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POLARIZING EFFECTS OF GLOBALIZATION:

POLITICAL REGIMES THAT ATTRACT OIL INVESTMENTS

Committee:

____
Robert Moser, Supervisor

____
Catherine Boone, Co-Supervisor

____
John Higley

____
Clement Henry

____
Cynthia Buckley

POLARIZING EFFECTS OF GLOBALIZATION:

POLITICAL REGIMES THAT ATTRACT OIL INVESTMENTS

by

Oksan Bayulgen, B.A.

Dissertation

Presented to the Faculty of the Graduate School of

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for the Degree of

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Dedicated to
my grandparents
Nemika and Kenan Dagdeviren

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It goes without saying that any of the remaining errors are my responsibility and mine alone.

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POLITICAL REGIMES THAT ATTRACT OIL INVESTMENTS

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This dissertation examines the role of political regimes in attracting foreign investments in the oil sector. Despite similar pressures from global capital, the degree of investment environment stability varies among states. Drawing on the experiences of three oil-producing countries, Azerbaijan, Norway and Russia, I argue that regime type determines the level of political competition for influence over investment policies and the institutional mechanisms that shape it. Based on the interaction of two dimensions - the number of veto players and the strength of mediating institutions - I distinguish three distinct regime types that have varying capacities in creating stable and attractive investment conditions for foreign investors. The three cases studied in this dissertation illustrate that both consolidated democracies and highly autocratic regimes are able to create stability in investment relations, while hybrid regimes, that are in between the extreme ends of autocratic-democratic continuum, are more likely to make arbitrary and unpredictable policy

changes that threaten the profitability and security of investment projects. I further argue that the procurement of foreign capital, as well as the failure to procure it, has effects on regime type. Once secured, foreign capital can reinforce both autocratic and democratic regimes or in the case of hybrid regimes can push them in either an autocratic or consolidating democratic direction. Hence, challenges of globalization polarize the options available to political elites in hybrid regimes as they try to open their economies to foreign investment.

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CHAPTER 1

WINNERS AND LOSERS OF FOREIGN INVESTMENT

I. Introduction

Azerbaijan signed the "Contract of the Century" in 1994, with ten foreign oil companies committing $8 billion in oil investment over the course of the next 30 years. Soon thereafter, the president of the newly independent state Azerbaijan embarked on an ambitious strategy of attracting as many and diverse foreign oil companies as possible into the Azeri oil industry. He pledged that as a result of this oil strategy, in the next decades Azerbaijan would experience "a new dawn."[1] And to the amazement and awe of analysts and policymakers alike, Azerbaijan, with a gross domestic product of only $4 billion, attracted a total of $3 billion investment in its oil industry over the course of the next seven years.[2] Even though it is not the former Soviet republic with the largest oil reserves, Azerbaijan has the most foreign direct investment per head of any state in the region. According to the Foreign Direct Investment (FDI) Performance Index created by the United Nations Conference on Trade and Development (UNCTAD), in terms of success in attracting FDI, Azerbaijan ranked the 3rd highest among 140 nations during 1994-1996 and the 8th highest during 1998-2000.[3] As such, not only did Azerbaijan become the 'showcase

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[1] Stefan Wagstyl and David Stern, *"Oil Strategy Can Change Nation,"* Financial Times Survey (November 22, 2000).
[2] U.S. Department of Energy, *Azerbaijan Country Analysis Brief (* May 2001) Energy Information Administration (www.eia.doe.gov).
[3] This ranking by UNCTAD is based on the ratio of a country's share in Global FDI flows to its share in Global GDP. It is considered a more accurate measure than absolute values of inflows of the shares

for the art of doing business' in the Former Soviet Union but also acquired the title of "frontier of global capitalism" among foreign investors. [4]

Not too far away from Baku, in Moscow, the capital of the biggest successor state to the Soviet Union, however, not much investment activity was taking place. Given the country's large endowment of natural resources and educated labor force, as well as its potentially large market, attracting foreign investment should not have been too difficult for Russia. Yet, the record has been discouraging. In spite of explicit efforts by the government to attract foreign capital to reform its oil industry and bring production levels up, Russia received far less foreign investment than it could, both relative to the size of its economy and in comparison with other emerging markets. For the period 1989 to 1998, Russia ranked 21st among 25 countries of Central, Eastern Europe and Commonwealth of Independent States (CIS) in terms of per capita foreign direct investment.[5] Between 1994-2001, Russia received about $ 21.5 billion in total FDI, of which $3.2 billion went into the oil sector. With 4.6% of world's total proven oil reserves, almost 6 times the oil reserves of Azerbaijan, Russia received 7 times less FDI for each barrel of its oil reserves than Azerbaijan.[6]

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of FDI in national investments because it assesses how successful a country is in attracting FDI relative to the size of its economy.

[4] Jeffrey Goldberg, *"The Crude Face of Global Capitalism,"* The New York Times Magazine (Oct.4, 1998): 57.

[5] Ernst & Young (CIS) *The Investment Climate in Russia* (1999):7. Adjusting for population size, Russia has received $15 foreign direct investment on a per capita basis compared to $84 for Poland, $118 for Czech Republic, and $221 for Hungary.

[6] Author's own calculations based on UNCTAD 2002 Handbook of Statistics, U.S. Energy Information Administration Country Reports and BP Statistical Review 2002. These figures are calculated by dividing total FDI in oil by total proven oil reserves in that country.

According to the same UNCTAD FDI Performance Index, Russia ranked 108th and 104th highest among 140 nations during 1994-1996 and 1998-2000 respectively. Even though there are signs of increasing FDI in Russia today, there is still suspicion and hesitation on the part of investors to make long-term commitments.[7] The initial euphoria of investing in Russia turned into a nightmare for most investors as the first decade of transition came to an end. After so many years of Soviet isolation, the doors to the Russian 'prize' wide open but eager investors would not walk through it. Indeed, Russia continued to be a "riddle, wrapped in a mystery, inside an enigma."[8]

In the 1990s, while these former Soviet republics were competing with each other to attract foreign investment, another major oil producer, Norway, was being commended in policy and academic circles as the example par excellence of a successful oil producing state.[9] Starting its oil development in the 1970s, 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 this to build national competence in oil and meet the high 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.[10] Calculations based on FDI figures from the UNCTAD Handbook of Statistics show that Norway

[7] For example, in February 2003, BP agreed to pay $6.75 billion to form a new Russian oil company. This deal is considered the largest single investment in post-Soviet Russia.
[8] A famous depiction of Russia by Winston Churchill in a radio broadcast on 3 October 1939.
[9] See for instance, Terry Lynn Karl, The Paradox of Plenty: Oil Booms and Petro-States (Berkeley: University of California Press, 1997).
[10] This figure includes domestic and foreign investment together. International Trade Administration. *"Oil and Gas Services Update: Norway,"* International Market Insight (06/21/2001).

