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21 Yermakov (2002).
22 Senecal, & Daly, (1996).
23 These PSA projects were Sakhalin I, Sakhalin II and Kharyaga.
operate. After another three years of fractious debate, the Federal Law on the Introduction of Amendments and Additions into the Law on PSA was finally signed on January 14, 1999.

The amending law resolved some of the uncertainties for foreign investors, but also introduced unwelcome new requirements and restrictions. Additionally, the so-called Normative Acts (detailed government-level regulations to implement the PSA Law), which have been circulating in various draft forms over the past years, remain to be finalized and adopted. These important acts were expected to be the responses to gray areas and gaps having to do with such fundamental matters as taxation, accounting, cost recovery, and supplemental procedures for tenders and fore entry into PSAs. For instance, the tax code’s PSA chapter is of paramount importance because it is the single most critical guide for Russian tax authorities on the specifics of PSA taxation and cost recovery. But, the latest proposal by the Finance Ministry relative to the draft tax code chapter on PSA further complicates tax terms and the stability of future agreements and would make it impossible for investors to conduct business. Finally, some of the amendments signed into law in June 2003 greatly complicate the procedure for qualifying a project for PSA status.

Russia now has a PSA law that was twelve years in the making. However, Russia does not have an effective PSA regime as of yet. In the nine years since the passage of 1996 PSA law, twenty-eight fields have been put on the list of PSA projects, but none, other than the grand-fathered three projects, has been in effect. Total investment in PSAs between 1993 and 2000 reached only $1.5 billion. This was not even close to what was actually required to develop the industry. The struggles over the PSA regime conservatively cost the industry billions of dollars in capital investments; the state lost revenues in tax collection, and missed opportunities to create much-needed employment.

**Why the Political Regime Matters**

This stark difference between the ability of Azerbaijan and of Russia to create an effective PSA regime for foreign investors can also be explained by

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24 Specifically, the amendments introduced quotas: 30 percent on the reserves that could be subject to PSA, 70 percent on the value of goods and services that must be purchased from Russian suppliers, and 80 percent as the minimum labor-force quota for Russian nationals.

25 Article 2(4) of the PSA law now requires that in order for a field to qualify for development under a PSA, the government must have been unable to interest investors in its development under the license/tax regime as evidenced by the absence of bidders in a tender for a license. In other words, this amended PSA law requires that the government exhaust all other alternatives before using a PSA.

26 Amirov (2000).
many structural and geopolitical factors. For instance, many emphasize Russia’s cultural uniqueness and its particular history in explaining the inhospitable attitude towards foreign initiative.\textsuperscript{27} The late and partial development of Russian capitalism, the weakness of the pre-Revolutionary middle class, and the indoctrinization of seventy years of Soviet rule are said to have left Russian citizens distrustful, individualistic, unconcerned with profits, and hostile toward private, especially foreign enterprises. In the extractive industries particularly, it is argued that a residual Marxist mentality engenders a zero-sum game orientation to joint projects, whereby any profit transferred to a foreign company is viewed as a direct loss to a corresponding Russian firm. In addition, others argue that the country’s large size has created a more self-sufficient, inward-looking economy with little incentive to open up to the outside world. The managerial structure of the oil industry inherited from the Soviet era has also entrenched domestic groups (i.e. domestic energy companies) that significantly resisted any foreign involvement. According to this view, these cultural and geographic features politicized investment issues in Russia, produced severe confrontation between opponents and proponents of foreign investment, and created an unstable policy environment.

In contrast, in explaining the success of Azerbaijan in creating a stable and attractive environment, many emphasize Azerbaijan’s geostrategic objectives. Accordingly, in order to bolster its sovereignty and independence from Russia, and win international recognition for the conflict over Nagorno-Karabakh, Azerbaijan created the best possible terms for investors. To these ends, it also allowed a wide array of foreign companies to be included in the oil projects. In Russia, on the other hand, the waning of superpower status produced a sense of national vulnerability. This increased the sensitivity of Russians to any type of foreign interference in the country’s political and economic affairs. “Russian pride” stemming from many years of international power is seen as one of the main factors in explaining the hostility towards foreign enterprises and thus domestic opposition to FDI among some groups.

These structural and cultural factors elucidate the constraints and challenges that these states face. However, they do not by themselves explain the conditions under which a favorable investment environment can be created. Not only are these explanations deterministic, but they also cannot explain the existence of different interests, how interests change over time, and what policy outcomes are derived as a result of their interactions. Hence, these explanations tend to ignore how domestic politics constrain economic policy and shape state responses to the external environment. They too readily assume that states are unitary actors and that there is consensus about how they should behave. Given

\textsuperscript{27} Dyker (1995).
the political debates and struggles over the investment policies in both of these countries, there are many limitations to making generalizations based on culture, ideology or size of country. These factors may perhaps be used to explain the preferences of certain groups in countries, but they do not explain the outcome of conflicts among these groups. In each country, there have been many losers as well as winners from investment policies formulated to attract investors.

Politics and political institutions, instead of underlying cultural and structural considerations, have been more influential in shaping states’ responses to foreign investors. The issue has not been the existence or absence of the will to adopt investment-inducing policies, but the ability of pro-investment groups to do so in the face of opposition. This paper makes the argument that the political regime—the number of veto players and the strength of mediating institutions—that shapes investment relations between host governments and foreign oil companies has significant implications for the development of oil resources as well as the management of the oil wealth in the future.