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 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.

TABLE 1.1: FDI statistics for Azerbaijan, Norway, and Russia

	Total FDI[1] (millions of $)	World FDI Rankings[2] (out of 140 nations)		FDI in Oil[3] (millions of $)	FDI in Oil / Proven Reserves[4] ($)
	1994-2001	1994-1996	1998-2000	1994-2001	1994-2001
AZERBAIJAN	3,787	3rd	8th	3,029	0.43
NORWAY	21,762	59th	60th	8,704	0.92
RUSSIA	21,524	108th	104th	3,228	0.06

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 and Norway these ratios are 0.3 and 0.3 and 0.9 and 1.0 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, Foreign Investment Promotion Center under the Russian Ministry of Economy, and U.S. Department of State Bureau of Economic and Business Affairs Country Commercial Guide: Norway.
4. Calculations based on UNCTAD 2002 Handbook of Statistics, U.S. Energy Information Administration Country Reports and BP Statistical Review 2002. These figures are calculated by dividing total FDI in oil by total proven oil reserves in that country.

These three countries with significantly different cultural, historical and socioeconomic backgrounds share several characteristics. First of all, they are all major oil producers with significant oil resources. Norway, Azerbaijan, and Russia possess 0.9%, 0.7%, and 4.6% share of the world's total proven oil reserves,

respectively.[11] Their oil industries remain the focus of most foreign interest. Second, the oil industries in these three countries provide a significant portion of their government revenues. Oil revenues as a percentage share of total government revenues in 2001 are 50% in Azerbaijan, 40% in Russia, and 25% in Norway.[12] Simply put, the engine of the economy in these countries is the oil sector. Lastly, all three countries have needed and still need foreign expertise and capital in order to develop their oil resources and build national competence. In essence, they have been competing for the same scarce international capital. Despite their similar needs for it, however, these cases demonstrate significant variation in the ability to attract foreign capital (see Table 1.1). While both Norway and Azerbaijan have attracted significant amounts of foreign investment, Russia has received very little capital relative to its needs and potential.

This dissertation explores the causes behind the different levels of foreign investment and their political effects in these three countries. I make two main arguments. First, regime type plays an important role in determining the extent to which foreign investment can be attracted and the form that investment takes. Second, the procurement of foreign capital, as well as the failure to procure it, has effects on regime type. Once secured, foreign capital can reinforce the political regime in place. I further argue that globalization can have a polarizing effect on regime type because

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[11] Data gathered from the BP Statistical World Energy Review (2001) (www.bp.com). With these figures, Norway, Azerbaijan and Russia have the 13th, 14th and 8th largest oil resources in the world respectively.
[12] Based on country reports of Azerbaijan, Russia and Norway from the Energy Information Administration/U.S. Department of Energy (www.eia.doe.gov).

elites aware of the importance of attracting foreign capital make institutional changes in their political regime in anticipation of the financial and political benefits that will ensue from such changes.

II. Explanations for Foreign Investment Patterns

In the emerging global world, foreign direct investment is an essential link between national economies, as well as a catalyst for economic growth.[13] "The benefits that FDI brings, such as capital, knowledge, technology, skills, management know-how and market access, are becoming increasingly important for development as complements to domestic resources in host countries."[14] In today's globalized economy, virtually all countries- and especially developing and transition countries- are competing with each other for greater amounts of foreign investment. FDI as one of the main agents of globalization, however, does not flow evenly across countries. While some countries benefit greatly from it, others are less successful in attracting it. Some have even lost the FDI that flowed in during the 1950-1975 period.

This unevenness in investment flows is explained by traditional FDI theories in terms of company-specific economic factors driving the location of international production. In brief, these theories include: The ***product cycle model***, which depicts FDI as a way firms capture remaining profits by expanding overseas to protected

[13] *"Chapter 1: Promoting Linkages,"* World Investment Report 2001 (New York: United Nations Conference on Trade and Development (UNCTAD), 2001). According to this report, empirical evidence suggests that for emerging economies a 1% point increase in FDI (measured as a proportion of GDP) leads, ceteris paribus, to an extra 0.8% point increase in per capita income.
[14] Ibid.

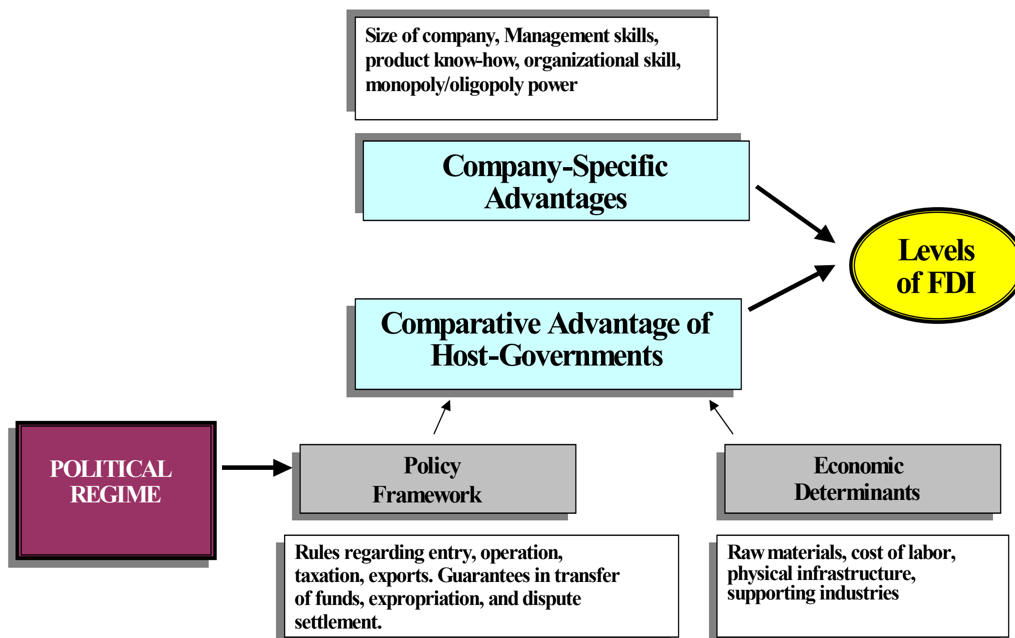
markets in search of lower production costs (Vernon 1974). The ***industrial organization theory***, which focuses on FDI as the natural outcome of the size, management, engineering, and organizational skills, and international oligopolistic rivalry of multinational corporations (Hymer 1960; Kindleberger 1969; Graham 1978; Buckley and Casson 1976,1981; Rugman 1985;) and finally ***trade theories*** that emphasize FDI emanating from differentials in the endowments of capital and labor between countries (Markusen 1995.)[15] In addition to these company-specific variables, other studies also pay attention to the country-specific economic determinants -such as market size, labor costs, access to raw material and infrastructure development- as major determinants of resource-seeking FDI [16] (See Figure 1.1).

While economic characteristics are clearly relevant, countries with similar economic endowments nevertheless show significant variation in their abilities to attract capital. International capital only goes to and stays put in places where the investment environment is conducive. A key factor in investment decisions is the stability of the policy framework that shapes investment relations between foreign companies and the government. Investment relations, whether governed by general legislation or ad hoc negotiated agreements entail rules of the game, which provide mutually agreed-upon conditions of behavior, interaction, and responsibility on the

[15] For detailed discussions of these economic theories of FDI, see Paul Fischer, Foreign Direct Investment in Russia: A Strategy for Industrial Recovery (MacMillan Press, 2000), 19-45.
[16] Harry G. Broadman and Francesca Recanatini, *"Where has all the Foreign Investment Gone in Russia,"* World Bank Policy Research Working Paper 2640 (July 2001):10.

part of the host government and a foreign company. A stable investment environment provides general standards of treatment (including guarantees in such areas as the transfer of funds, expropriation and dispute settlement) and has a predictable and transparent legislative and regulatory framework in which channels of negotiation are clear and open. In the absence of a clear, enforceable framework defining ownership, taxation, dispute settlement and regulation, foreign investors fear that they risk expropriation, onerous administrative intervention, or unpredictable laws and regulations.

FIGURE 1.1: Explanations for FDI Patterns



While many studies of FDI recognize the importance of stability in investment regimes, they do not systematically analyze the conditions under which it is created.

Although concepts such as "political risk" and "political and legal stability" are often used to explain patterns of FDI, no theoretical connection between regime politics and stability of the investment environment has been offered.

III. Regime Type and Policy Stability

This dissertation analyzes relations between regime type and the stability of investment environments that makes foreign investment possible. Its basic assumption is that legal, regulatory and administrative guarantees and incentives for foreign investors are the product of a political process resulting from the interaction of many domestic groups within an institutional context. The challenges of globalization tend to create winners and losers within countries. While some groups are able to take advantage of access to technology and integration with the world markets, other groups are threatened by the presence of multinational corporations and do not benefit from foreign investment.

The stability of a policy environment depends on overcoming the opposition, or winning over the consent or acquiescence of non-beneficiaries. Regime type is important because it determines the relative political power of opponents and proponents of FDI by shaping institutional relations between them. It also determines the institutional channels open for foreign investors to influence decision-making. Overall, regime type molds the level and intensity of competition for influence over policies and the institutional mechanisms that shape that competition. Therefore an

analysis of the winners and losers of globalization requires a comparative study of political regimes that are more and less conducive to international investment.

I distinguish among three regime types according to the degree of institutionalized competition they provide. As indicators of institutionalized competition, I focus on the strength of veto players in the state and the strength of mediating institutions that build policy coalitions and offer bargaining mechanisms among veto players. I argue that the interaction of these two variables produces policy environments that are characteristics of three distinct regime types: authoritarian regimes, consolidated democracies and hybrid regimes. Such treatment of regime type as a continuum rather than a dichotomy is in line with the recent burgeoning literature on hybrid regimes (Karl 1995, Diamond 2002, Schedler 2002, Levitsky and Way 2002, Carothers 2002). This dissertation contributes to the recent literature by analyzing ways in which the hybrid regime category differs from authoritarian and democratic regimes in terms of its ability to integrate into the global economy.

In authoritarian regimes, there is virtually no meaningful institutionalized competition for power and influence over government policies. The coexistence of weak veto players and inadequate mediating institutions insulates decision-makers from group pressures, expands their range of directive powers, and increases their capacity and flexibility to offer investors attractive investment policies with long-term guarantees. In such weakly institutionalized and uncompetitive political regimes, foreign investors usually have direct access to a small number of ruling elite persons.

This simple power structure makes it possible for rulers to promise that terms of an investment relationship will be secure throughout the life of investment projects.

On the other end of the spectrum are highly competitive and institutionalized democracies. In such regimes, there are many veto players to check and constrain the authority and policies of the government. However, this high degree of pluralism does not necessarily lead to institutional deadlocks or policy instability because there are strong political parties, interest organizations and effective bureaucracies to aggregate different interests into policy coalitions and establish mechanisms of negotiation and bargaining among them. Decision-makers use these mediating institutions to co-opt veto players into the policy making process and overcome their opposition through compromises. The result can be a stable policy environment in which investors feel that their contracts are secure. Moreover, a democratic institutional structure creates opportunities for investors to ally themselves with domestic groups to influence government decisions or get involved in policymaking directly. Their perception of stability derives from open, transparent channels of competition and negotiation in the political system and from the sense that they have reliable means of promoting and defending their investment interests.

Finally, in hybrid regimes that are neither fully democratic nor authoritarian, the level of institutionalized competition is limited. There are some significant veto players that challenge government policies, but there are not enough institutional incentives or constraints to ensure effective conflict resolution among veto players. In hybrid regimes it is difficult to overcome opposition through negotiations and

compromises. This limited institutionalization can contribute to radical and sudden policy changes or at least, too much uncertainty about government policies. Foreign investors consequently feel insecure about the future of their projects. Moreover, they do not have clear institutional channels to influence decision-making directly or through alliances with strong interest groups.