**PSA in Azerbaijan: “One-stop shopping”**

Given the importance of oil for Azerbaijan, it is not surprising that foreign investment and politics are closely linked. Institutionalized competition for power and influence in the Azeri political system is limited. State power has been concentrated around President Heidar Aliev and, since October 2003, his successor and son Ilham Aliev. Even though the veto powers of the legislative and judicial branches of the government are recognized in the Constitution of 1995, in reality they are subordinate to the president. Policymaking is a presidential domain and only his close advisers and aides participate in decision making. An extensive network of patronage, the most prominent recipient being the regional tribe from Nakhichevan, generates unquestioned loyalty to the president and his regime. In return, these supporters are given preferential contracts, tax exemptions, or promotion to profitable positions. Especially close family members secure prominent jobs. For instance, Heidar Aliev’s two brothers and his son, Ilham Aliev, were in the political council of New Azerbaijan Party (NAP) and his son, before he himself became the president, also served as the vice president of the state oil company (SOCAR). A sultan-like cult has been built around him, with numerous portraits in public places and adulatory commentaries in the official media. Such organization of autocratic power brings the Azeri system close to what Linz and Stepan call a “sultanistic regime.”

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29 Akiner (2000).
30 Linz, & Stepan (1996).
The absence of institutional mechanisms to check and balance the powers of the president creates an accountability deficit in Azerbaijan. The ruling elites are able to negotiate investment contracts with the utmost flexibility, bypassing any potential opposition to the attractive terms they offer to investors. The situation can be thought of as a “one-stop shopping” for investors who have easy and direct access to a few concentrated elites. A close look at the structure of the oil industry and PSA regime of the Azerbaijani state in the 1990s clearly delineates the relationship between the investment environment and the authoritarian regime.

The mechanisms for controlling Azerbaijan’s oil sector have been tightly clustered around the president. Based on a presidential decree dated September 13, 1992, SOCAR maintains a near-monopoly over the management of the oil industry. Even though SOCAR has many departments and an extensive organization, only three men directed most of its affairs in the 1990s: SOCAR President Natik Aliev, SOCAR Vice President Ilham Aliev and Valekh Alekperov, director of SOCAR foreign relations department. The president of SOCAR acts as a minister reporting directly to the Azeri president. Between these three actors and Heidar Aliev, top-level decisions were made without regard for the formal government hierarchy. “Potentially powerful state bodies such as those involved in investment activities, privatization or regulatory duties have proven incapable of either diminishing SOCAR’s hold over the industry or of extending their influence into this lucrative sector.” 

The proximity of SOCAR to the heights of political power has precluded possible administrative turf wars and helped the Azeri government design and implement oil contracts in a timely and efficient manner.

Using his overarching control of the oil industry, Heidar Aliev, personally presided over the PSA process in the past decade. Without his initial consent, negotiations between foreign companies and SOCAR could not begin. Once his consent was given, the three SOCAR officials and foreign company representatives could negotiate on the terms of the agreement. When they reached an agreement, the presidential approval was again needed before the contract could be sent to the parliament for ratification. Meanwhile, for a technical, legal, and “grammatical” inspection, the draft would be sent to the Petrochemical Department of the Government, which collaborate with legal and tax advisers. There except for some typographical corrections, nothing actually would get changed. The only real contribution of this department was the signature of its chairman on a statement of “government guarantees,” already designed by the

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32 Author’s interviews with Unal Bayram (Project Manager, MOBIL) and Vitaly Bagliarbekov (Deputy General Manager, Foreign Investments Division, SOCAR ), Baku, 2 July 2 1999.
president beforehand. After this procedure, the president would send the document to the parliamentary Commission on Mineral Resources, Energy, and Ecology the day before the ratification session in the parliament. The commission would spend about half an hour- at most an hour- on the draft. Without making any changes, the chairman of the commission and the head of SOCAR Foreign Investment Department would give a briefing to the parliament on the terms of the agreement and within a short time the deputies would be asked to vote yes or no on the draft proposal. The parliament, irrespective of the Constitution, exercised virtually no oversight. Not even once has it rejected or even returned for review an oil contract put before it. After ratification by the parliament, the contract would return to President Aliyev for final approval and then would become law when he signs and officially declares it. As it is, the procedure was set up so that nobody except for the president and three SOCAR officials would have input in the decisions.

The absence of strong and relatively autonomous state institutions in Azerbaijan has been seen as a blessing for foreign investors. SOCAR’s dominant position and direct relations with the president make it a favored negotiating partner for oil investors. During negotiation and implementation of contracts, foreign investors feel no pressure to defend their intentions to opposition parties or interest groups. Meanwhile, despite their many concerns with the format and content of the oil contracts, opposition groups have no say in the decision-making process, nor can they pressure the government or the foreign companies. The informal distribution of political power gives ruling elites the incentives and authority to exclude opposition groups and to co-opt others through patronage networks. As a result, foreign investors are satisfied with the simple power structure and absence of institutional opposition to contracts. They know where the political power resides. This knowledge assures them that as long as they have access to these few elites, their interests will be protected. The PSAs, as one

33 Author’s interview with Rasim Dadasov (head of the Petrochemical Department in the government) Baku, 3 July 1999.
34 Author’s interview with Asia Manafova (chairwoman of Mineral Resources, Energy, and Ecology Commission in the parliament), Baku, 8 July 1999.
35 Author’s interview with Nazim Imanov (opposition National Independence Party deputy), Baku, 7 July 1999.
36 Author’s interview with Magerram Zulfugarov (National Independence Party official) Baku, 3 July 1999. She further depicted the parliament as “a branch of the president.”
37 Author’s interview with Sulhettin Akperov (opposition Musavvat Party official) Baku, 5 July 1999. He indicated that the contracts given to deputies are not the same as the original contracts. They are either a very short version or a narrowly selected part.
38 Author’s interview with Fred Marshall (Government Affairs Manager, EXXON), Moscow, 6 July 1999. He further stated that as a foreign oil company, Exxon does not have much of a relationship with the parliament and opposition parties. He commented that as a commercial entity, Exxon tries not to become involved in politics and take sides.
company representative put, provide them with “a suit of armor in terms of being able to walk through what would otherwise be dangerous and difficult.” Even though foreign companies assert that they have no regime preferences in the countries in which they invest, they nevertheless have not denied having had very good relations with Heidar Aliev and found him to be a “very smart and far-sighted individual.” Despite irregularities in the 2003 presidential elections, foreign oil companies, as well as foreign governments, have been supportive of the new president, especially after receiving assurances that all contracts and commitments under Heidar Aliev would continue to be honored.