The Azerbaijani and Norwegian cases in this dissertation suggest that globalization in respect of FDI flows favors two polar opposites: established democracies and authoritarian regimes. Both regime types are able to create policy environments that significantly reduce political risk for foreign investors. By contrast, the Russian case demonstrates that globalization in the form of FDI flows is not favorable to countries struggling to create new democratic structures in the midst of economic uncertainty. Limited institutionalized competition in a hybrid regime that is located between the extremes of the authoritarian-democratic continuum can lead to arbitrary and unpredictable policy changes that threaten the profitability and security of investment projects. In hybrid regimes like Russia, high degrees of political risk keep investment levels down.

IV. Political Effects of Foreign Capital

In this dissertation I further argue that the flow of foreign capital, as well as the need to attract it, has significant effects on regime type. Generally, in the literature, the political effects of foreign capital are seen as either positive or negative without any distinction among the political systems in recipient countries.

Emphasizing the positive effects of foreign capital, neoliberals assume that FDI brings economic prosperity to countries and sows the seeds of democracy. They argue that national differences in an increasingly interdependent world become less important and that foreign investment flows have a largely uniform effect on countries. Most neoliberal theorists do not pay much attention to the challenges facing hybrid regimes, as in the post-Soviet region, where countries are trying to establish democracy and market institutions at the same time. Analyzing the effects of foreign capital without paying attention to the different capacities of political regimes to attract it fails to recognize divergent state responses to globalization.

Dependency theorists, on the other hand, argue that the structure of the world economy produces a group of peripheral states that are exploited by foreign capital and are doomed to remain authoritarian as a consequence of their marginal economic position in the world. A variant of dependency school, the rentier state literature looks more specifically at the negative effects of oil rents and contends that reliance on a primary commodity, almost without exception produces a distinctive institutional setting in which democratic accountability of rulers is weakened.

Challenging these two schools of thought about the political effects of foreign capital, I argue that international capital's involvement should not be taken as given, but should instead be regarded as shaped by domestic politics. The negative or positive political effects of foreign capital depend on the existing political structures. In an authoritarian regime like Azerbaijan, political elites use foreign capital to deepen their control over society. In Azerbaijan foreign capital has strengthened the

authoritarian regime. In a democratic regime like Norway, by contrast, economic success brought by the inflow of foreign capital has increased the legitimacy of decision-makers and strengthened the foundations of a democratic welfare state. Foreign capital in this context has had a positive effect on further consolidation of democracy. It is this dissertation's contention that political regimes not only help determine whether there will be foreign investment in the first place, they also mediate the effects of foreign capital once it arrives.

The Russian case that I explore further suggests that pressures from foreign investors for a stable investment environment induce certain institutional changes in hybrid regimes facing dire economic problems. Ruling elites have the option of creating policy stability either by excluding or co-opting opposition groups. In doing one or the other, they move the regime either towards more democracy or more authoritarianism. Specifically, political adjustments that Russian president Vladimir Putin has been making in order to attract foreign investment illustrates the effects of globalization on hybrid regimes.

V. Importance of Stability in Oil Investments

To study the relations between regime type and FDI, I examine foreign investments in the oil industry. The oil industry has historically been one of the most globalized industries in the world. Oil is a key fuel in industrial production as well as a vital input in the manufacture of a wide range of products. "By the early 1980s the oil industry accounted for one-half of the tonnage, two-thirds of the ton miles, and

one quarter of the value of all commodities traded internationally."[17] Not only in terms of trade, but also in terms of oil exploration and production, the oil sector has historically been highly internationalized, involving many governments and multinational corporations.

At the same time, political risks involved in oil investments have usually been very great compared to other industries with similar global reach. Due to the high stakes involved in oil, both multinational corporations and host governments have striven to control the development of oil resources. Corporations want to maximize their return on massive capital investments and ensure the long-term stability of projects. Governments also want to maximize their share of the financial gains and exert control over the industry's management. Due to the nature of the oil industry, however, governments and foreign investors need each other to share technology and the costs of development. Because of the capital-intensive nature of exploration and development, the sunk and fixed nature of investments, as well as the long lead times before production commences, generates income and recovers costs, the investment regime's stability and reliability is of vital importance to multinational oil corporations. Governments provide for stability and reliability first by formulating laws that establish the terms of an investment relationship as regards taxation, ownership, regulation, use of resources, and dispute management. Second, they provide stability by creating an administrative framework that oversees the

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[17] Albert L. Danielsen, The Evolution of OPEC (New York: Harcourt Brace, 1982.)

implementation of laws and regulations and offers channels of negotiation for investors.

Stability and reliability of the investment environment has always been a crucial factor for foreign investors in the oil business. At the beginning of the twentieth century, international oil companies with their technological expertise, significant capital resources and sophisticated networks of refining and marketing facilities had unprecedented control over the development of natural resources around the world.[18] By 1947, "the seven sisters cartel controlled 99% of international production and in 1966 was still producing 84% of the crude oil traded on international markets from reserves estimated to comprise 89% of the world's total."[19] Especially in the Middle East, where most of the world's oil is located, these companies dominated oil operations based on traditional concessions that covered large territories for long periods of time.[20] The host countries obtained no propriety claims to the petroleum produced and merely received the financial returns of bonus, rent and royalty.[21]

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[18] A major exception to this trend became the Soviet Union after the revolution in 1917; The Soviet state nationalized all assets and major international companies left Russia.

[19] Theodore H. Moran, *"Managing an Oligopoly of Would-be Sovereigns: The Dynamics of Joint Control and Self Control in the International Oil Industry Past, Present, and Future,"* International Organization 41:4 (Autumn 1987), 594.

[20] The traditional concession had its origin at the turn of the century with the grant in 1901 by the Persian Government of an oil concession to W.K. D'Arcy. For further discussion of traditional concessions, see Henry Cattan, The Evolution of Oil Concessions in the Middle East and North Africa (1967); Theodore Moran, The Evolution of Concession Agreements in Underdeveloped Countries and the United States National Interest (1974).

[21] Keith W. Blinn, *"Production Sharing Agreements for Petroleum and Minerals,"* Private Investor Abroad- Problems and Solutions in International Business in 1978, The Southwestern Legal Foundation (1978): 307.

Unable to challenge the multinationals, for many years the oil producing countries could not translate their interests into action. Starting in the 1950s, however, governments of oil producing countries tried to exert political control and sovereignty over petroleum resources and restrict the operations of multinational corporations.[22] They regarded oil as the most strategic sector in their economy- its "commanding height"[23]- and saw control of the oil industry, even at the expense of additional international capital, as the key to economic development. The emergence of new entrants in the form of independents, the 'communist oil offensive,' as well as the new international order that the U.S. sought in the aftermath of the World War II contributed to the rising wave of natural resource sovereignty assertions by host countries, which culminated in the establishment of OPEC.[24] As a relatively unified and collective bargaining entity, OPEC achieved success in maintaining posted prices artificially above the world petroleum price, and it helped change the terms of the investment relationship between multinationals and host governments. In the 1970s and early 1980s, market forces favored the oil producing countries and created significant political risks for investors.

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[22] In 1950, Saudi Arabia concluded negotiations with Aramco to rectify a perceived economic inequity to the host countries by establishing the 50-50 profit-sharing principle. In 1951, the Iranian Prime Minister Musaddeq nationalized the Anglo-Iranian Oil Company.

[23] According to Daniel Yergin and Joseph Stanislaw in their book The Commanding Heights: The Battle Between Government and the Market Place That is Remaking the Modern World (1998), this term goes back to 1922 when Lenin first used it during his speech at the Fourth Congress of the Communist International. Later it was adopted by Nehru and the Congress Party in India and spread to many parts of the world. It refers to the most strategic parts of the economy.

[24] Kate Gillespie and Clement M. Henry, *"Introduction,"* in Kate Gillespie and Clement Henry (eds.) Oil in the New World Order (University Press of Florida, 1995), 1-21.

Since the early 1980s, however, the investment relationship has changed significantly. There is no longer a fear of oil scarcity, instead, there is severe competition for investment capital to exploit abundant oil deposits. International oil companies have secured access over the last decade to petroleum resources in countries previously not open to them.[25] Oil and gas operations are today pursued in more than 100 countries worldwide.[26] Whereas the gist of governments' policies in developing countries was previously to replace the investments of international oil companies with their own national capabilities, now many governments have reversed their policies and are actively seeking foreign investors to contribute capital, technology, managerial capacity, and access to markets.[27] Increasingly restrictive investment and oil legislation during the 1970s has been modified or replaced by new laws that emphasizing investment guarantees and incentives.[28]

This most recent relationship between host governments and multinational corporations for developing oil resources is best reflected in oil agreements. In their new partnership, governments and companies negotiate their interests through one of two main types of oil agreements: concessionary and contractual. Concessionary

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[25] Those new provinces that are opened to private interests since mid 1980s are Algeria, Vietnam, Iran, Brazil, Venezuela, Azerbaijan, Kazakhstan and Russia.
[26] Ministry of Petroleum and Energy of Norway, *"Ownership of Statoil and Future Management of the SDFI,"* Storting proposition no.36 (2000-2001).
[27] One major example of government-industry cooperation in the oil sector is the so-called "Apertura" program adopted in Venezuela. Apertura, or openness, was an ambitious program adopted by the government of Rafael Caldera and the Venezuelan national oil company (PDVSA) to attract international investment and substantially increase country's oil production capacity. Saudi Arabia similarly reestablished severed ties with multinational oil companies to develop oil fields in remote regions of the kingdom.
[28] According to UNCTAD World Investment Report 2001, between 1991 and 2000, a total of 1,185 regulatory changes were introduced in national FDI regimes, of which 1,121 were in the direction of creating a more favorable environment for FDI.

agreements are divided into administrative licensing and auction-based licensing, while contractual agreements are divided into service and production sharing agreements. Although these two types of agreements differ in terms of levels of control by company, differing compensation and revenue shares, and differing levels of state-company involvement[29], they all serve the same purpose: to stabilize legal and fiscal rights of investors in exchange for their operational and financial obligations to host governments. The three cases examined in this dissertation suggest that concessionary agreements work better in developed countries where legal and fiscal systems run smoothly and where there is trust in administrative practices. In less developed countries foreign investors demand contractual agreements, like service contracts and, increasingly, production sharing agreements (PSAs) in order to guarantee their rights and obligations under a contract that is not subject to possible arbitrary administrative interventions.[30]

The cases that I analyze - Norway, Azerbaijan and Russia- display a significant variation in the ability to create a stable investment environment. Through different types of oil agreements Norway and Azerbaijan have provided legal, administrative and fiscal guarantees and incentives for foreign investors, while Russia has driven off eager foreign investors as a result of arbitrary, unstable, and unrewarding investment rules. A brief overview of each country's investment environment will be useful at this point.

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[29] Ernest E. Smith and John S. Dzienkowski, *"Fifty-Year Perspective in World Petroleum Arrangements,"* Texas International Law Journal (Winter, 1989):10.
[30] Blinn (1978).

VI. A Comparison of Investment Environments

Norway began to develop its oil resources at the end of the 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. As early as 1965, the government issued a Royal Decree, which formulated a concessionary oil agreement model for the administrative allocation of exploration licenses. In this "North Sea model,"[31] instead of signing a civil contract with investors, as in a PSA, the state entered into negotiations with oil companies for exploration programs, and for commitments written into exploration licenses. The licenses were obtained through 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 schedules etc., were embedded in the licenses.

In step with the unprecedented growth of host governments' bargaining power during the 1970s, the Norwegian state retained full control over the development of

[31] 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 regulations in order to capture a given part of the rent and in order to influence the micro-economic behavior of foreign companies.

oil resources, and at times imposed relatively unfavorable terms upon foreign investors. The bargaining power of the Norwegian state peaked in the early 1980s, as indicated by toughened terms in its investment agreements. These policy changes in the 1970s and early 1980s reduced the profitability of some oil projects but were never regarded as posing political risks by foreign investors. The stated principles of the legal and administrative framework for the oil industry remained intact and there were no uncertainties about rules of the game. No major changes were made in the principles, rights, and obligations of state institutions and the oil companies. Investors were provided with enough legal and fiscal guarantees to function satisfactorily in Norway at a time when their interests were being systematically challenged and even compromised elsewhere in the world.[32]

By the mid 1980s, when oil prices collapsed and competition for investment intensified, the Norwegian government adjusted the economic terms of its relations with foreign companies. For instance, in 1986 the Norwegian state initiated a tax reform that reduced the government take substantially. While remaining responsive to the interests of foreign companies, the Norwegian state also pursued goals such as the geographical and social distribution of offshore activities and prevented major accidents or negative side effects like harm to fishing grounds. In these ways, the

[32] 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.