**PSA in Russia: “Progress Stalled Again”**

In contrast to the authoritarian regime in Azerbaijan, during 1993-2000 Russia was a struggling quasi democracy. It has had many components of democracy, such as regular elections and free competition, but failed to approximate a consolidated democracy. This is why many scholars have labeled it “low-caliber democracy,” “bureaucratic quasi-authoritarianism,” “electoral democracy,” “unconsolidated democracy,” or “hybrid regime.”

Unlike in Azerbaijan, some political competition has been allowed in Russia in the past decade. Both houses of the legislature have become significant institutional veto players in the system, oftentimes blocking and constraining the policies of the executive branch. Nonetheless, despite a certain degree of pluralism within the state, institutional mechanisms of conflict resolution, such as strong political parties, institutionalized interest groups, and a coherent bureaucracy, were still painstakingly absent.

Given this institutional mix and the enormous stakes involved in controlling oil resources, the PSA issue immediately became known as a “political football.” Promoting and controlling PSAs was politically attractive. At the federal level, the executive and legislative branches have been locked in a battle for political authority, and the government itself has had to fight, often in vain, to assert its control over semi-independent administrative agencies. Moreover, the federal government and the regions clashed over resource ownership. A detailed analysis of the PSA politics demonstrates the damaging effect of partial democratization on the ability to create a stable, attractive investment environment.

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39 Author’s interview with Peter Henshaw (BPAmoco Vice-President, Government and Public Affairs), Baku, 20 July 1999.

40 fn.37.

41 Fish (2001); Shevtsova (2001).
The initial government draft law on PSAs encountered significant opposition in both houses of the Russian parliament because it would involve a transfer of regulatory power in the other direction, away from the legislative branch (which was responsible for defining license-issuing procedures under the Natural Resources Law) to the executive branch, which would be responsible for negotiating the conditions of PSAs with investors. Especially, the leftist factions in the State Duma had problems with the clauses on the contractual nature of the relation between investors and the government, international arbitration, and the royalty system of payments. The veto power of the legislative branch over the creation of the PSA law and over the approval of each field to be put under a PSA have created major obstacles for foreign investment. The reluctance of both houses of the legislature to relinquish the regulatory power, which they have long enjoyed, has been effective in delaying the PSA law.

The tendency of the upper house, the Federation Council, to challenge the legislative authority of the lower house has also exacerbated the PSA legislative impasse. Members of the council on many occasions utilized their constitutional powers to veto PSA legislation in fear that it would limit the prerogatives of regional governments and impose financial obligations on them. For instance, one challenge came during the deliberation of the PSA draft law in 1995. Even though the council favored the concept of PSA legislation, it opposed the simplified tax plan contained in the draft. The provision, according to the regional and local government leaders, limited their ability to collect taxes from PSA projects within their jurisdictions. Because the draft law undermined the lengthy tradition of unlimited state control of Russia’s natural resources, it faced opposition from several factions within the council. Moreover, a powerful group of regional senators representing the interests of heavy equipment manufacturers in their region also opposed the terms of the PSA draft law. Burdened with a glut of outmoded and financially struggling manufacturers, they fiercely lambasted the draft law, demanding guarantees that domestic enterprises receive as much as 70 percent of the orders for equipment required for use under PSAs.

Even though partial democratization in Russia empowered the state veto players, it failed to provide strong institutions of conflict resolution. Bureaucracy is one such mediating institution. Rather than mitigating conflicts of interest between the executive and legislative branches, the bureaucracy at both the federal and regional level, was dragged into severe infighting and became a notorious barrier to creation of an effective PSA regime. There has been a covert struggle within the government over control of PSAs since 1993 because PSAs directly affect revenues on which all parts of the government depend. The whole subject became a “talking shop”; proposal after proposal was drafted and then argued about among the Ministries of Fuel and Energy; Finance; Economy; and Natural Resources without developing a common, constructive approach.
Ministers and top civil servants have been continuously reshuffled making it difficult to consolidate any position.\textsuperscript{42} This zigzagging of power at times brought policy deadlock and passivity within the federal government.\textsuperscript{43}

Not all departments and agencies of the government have been similarly interested in creating an attractive foreign investment climate. The Finance Ministry, the Ministry of Foreign Economic Relations, and the Customs Committee, for instance, for a substantial period regarded PSAs as simply income flowing into the federal treasury and imposed heavy tax burdens without taking into consideration their long-term effects on foreign investment. These entities also feared the fixed terms of the PSAs, which had the potential to lessen their control of oil revenues. The Geological Associations (represented by the State Committee on Underground Resources, Roskomnedra) were equally against the PSAs because they feared that the licensing process over which they have significant control would be bypassed and made null by the PSA regime. On the other hand, government agencies responsible for long-term economic development, such as the Ministry of Fuel and Energy, the Committee for Foreign Investments, and the Ministry of Economics, were supportive of PSAs. The differences in bureaucratic priorities and the competition for control and resources among various government bureaucracies has been the main reason why the enactment and implementation of PSA legislation have been obstructed by the government for so long. “The interests of government officials and agencies were best served not by laws which outlined their powers and responsibilities in a very precise way, but by a system in which they enjoyed as much freedom as possible to enter into negotiations with individual clients, to request certain kickbacks and bribes in return for particular favors.”\textsuperscript{44}

The stalemate over the PSA regime within the federal bureaucracy has also been exacerbated by a challenge to the federal government by the regional administrations. The Article 72 of the Russian constitution invests the regional governments with joint jurisdiction (alongside federal authorities) over the underground resources in their regions. Because of the two-key system, which requires that investors negotiate PSA contracts with both the regional governments and the Ministry of Fuel and Energy, the regional governments have been pivotal in the signing and implementation of the contracts. Although some, such as the Sakhalin administration, have been strong advocates of PSA contracts, others, such as the Nenets Autonomous Okrug, have been opposing them and obstructing attempts of foreign investors to initiate their development projects.