Norwegian state was able to strike a balance between the interests of the foreign investors and domestic groups and ensure the investment regime's stability. Consequently, despite difficulties in working in one of the world's harshest exploration areas, major foreign companies from around the world continued to invest in oil projects in Norway. The policy environment's stability and reliability became an argument for oil companies to accept the terms offered, even when they were less favorable.

Opening its oil industry to international capital only during the 1990s, Azerbaijan has also been successful in creating a stable investment environment, which swiftly and efficiently met the demands of foreign investors. The Azeri government not only used PSAs, which by this time were proven to be instruments of stability for investors in developing countries, but it also created an investment regime in which each contract have the status of a law. This meant that each PSA contract would acquire the force of law of the Azerbaijani Republic and prevail over any other existing or future law, and decree, whose provisions might conflict with a specific PSA. This arrangement gave investors a sense of stability and reduced the political risks of investing. The result was 21 PSA contracts with Azerbaijan that committed an estimated total investment of $60 billion.[33]

Unlike in Azerbaijan and Norway, foreign investors faced even greater difficulty in Russia after 1991. The legal system governing oil activities was fraught

[33] U.S. Department of Energy, *Azerbaijan Country Analysis Brief*, Energy Information Administration, (May 2001).

with complexity and ambiguity. For much of the 1990s the only regulated form of investment in the Russian oil sector was joint ventures for which a license to carry out oil development had to be obtained. However, the licensing regime did not provide sufficient security, stability or predictability for foreign investors, in contrast to Norway's. In fact, the Russian system contained a number of grave concerns for investors. For instance, licenses were subject to state legislative action that resulted in unilateral changes and modifications of licenses, without granting foreign investors any ability to prevent or influence this process. Rules for the length, operation, or termination of licenses in many of the laws were contradictory or vague. This paralyzed the operations of foreign investors. Moreover, the legal hierarchy established under the Constitution of 1993 was not very clear as to the distribution of authority between the Federation and its regions in which oil reserves were actually located. Finally, the severity of the tax burden was rivaled only by the frequency and unpredictability with which it changed. Export duties were changed perhaps a dozen times in ten years under this licensing regime. Exporters struggled with cumbersome and restrictive quota and licensing requirements, only to be plunged into confusion when the restrictions were lifted albeit with no clear procedures for gaining access to overburdened pipelines.

Given these problems with the Russian legal and fiscal framework, the preferred form of investment in the petroleum sector soon became PSAs. Russia is a textbook setting for the use of PSAs. It is rich in hydrocarbon resources, but lacks the financial and technical means to develop them efficiently. Moreover, as just

discussed, its tax and legal regime has been too unpredictable and burdensome to attract large-scale, long-term investments. The PSA law in Russia was designed to 'jump-start' oil and gas investments by immediately establishing a special legal regime for PSAs in an attempt to insulate investors from risks. Despite the immediate need for and continuing insistence of foreign investors on PSAs, however, adoption of a PSA law and necessary regulations for its implementation have not even now been fully completed. In fact the creation of a stable investment environment for oil investors has been one of the fiercest political struggles that the new Russian state has experienced during its first decade of existence. No wonder that PSAs soon became labeled as '***P***rogress ***S***talled ***A***gain.'

There are several alternative explanations for why Azerbaijan and Norway created stable investment environments and attracted significant amounts of oil investment while Russia did not. In the next chapter, I discuss some of these possible explanations. While I acknowledge the influence of other factors, I conclude that regime type has the greatest analytical utility in explaining the variation.

VII. Research Methodology

A comparison of the three cases is based on field studies conducted in Azerbaijan in the summer of 1999, Norway in January 2001, and Russia in spring 2001. In order to analyze oil sector investment environments in these countries, I conducted a total of 75 in-depth interviews with various foreign investors, leaders of their lobbying organizations, government bureaucrats, legislative deputies,

journalists, scholars, and special analysts. In addition, I studied numerous government and private reports, documents, journal and newspaper articles, and scholarly works.

The research had two components. The first consisted of interviews about the investment environment in each country. Respondents were asked to assess contracting or licensing policies in terms of the legal and fiscal guarantees they provided for foreign investors. Technical aspects of each investment regime were studied in depth with the help of numerous documents provided by oil companies. Historical data on the evolution of each country's investment regime was collected through archival study of various journal and newspaper articles. The second research component involved questions about the political risks that the investment environment posed for investors. Respondents were asked to discuss the different interests of societal and state actors regarding oil investment policies. Then, they were asked to evaluate the institutional mechanisms through which state and societal actors interacted with each other and reached policy outcomes.

Offsetting methodological limitation of comparing and contrasting just three cases, my study facilitates a close examination of the investment policy process in these important oil producing countries and uncovers more clearly mechanisms that link regime type to foreign investment flows. My analysis rests on a comparative analysis using both the 'method of difference' and the 'method of similarity'. I compare countries that follow alternative paths, assessing the explanatory power of hypothesized critical differences. I also explore variations among countries following a similar trajectory, which isolates the peculiarities of each case.

VIII. Organization of the Dissertation

The dissertation is organized as follows. *Chapter Two* situates my two main arguments in literature dealing with the relations between regime type and foreign capital. Its first part, I briefly outline the alternative explanations for stability in an investment environment and give reasons why I do not find them convincing. I then discuss the two dimensions of institutionalized competition as they affect the ability of governments to overcome opposition to investment policies that are favorable to foreign investors. Using these dimensions, I construct a continuum of regime types in order to distinguish the capacities of states in creating stable investment environments. In the second part of the chapter, I discuss the shortcomings of neoliberal and dependency theories for explaining the political effects of foreign capital and I present my argument about globalization's *reinforcing* and *polarizing* effects on regime type. I conclude the chapter with a thumbnail sketch of how the political regimes in Norway, Azerbaijan and Russia fit with my theoretical model.

Succeeding chapters analyze in-depth each country's experience with the globalized oil industry. *Chapter Three* looks at Norway's oil investment environment and its political regime's capacity to overcome opposition to investment policies. The Norwegian case provides an example of how a consolidated democracy with high degrees of institutionalized competition can provide policy stability and reduce political risks. It also shows the positive effects of foreign capital in further consolidating a comprehensive welfare state. Azerbaijan's investment environment is

explored in *Chapter Four*. The lack of institutionalized political competition there is depicted as an alternative source of stability that is attractive to foreign investors. The Azeri case shows how less developed countries can compensate for lack of credible institutions by providing safe havens for investors. Unlike Norway, however, foreign capital's alliance with the Azeri regime has contributed to large income inequality, widespread poverty and strong political repression. As such it has reinforced an authoritarian regime. *Chapter Five* analyzes attempts by the Russian state to produce a stable investment environment, emphasizing the struggles to create a PSA regime. The chapter focuses on the weakness of hybrid regimes in attracting foreign investment and highlights the political choices facing Russia's leaders today as they join the international competition for investment capital. Finally, *Chapter Six* summarizes how the empirical evidence accords with my theoretical model in Chapter Two. I discuss my argument's generalizability to other possible cases. Overall, this dissertation grapples with the compatibility of various regime types with oil-driven globalization, and the political effects of foreign capital that this globalization entails.

CHAPTER 2

POLITICAL REGIMES AND FOREIGN CAPITAL

I. Introduction

A country's comparative advantage in attracting foreign investment in oil is based not only on economic variables such as the size of its resources, the cheapness of labor, the size of its domestic markets and supporting industries, but also on the legal, operational, and regulatory framework of its investment relations with foreign investors. Hence, countries with similar economic endowments in oil compete with each other on the basis of stability in their investment environments. The questions that this chapter addresses are: *why some oil-rich countries are better at providing guarantees and incentives for investors, while others are slow or reluctant to do so* and *how success or failure in attracting foreign investment affects political regimes.*

I first discuss alternative explanations for why some countries do better than others in creating stable investment environments. Culture, geo-political considerations, ideology, and even a country's size are frequently regarded as important ingredients of stability. Without entirely dismissing these ingredients, however, I focus on the capacity of different political regimes to formulate and implement attractive investment policies. In this section, I canvas the limitations of a dichotomous distinction between regime types and I offer an alternative way to distinguish political regimes along a continuum of varying degrees of institutionalized

competition. In step with recent scholarly interest in hybrid regimes, I give special attention to the difficulties hybrid regimes face in their attempts to create stable investment environments and attract foreign investment.

In this chapter's second section, I discuss neoliberal and dependency claims about the political effects of foreign capital and argue that the direction and magnitude of these effects depend on the success or failure of a political regime to attract foreign capital in the first place. I argue that once attracted foreign investments have a reinforcing effect on authoritarian and democratic regimes. For hybrid regimes, by contrast, foreign capital has polarizing effects. In the face of globalizing pressures, a hybrid regime type is at base not viable and it will transit either to the authoritarian or the democratic type. I conclude the chapter with a thumbnail sketch of the political regimes in Norway, Azerbaijan and Russia and how they fit with my theoretical model.

II. Structural and Cultural Explanations

In explaining the variation in the stability of investment environments in different countries, variables such as culture, ideology, prior integration with the world economy, geopolitics and even the size of a country can provide some background conditions and underlying trends.[34] For instance, the historical, socio-

[34] A similar cultural argument is made by Charles Kindleberger in his 1951 piece *"Group Behavior and International Trade."* He argues that a country's level of social coherence determines policy/institutional response to economic changes. According to Kindleberger, social coherence

economic and cultural development of some countries may make them more open to foreign capital. Positive attitudes, beliefs and values towards foreigners may prevent the politicization of investment policies and make it easier for the decision-makers to offer attractive terms to foreign investors.

This line of argument is often used when comparing the performances of countries like Norway and Russia. In Norway, for instance, it is argued that Scandinavian culture, the small size of the country and its strong economic relations with the outside world historically have created a certain business mentality that inhibits the politicization of investment issues and thus enables smooth formulation and implementation of legal, regulatory and administrative rules governing investment relations with foreigners. Conversely, many emphasize Russia's cultural uniqueness and its particular history in explaining the inhospitable attitude towards foreign initiative.[35] 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

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includes internal social mobility, communication and shared values. An example for how size matters in integration with world economy is Peter Katzenstein's Small States in World Markets: Industrial Policy in Europe, (Ithaca, NY: Cornell University Press, 1985).

[35] David Dyker, ed. Investment Opportunities in Russia and the CIS (The Royal Institute of International Affairs, 1995).

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. According to this view, these cultural and geographic features politicize investment issues in Russia, produce severe confrontation between opponents and proponents of foreign investment, and create an unstable policy environment.

There are also geostrategic explanations for why some countries offer stability in investment environments and others do not.[36] For instance, 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, by contrast, 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.

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[36] Along similar lines, Meredith Woo-Cumings, Michael Loriaux and Sylvia Maxfield, in Loriaux, ed., Capital Ungoverned: Liberalizing Finance in Interventionist States (Cornell: Ithaca New York, 1997) explain financial liberalization that took place in many countries in the 1980s as a result of their geo-political positions and the "predatory hegemony" of the United States.

These structural and cultural factors elucidate the constraints and challenges that these and other states face. However, they do not by themselves explain the conditions under which stable investment environments are 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 the political debates and struggles over the investment policies in each 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 interests of certain groups in countries, but they do not explain the outcome of conflicts among many groups. In each country, there have been many losers as well as winners from investment policies formulated to attract investors.

Politics, instead of underlying cultural and structural considerations, have been more influential in shaping states' responses to globalization. Regardless of their different backgrounds, governments in all three countries considered here have become convinced of the need to make changes in their investment regimes in order to attract foreign investment. But, despite the common objective, outcomes have varied considerably. The issue, then, 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.