\textsuperscript{42} Part of this reason was certainly the legal vacuum that provided no clear guidelines as to how government agencies should act.
\textsuperscript{43} Author’s interview with Anatoly Averkin (analyst in PriceWaterHouseCoopers and advisor to the Duma), Moscow, 13 April 2001.
\textsuperscript{44} Watson (1996), p. 440.
Moreover, even though the Constitution grants them no rights relative to underground resources, some municipal governments have used independent taxation powers granted to them by presidential decree to exact additional revenues from foreign investors. Even if investors have managed at times to win exemptions from such taxation, municipal authorities exercised control of utilities and their influence with the local population to extort payments from foreign investors.45

In addition to the lack of coherence within and between the central and regional bureaucracies, societal interest groups have had few institutional mechanisms to mobilize their interests into voting as a bloc and to exert influence on PSA policies. Groups that could have benefited from PSA projects could not constrain the jurisdictional power struggles between the institutions of the state. Considering the impact of PSAs on many interest groups, the absence of such societal pressure has further contributed to policy deadlock and instability. PSAs were considered especially beneficial to established communities in regions experiencing hard times. They not only serve to preserve existing jobs in the old oil towns but also create new ones in new oil fields.46 Moreover, the domestic-content requirements in PSAs can in the long run serve to improve local industries and subsequently bring significant amounts of welfare to the regions. Despite the potential benefits from PSAs, interest groups such as worker unions and industrial groups could not pressure the state into making the investment environment more attractive for foreign investors.

In some ways, the oil lobby was an exception to this rule. The Russian oil elites were able to influence investment decisions to a certain extent by means of their interest organizations and political connections. One example of this was the Our Home is Russia party, led by Chernomyrdin. This party was, in fact, called “Our Home is Gazprom,” for it was seen as representing the interests of the energy lobby and the financial corporations associated with them.47 The Ministry of Fuel and Energy also articulated the interests of the oil industry. The careers of ministers like Vladimir Lopukhin and Yuri Shafranik were closely tied to the industry and, in consequence, they were supporters of industry interests in the government. The Russian oil companies had direct access to the government and strongly affected the appointment of some cabinet members. Many midlevel

46 Typical Russian oil towns that were built next to an oil field and populated by immigrant workers from other provinces are entirely dependent on the viability of local oil production. If a field closes, authorities face imminent mass unemployment and the evacuation of hundreds of residents.
47 Rutland (1997).
government officials were paid by oil companies to promote the companies’ interests.48

Even though the oil lobby had some success in eliciting support for its interests, it lacked the organizational and ideological unity that would enable its acting as a strong interest group. The Russian oil companies did not have a uniform influence on policies relating to foreign investments. The most important form of lobbying has been conducted through informal personal contacts between oil directors and government bureaucrats and deputies in the parliament. The lobbying process was highly opaque and fragmented. Organized groups have been created, such as the Union of Oil Industrialists and Entrepreneurs, the Union of Oil Exporters, and the House of Oil but their influence generally has been weak and sporadic. Moreover, support for the oil industry in the government was only conditional. The role of the oil companies in using the Ministry of Energy to express their views depended on the issue and changed over time.49 The ministry also had its own agenda: to maintain its supervisory functions. It was not always considered captive to company interests.

Last, Russian oil companies’ attitudes toward PSAs were mixed. In the early years of the Russian Federation, many were wary of entering into partnerships with foreign companies on an individual basis. Prior to partial privatization, the position of the heads of large oil production associations- the “oil generals”- were very insecure and believed that partnership with a foreign company would be more hindrance than help because it would bring increased publicity and more fiscal demands from central and local governments. Overall, companies had no tradition or mentality of partnerships, even with other domestic companies.50 They did not want multibillion-dollar PSAs on the books, driving the prices up. They had short-term concerns and priorities; planning for the long-term performance of the industry was not on their agenda. As Russian banks gained more control of the oil industry, the short-term profit motive of the industry was reinforced. With access to bank capital, domestic companies did not see the need to attract foreign investors.

Some of the domestic companies have been trying to limit foreign investment because they feared the advantages that projects involving foreign investment enjoy over Russian producers and fear the competition for export capacity. More importantly, the companies have been more interested in empire

48 Author’s interview with Alexander Misulin (head of the Department of Foreign Economic Relations in the Ministry of Energy), Moscow, 17 May 17 2001.
49 Lane (1999).
50 Author’s interviews with Mikhail Subbotin (Adviser to the government), Moscow, 19 April 2001, and with Valeriy Ovcharenko (Conoco), Moscow, 16 April 2001. Mr. Ovcharenko further argued that this lack of trust in partnerships was a legacy of the command economy in which companies were always competing for funds and equipment but not for profit. If the end goal had been profit, these companies would have engaged in a win-win situation by forming partnerships.
building or exporting their capital than in investing in renewal of their assets or in restructuring their operations. In the beginning, then, most Russian companies were very reluctant about PSAs. They were not necessarily always against them but they were not always for them either. It was just that the companies lived quite well under the existing system. They knew how to maneuver, how to influence, and whom to influence.

Over time, however, the former corporate unity of the Soviet oil elite was weakened by the appearance of outsiders in the top echelons of administration. Increasingly, bankers and financial dealers were recruited to the boards of directors. This change in management structure has made some companies more open to foreign investment. As operations grew and the geographic span widened, some companies became less locally based and more nationally oriented with headquarters in Moscow. Such companies made significant progress in the lobbying for the full-scale introduction of PSAs in 1998-2000, but their support was conditional. They were in favor of PSAs when the price of oil dropped, costs were high, and alternative financing was unavailable. On the other hand, when they could finance the projects themselves or through lending, they did not lobby for PSAs.

Finally, political parties could not establish institutional links between different interest groups and state actors. They could not adequately aggregate interests into majority coalitions in the parliament. They often voted as a bloc for or against PSA legislation, but their positions depended more on the institutional balance of power than the interests of their constituents. Business groups have contributed to political parties and parliamentary factions, but no clear pro-business party organization has emerged. As a result, Russian parties could not provide the representative and integrative functions that are expected of strong parties. The lack of integrative and conciliatory institutions left ample room for jurisdictional struggles with one another.

To sum up, the PSA process failed in Russia in the 1990s because of the weakness of the democratic regime that gave formal veto powers to opposition groups without corresponding institutions that could mitigate conflicts and keep state actors checked. The pluralism within the state in the absence of mediating institutions, such as a coherent bureaucracy, strong parties, and interest groups led to intense struggles over oil policy. All of these struggles hindered the

51 Gustafson (1999).
52 Author’s interview with Alexander Strugov (director of the Center for PSAs in the Ministry of Natural Resources), Moscow, 18 April 2001.
53 Author’s interview with Anders Morland (BP), Moscow, 3 April 2001.
54 Author’s interview with Alexander Levshov (Statoil), Moscow, 14 March 2001, and with Dmitri Zhdanovich (Surgutneftegaz), Moscow, 9 April 2001.
development of a coherent legislative and regulatory framework as well as the implementation of these rules for the oil industry.

**Oil Investments in Norway: The ‘Magic’ of Institutionalized Competition**

The importance of mediating institutions in overcoming the challenges posed by many veto players in a democracy can best be demonstrated by a discussion of another oil producing country, Norway, which provides an interesting contrast to the Russian case. In the 1990s, while Azerbaijan and Russia were competing to attract foreign investment, Norway, was being commended in policy and academic circles as the example of a successful oil producing state. Starting its oil development in the late 1960s, early 70s, during a tough period for the oil industry around the world, Norway was able to attract significant amounts of foreign direct investment in its oil industry and then use these resources to build national competence in oil and meet the welfare demands of Norwegian society. From 1971 to 1996, a total of $200 billion was invested in exploration, construction, and operations on the Norwegian continental shelf. Calculations based on FDI figures from UNCTAD Handbook of Statistics show that Norway received 92 cents of foreign investment per barrel of its proven oil reserves between 1994-2001. In the recent years, Norway has been sharing its experience of oil development with other oil producing countries, especially with Russia and Azerbaijan. Norwegian delegations of oilmen have been frequenting Baku and Moscow, giving advice to governments and oilmen about how to successfully operate partnerships with foreign companies and how best to use their oil revenues.

In 1960s, having no geologists, petroleum economists or lawyers specialized in petroleum issues, Norway needed foreign expertise and risk capital to share the burdens and costs of exploration and extraction of oil under the North Sea. Already in 1965, the government passed a Royal Decree, which formulated a concessionary oil agreement model with administrative allocation of licenses. In this “North Sea model,” instead of signing a civil contract with investors, as in a

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57 This type of administrative licensing was first used by Norway and U.K. in the 1970s and is known as the North Sea Model. With strong state traditions but with equally strong need for foreign investments, these countries elaborated this model of oil resource management to accommodate company interests under public control. The advantage was the access to the experience and technology of foreign partners without totally giving in to their demands. To offset the domination of foreign companies, these governments created a web of legal and financial
PSA, the state entered into negotiations with oil companies for exploration programs, and for commitments attached to licenses. The licenses were granted by an administrative procedure, in which the state chose companies according to specific criteria. General standards of treatment, such as dispute settlement mechanisms, expropriation, repatriation of funds, work programs etc. were embedded within these licenses.

In line with unprecedented growth in the bargaining power of host governments during the 1970s, the Norwegian state retained full control over the development of oil resources, and at times imposed relatively less favorable tax and regulatory terms upon foreign investors. These policy changes in the 1970s and early 1980s reduced the profitability of some oil projects but were never regarded as posing political risks for foreign investors. The stated principles of the legal and administrative framework of the oil industry remained intact throughout the whole period and there were no uncertainties about the rules of the game. No major changes were made in the principles, rights, and obligations of state institutions and the oil companies.\(^{58}\) Investors were provided with enough legal and fiscal guarantees to function satisfactorily in Norway at a time when their interests were being systematically compromised elsewhere in the world.\(^{59}\)

By the mid 1980s, when oil prices collapsed and competition for investment intensified, the Norwegian government adjusted the economic terms of their relations with foreign companies. For instance, in 1986 the Norwegian state initiated a tax reform by which the government take was reduced considerably. At the same time that it was responsive to the interests of foreign companies, the Norwegian state also continued to pursue goals such as the geographical and social distribution of offshore activities, prevention of major accidents or negative side effects like harm to fishing grounds. As such, the Norwegian state was able to strike a balance between the interests of the foreign investors and domestic groups and ensure investment regime’s stability. Consequently, despite difficulties in working in one of the world’s harshest exploration areas, major foreign companies from all around the world continued regulations in order to capture a given part of the rent and in order to influence the micro-economic behavior of foreign companies.

\(^{58}\) Author’s interview with Oystein Noreng (professor and oil analyst in the Norwegian Business School) in Oslo, Jan. 22, 2001.

\(^{59}\) Author’s interview with Willy Olsen (Statoil) in Oslo, Jan. 20, 2001. The 1970s represent a period in international oil markets when most host governments increased their assertiveness and sought for a greater share of profits, more restricted areas with expedited exploration schedules, provisions for periodic surrender of portions of the granted area, and commitments to train personnel in the related skills and technology. Countries in the Middle East and other OPEC countries turned to nationalization at the end as a means of regaining control over their resources. North Sea countries, Norway and UK stand out in this period as providing a less assertive environment for foreign investors.
to invest in oil projects in Norway. The stability of the policy environment became an argument for oil companies to accept the terms offered, even when these terms became less favorable.

What explains the success of the Norwegian government in providing such a stable and reasonably attractive investment environment even though the competition over the oil policy has been as acute as (if not more than) the one we witnessed in Russia in the 1990s? The answer lies in the institutionalized competition that the Norwegian democracy has produced. Just like in Russia, there are many veto players that participate in the Norwegian policymaking process. For instance, the parliament - comprised of strong, coherent parties - acts as a significant check on the executive branch. Regional governments and legislatures exert further constraints on the government. Even though Norway has a unitary political system, power is dispersed geographically. The political system has three levels: the national level with the national assembly and state bureaucracy; a regional level with democratically elected assemblies and regional bureaucracies; and local level municipalities with their own political assemblies and bureaucratic administrations. Finally, in addition to government ministries, numerous parastatal organizations with different agendas and interests create a highly competitive policy environment.

Despite this high degree of pluralism, however, the existence of strong and coherent parties with close links to constituents has given the Norwegian decision-makers ample opportunity to reconcile conflicts of interest among veto players. An extensive corporatist structure and a strong centralized bureaucracy have further mitigated collective action dilemmas by institutionalizing bargaining and cooperation among various societal interests, such as environmentalists, labor unions and business groups. The resulting balance of power moderated radical opposition to government policies by emphasizing consensus building and co-optation. The stability needed to attract foreign capital was derived from the negotiations and compromises made among veto groups.

The debate over the depletion policy (the rate with which oil is to be extracted) demonstrates one of such compromises made by the Norwegian government to co-opt different veto players into investment policies aimed at attracting investors. This policy is crucial for shaping the bargaining position of the host government in relation to foreign companies. After the Labor Party returned to power in 1973, it presented two White Papers to the parliament in 1974 regarding a new concession policy and need to control production volumes. The parliamentary report of Petroleum Industry in Norwegian Society recommended a restrictive approach to oil, emphasizing the need for a moderate

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60 A government opting for a high rate of production can be exposed to the demands and needs of foreign companies controlling the technology than a government opting for a low rate of production.
rate of development and the need for public control over important aspects of the oil industry. A moderate rate of development was seen as a level of production of approximately 90 million tones of oil equivalents per year. There were long debates in 1974 over concerns about the inflationary pressures and structural change that might result from too much oil revenue. Hence, controlling production volume became essential for avoiding the economic and social consequences of the ‘Dutch Disease’ in Norway. There were also concerns that necessary adjustments in sectoral and regional distribution of employment as a result of this policy would threaten the Norwegian style of living. Even though the parliamentary report assigned a role for foreign oil companies, it recommended an increasing and progressive system of state participation in oil production.

This depletion policy was however opposed from several quarters. Interests that might have profited from a higher rate of production and a greater role for private enterprise felt cheated. This included private banks, private oil companies-both domestic and foreign- and the private ship owners who had invested heavily in drilling rigs. The Norwegian Ship Owners’ Association accused the government of unduly politicizing the oil issue by using the oil revenues to turn Norway towards socialism and undermining confidence in private industry.64

The government, however, was also subject to counter-pressure from a wide range of interests fearing a rapid pace of oil development. These interests included fishing, agriculture, many smaller enterprises, labor-intensive industries fearing a high cost pressure, and many wage earners fearing inflation and a more unequal distribution of income. Many of these groups thought that the level of production for foreign oil companies was too high. The Socialist Electoral Alliance, for instance, claimed that a lower rate would be more environmentally responsible, would cause fewer disruptions in Norwegian society and would preserve the country’s sovereignty over its resources by not trying the country too closely with the West.65

Another interest group that was adversely affected by oil production was the fishing industry. By 1970, 40 percent of Norwegian fish was coming from the North Sea, but about 50 percent of the Norwegian shelf south of the sixty-second parallel was in various stages of oil and gas exploration. Fishing suffered from operational interference; nets were damaged and navigation was impeded by oil

63 Dam (1976), p.66.
activities. By 1975-76, southern fishermen had responded by organizing politically. To reduce the opposition of this domestic group to oil development projects by foreign and domestic companies, the government began granting compensation for gear damage through the Directories of Fisheries. The total amount granted by August 1977 was $1.67 million. The strength of these interest groups forced the government to respond to their interests. To enlist the support of both sides in the depletion policy, the government co-opted them through compromises.

The debate over depletion policy did not end there however. In 1971, the government had established the north of the sixty-second parallel as the northernmost limit for oil licensing because Norway, Britain and USSR at the time had disagreed on how to divide rights above that line. In mid 1970s, however, oilmen, backed by the Conservative party and a coalition of construction, shipbuilding industries, southern labor union groups and foreign companies pressed for northern licensing. The coastal counties Nordland, Troms and Finmark also stood to gain from the activity off their shores. They argued that more drilling would increase the rate of oil production and economic growth, provide more jobs, and increase government revenues. Opposing these demands for oil production above this northern line, northern fishermen represented by the Ministry of Fisheries joined environmentalists and liberals lobbying in the Parliament to prevent future northern oil operations. Also supported by the Agrarian, Christian and Socialist parties, this “Green Opposition” called attention to oil spills, damage to the fishing industry, and changes in the economy and lifestyles in the region.

Once again a compromise was reached. The “Northern fishing industry had pivotal political clout because fishing communities in the North controlled two seats critical to the Labor party’s parliamentary majority. These fishing interests threatened to shift the Socialist votes of northern fishermen if the Labor government, which was supported by the Socialists in the Parliament, allowed drilling north of the sixty-second parallel.” The debate in the parliament in the early summer of 1974 showed that the government was ready to strike a balance between opposing groups. As a compromise, the government in 1977 required the foreign oil companies to develop oil related support and service industries onshore. Moreover, it required that oil companies finance the cleanup of the seabed. In fact, Norway became the first North Sea country to introduce requirements for oil companies to avoid pollution and damage to marine life. In

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66 According to Noreng, experiments indicate that oil has a fairly lethal effect upon plankton, fish eggs, larvae and shellfish. Because oil is lighter than water, it spreads over a large area quite quickly and can be taken by currents towards the large fishing areas off northern Norway.


68 Ibid.
return, the labor organizations of two northern fishing counties, Troms and Finnmark, decided to support northern drilling but at a much slower rate.\textsuperscript{69}

As this example also clearly demonstrates, since the discovery of the Ekofisk field in 1969, oil policy in Norway has been very politicized. Political parties, interest groups, local authorities, and government agencies got involved in one way or the other in the formulation and implementation of policies that affected the stability and attractiveness of the investment environment for foreign companies. Despite the high degree of political competition among many interested groups, however, the policy environment stayed stable and posed very little political risk for foreign investors. The institutionalized competition among interest groups provided incentives for political elites to build policy coalitions and reach consensus through compromises. The tax reform in 1986, a scaling back of the role of the state oil company, abolishment of the ‘sliding scale’ mechanism of profit distribution and a robust set of safety regulations are some of the other examples of compromises made by Norwegian political elites to co-opt different veto players into policies aimed at attracting investors.\textsuperscript{70} The result of such institutionalized competition was a balanced attitude towards foreign investment. The Parliamentary Report (no. 25) in 1972 ensured the rights of democratically elected institutions to exercise full control over all aspects of oil policy. All the major policy changes were prepared in consultation with every important state institution and interest group that had a stake in oil policy. The system of regular parliamentary reports on the oil industry kept the general public well informed of the various issues.\textsuperscript{71}

To sum up, Norway’s institutionalized competition, in contrast to Russia’s unchecked pluralism, demonstrates the qualitative differences among democracies in terms of the administrative, regulatory and legal terms they provide for investors. The Norwegian experience also provides an interesting contrast to the Azerbaijani case. Even though both regimes were able to successfully attract large amounts of foreign investment into their oil industries, there were apparent trade-offs involved for both foreign investors and domestic interest groups. In a consolidated democracy, deliberations may take longer among different interest groups but oftentimes a compromised solution is reached at the end that produces stability. In an authoritarian regime, on the other hand, contracts are signed faster and with more rewards for foreign investors, but at the expense of greater benefits for the society. Authoritarian regimes may produce quick fixes and short time stability but “the only societies where individual rights to property and contract

\textsuperscript{69} \textit{Ibid.}

\textsuperscript{70} For further details on the Norwegian case, see Bayulgen (2003).

\textsuperscript{71} Lind and Mackay (1979).
are confidently expected to last across generations are the securely democratic societies.\textsuperscript{72}

\textit{Conclusion: Political Effects of Foreign Capital}

The rentier-state literature pays no attention to the initial political conditions that shape the way an oil-rich country develops its resources. One of the key causal mechanisms linking oil wealth and regime type is the relationship between foreign investors and governing elites. Especially in the developing countries that depend on international financing and expertise, the role of foreign capital in fashioning the balance of power in the political system and thereby the distribution of oil wealth becomes ever more important.

As the Azerbaijan case demonstrates, in authoritarian regimes, success in attracting foreign capital has a “reinforcing effect” on the political regime. Authoritarian leaders solidify their hold on power by allying themselves with foreign investors. The durability of authoritarian regimes in the developing world is partly a function of this external legitimation from foreign investors. In Azerbaijan, the holdover elites from the communist era acquired the right to set the rules of the game for international oil contracts, and in that way attracted the active support of foreign capital in further concentrating their power. The former president Heidar Aliev designed tax laws that gave the top echelons of government maximum control over the awarding and subsequent distribution of oil rents.\textsuperscript{73} Thus, the ratification of each PSA allowed the government to increase its leverage over the society. The experience of Azerbaijan runs counter to the conventional wisdom in the literature, which posits that oil-rich countries exhibit lower regime durability and higher levels of political instability.\textsuperscript{74}

In democratizing/hybrid regimes, failure to attract foreign capital can also have a democracy-impeding effect. Globalizing pressures, i.e., the requirements of foreign investors and the need for external capital, can make democratic consolidation more difficult. In a globalized world economy, severe competition for scarce international capital limits the options available to ruling elites to overcome opposition. Especially during a serious economic crisis, in an attempt to create more favorable conditions for international business, governing elites may resort to institutional changes that push veto players out of the decision-

\textsuperscript{72} Olson (2000), p. 42.  
\textsuperscript{73} Karl (2000).  
\textsuperscript{74} Smith (2004) empirically demonstrates that oil wealth does not have the uniformly destabilizing effects that it is commonly assumed to have and that in many oil-dependent countries oil wealth explains the durability of authoritarian regimes.
making process. In democratizing/hybrid regimes, the result is more globalization at the expense of democracy. Those in power may rationalize their authoritarian measures as temporary solutions to economic problems. They might use the rhetoric that an iron fist is necessary to achieve economic growth and democracy in the long run.

Recent evidence from Russia under Vladimir Putin’s presidency shows that this is exactly what is happening there. Putin is consolidating increasingly more power in the state. The outcome of the December 2003 elections gives him a confident and absolute majority in the new Duma, which will enable the Kremlin to control all key positions and committees and pass whatever bills that the administration chooses. Opposition to the Kremlin has been marginalized by state domination of the media, violations of campaign funding regulations, and the campaign against some oligarchs, exemplified by the arrest of Mikhail Khodorkovsky, chairman of the country’s largest oil company.

More specifically in the area of oil-investment policy, Putin has taken institutional measures to deprive certain groups of their right to oppose and question his policies. As well as streamlining the government bureaucracy, Putin is challenging the authority of Duma’s involvement in the PSA process by proposing to transfer the functions of PSA approvals from the Duma to the federal executive. Moreover, with the new draft law on subsoil, Putin plans to abolish the so-called two-key system of control over subsoil licenses whereby the federal center shares power over key licensing decisions with regional authorities in the energy-producing regions. This draft law, together with the reorganization of the Federation Council, is meant to bypass the regional administrations and reduce the authority of governors in the investment policy. Such exclusive measures often translate into a vote of confidence by investors who regard stability as the prime requirement for long-term investment. In fact, the regular tax regime has become so much more predictable in recent years that foreign investors are less likely to hesitate investing in Russia without a PSA framework. The latest investment by BP in a new Russian oil company underscores the fact that foreign investors are increasingly feeling more secure with the terms the Putin regime is providing them and are more comfortable operating in Russia even without the guarantees provided by a stable PSA regime.

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75 This is what Evans (1997) refers to as “leaner and meaner states.” These states constrict their role to activities essential to maintaining the profitability of transnational markets.

76 For instance, the March 2004 presidential decree abolished thirteen ministries and called for only one deputy prime minister instead of six. Putin also created a consolidated ministry, uniting the ministries of energy and industry. The new government that Putin has just put in place is very much the president’s team. The last remnants of the “family” have been swept from office and replaced by people who were associated with Putin in his first term.

77 BP agreed to pay $6.75 billion to form a new Russian oil company, a deal considered to be the largest single investment in post-Soviet Russia.
Certainly the arrest of Khodorkovsky and the now infamously known “Yukos affair” initially produced a negative image for Putin and the rule of law in Russia and led to concerns that foreign investment would significantly dwindle as a result. On the contrary, however, FDI increased since this incidence and reached a record level in 2004, beating 2003’s achievement and promoting the country to the top division of emerging market FDI recipients. Furthermore, a spate of new deals, worth billions of dollars, in the energy sector has been announced in the last year.

One explanation for this seemingly ironic situation is that many foreign investors see the conflict between the government and Yukos as a merely isolated criminal case and thus a domestic matter for Russia. It seems that if the oligarchs steered clear of politics, Putin would allow them to keep the lucrative assets they amassed during the chaotic rule of Yeltsin. Putin himself had said many times that the results of the privatization would not be revisited in Russia. There is also a sense among foreign investors that the Kremlin may even prefer to deal with large foreign multinationals rather than the most powerful domestic oligarchs, as the former are seen as less likely to pose a political threat to the state. Finally, the greater political stability that Putin has created (as discussed above) as well as the robust and ongoing economic recovery in the recent years may explain the fact that the Yukos affair did not have the expected reverse effect on FDI.

Even though the recent hike in oil prices and increase in oil production are benefiting Russian oil companies and giving the impression that PSA is not an urgent issue in Russia, Putin’s personal endorsement of the PSA regime demonstrates the indisputable need for foreign investment for the development of new and technologically-challenging oil fields. The bulk of current production comes from fields in the middle to late stages of their production lives and domestic companies are able to exploit these old fields without much foreign involvement. However, the next generation of oil deposits will require substantial foreign investment to develop because they are generally offshore or in hard-to-

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78 “Russia economy: Yukos Crisis? What Crisis?” Economist Intelligence Unit (October 19, 2004); Yurova (2005).
79 For instance, the French oil major Total announced that it will buy a 25 percent blocking stake in Novatek, Russia’s second-largest natural gas producer, for an estimated US $1 bn. In addition, Gazprom announced that it has signed a memorandum of understanding with the US oil major ChevronTexaco on gas sector cooperation, including the likely joint development of the Shtokman Arctic gas fields. Also announced in September 2004 was US$ 3.5bn-worth of South Korean investment into Russian oil projects. Finally, the US oil major ConocoPhillips paid nearly US $2bn for a 7.59 percent stake in Russia’s second largest oil company, Lukoil.
80 “Russia economy: Yukos Crisis? What Crisis?” Economist Intelligence Unit (October 19, 2004).
81 In his address to the PSA-2000 Conference in Sakhalin, Putin pledged personal control over the PSA process and said that PSAs were Russia’s strategic priority and delaying them would be against the country’s interests.
reach areas without sufficient infrastructure. Having realized the importance of PSAs for large offshore or greenfield developments, Putin is undertaking institutional measures to streamline the PSA process. He is also creating a more effective tax and licensing regime to make it possible and comfortable for investors to invest outside of the PSA framework. Not surprisingly perhaps, the bureaucracy and some interest groups still continue to create setbacks for foreign investors despite the personal endorsement and efforts of Putin.82 Even though the reform process continues to be seen as **two steps forward, one step back**, it is clear that there is a significant change from the Yeltsin period and a relatively more positive trend for foreign investors overall.

Putin’s increasing exclusionary tactics in the formulation of the investment strategy have significant implications for the distribution of oil wealth in Russia. As he consolidates more power in the state to deal effectively with the demands of foreign investors, he is also creating the basis for a state apparatus that will have the ultimate control over rent management and distribution. To understand the underlying dynamics of a possible oil curse in Russia, we must pay attention to the role foreign investment plays in undermining the democratic consolidation process.

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82 For instance, in February 2005, Russia’s Natural Resources Ministry announced that foreign companies would be banned from bidding for large strategic oil and metal deposits. According to this new regulation, foreign participation will be permitted only for ventures in which a Russian partner has at least a 51 percent shareholding. This decision will most likely to affect a number of large existing joint ventures and very lucrative planned tenders. For more detail, see Lavelle (2005) and “Russia Risk: Alert- Foreigners Held Back.” *Economist Intelligence Unit* (February 2005).
Colophon

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