III. Domestic Politics: Interests and Institutions

Instability in an investment environment occurs when the legal, regulatory and administrative terms of an investment relationship are unilaterally changed or undermined as a result of the actions of groups that are threatened by foreign investment.[37] Therefore, one way to analyze the stability of the investment environment is to first look at the different interests that are affected by foreign investments and the distribution of power among them.[38]

Challenges of globalization- the pressure to meet the heightened demands of foreign investors in this case- create winners and losers in every society. Because of the strategic importance of oil investments, opposition to investment policies come from various domestic groups such as nationalists, workers, environmentalists and business groups that feel threatened by the advantages these policies give to foreigners. However, as Geddes (1995) rightly points out, opposition to economic policies does not always come from societal actors. "In many countries the biggest,

[37] Certainly instability may also be a result of external factors such as natural disasters, market price changes, war, etc. In this dissertation, however, I am interested in explaining the direct political causes of instability in the investment environment.
[38] In the political economy literature, these interest-based explanations are used to explain adjustments to the international economy. Similar to the main tenets of Marxism, these explanations emphasize economic determinism and focus on the costs of adjustments to private interests and the punishment that they can inflict on the state as a result of unpopular policies. For more details on this approach, see the works of Gourevitch 1997; Frieden and Rogowski 1996; Simmons 1994; and Milner 1998.

and certainly the most articulate and politically influential, losers from the transition to a more market-oriented economy are government officials, ruling-party cadres, cronies of rulers, and the close allies of all three."[39] Therefore, opposition to investment policies may also come from executive, legislative, regional or administrative actors whose power and authority are curtailed as a result of regulatory changes in investment relations. The pressures that these veto groups exert on decision-makers have a significant impact on the terms and consistency of the agreements.

Governments that favor foreign investment are faced with the task of managing opposition to their policies that regulate the financial, regulatory and legal relations with the oil investors. Policy stability, then, depends on their ability to either build and sustain bases of support or to cut out opponents from the policy process. The strategies that government elites pursue, and the fashion in which they are implemented, hinge less on broad structural and economic forces than on the institutionally determined choices of these elites. Hence, the capacity of the government to create a stable and attractive investment environment depends on its ability to either co-opt or exclude opposition groups from decision-making.

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[39] Barbara Geddes, *"Challenging the Conventional Wisdom,"* in Diamond and Plattner, eds., Economic Reform and Democracy (John Hopkins University Press, 1995), 68. Geddes argues that understanding who the state actors are, what their interests are and what shapes those interests are good predictors of whether policies will be initiated and how far they will go. She makes this argument based on the empirical observation that-contrary to what conventional wisdom assumes-costs of liberalization on social forces have not been very high for many countries and that the opposition by labor unions was weak due to unemployment and economic crisis prior to liberalization attempts.

Andrei Shleifer and Daniel Treisman in Without A Map: Political Tactics and Economic Reform in Russia (2000) discuss the two ways by which opposition to government policies can be neutralized. They argue that "either he who opposes must be expropriated of the stake that gives him leverage. Or he must be co-opted/ persuaded not to exercise his power to obstruct."[40] Expropriation -or exclusion- means cutting the opposition interests out of the policy process or of the dominant coalition in the central policy arena. It is to basically undermine their ability to subvert the implementation of the reforms. One way to do that would be to simply deprive them of their rights. Co-optation, on the other hand, implies not dealing these groups out of the game but dealing them new cards. The veto-power of the groups is not removed, but new incentives are created for them not to exercise it. This may involve an explicit bargain or a compromise that involves creating opportunities that give the opposing groups an independent interest in reform.

Interests are essential in understanding policy success but without a consideration of the institutional context within which they interact, they cannot tell us the whole story. Pluralist approaches explain policy willingness and design, but they do not adequately explain policy outcomes. They simply extrapolate directly from interests to policy outcomes. There is no systematic effort in these analyses to

[40] Andrei Shleifer and Daniel Treisman, Without A Map: Political Tactics and Economic Reform in Russia (The MIT Press, 2000),8. They cite a relevant quote from Machiavelli: "Men can either be pampered or crushed."

explain how veto groups overcome dilemmas of collective action[41], or gain access to centers of decision-making and exercise influence.[42] The institutions of the state not only affect the range of policy instruments available, but they also tend to favor certain types of conflicts and outcomes while actively discouraging or preventing others. Institutional variation is therefore critical for understanding why some states are more capable than others in creating stability in their investment environments.

The emphasis on both interests and institutional variation falls broadly within the realm of rational choice institutionalism, which sees institutions as setting the parameters of choice and imposing constraints on the behavior of individuals.[43] Accordingly, institutions structure the sequencing and availability of alternatives so as to lead the choices of rational individuals towards optimal and stable outcomes. Hence, the ability to use co-optation and/or exclusion strategies to overcome opposition groups is constrained by the institutional structure. The important question

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[41] According to Mancur Olson (1982), economic development can be viewed as a problem of collective action, which is that different social groups may benefit in the long run from cooperative sacrifices, but in the short run each has an interest in turning economic policy into a distributive game.
[42] An exception to this literature is Michael Shafer's work Winners and Losers: How Sectors Shape the Developmental Prospects of States (1994) in which he argues that sectoral characteristics are a determinant of their capacity for collective action. Accordingly, the lower the economies of scale in a sector, the simpler the technology and skill-level used and the lower the capital required for entry, the lower the capacity for collective action.
[43] For a detailed description of the rational choice institutionalism and its differences with historical institutionalism, see Kathleen Thelen and Sven Steinmo, "*Historical Institutionalism in Comparative Politics*," in Steinmo, Thelen, and Longstretch, eds., Structuring Politics: Historical Institutionalism in Comparative Analysis (Cambridge and New York: Cambridge University Press: 1992),1-32 and Peter A. Hall and Rosemary C.R. Taylor*, "Political Science and the Four New Institutionalisms,"* paper presented at the Annual Meeting of the American Political Science Association (New York, September1994). According to rational choice institutionalists, relevant actors have a fixed set of preferences that they behave entirely instrumentally so as to maximize their attainment of these preferences often in a highly strategic manner that presume extensive calculation and access to relatively full information. The role of institutions is to resolve collective action dilemmas by providing actors with that information.

then becomes, under which institutional conditions are exclusion and cooptation more likely?

IV. Significance of political regimes

The relevance of regime type for understanding the institutional variations that shape economic policies has been the subject of one of the most heated and long-standing debates in the political economy literature.[44] A wave of bureaucratic-authoritarian regimes in the developing world during the 1960s and 1970s brought, for the first time, the compatibility of capitalist economic development and democracy into question. Dependency theorists argued that authoritarianism was linked to the deepening phase of import-substituting industrialization and that in the face of dependent development the need for democracy dwindled (O'Donnell 1973; Cardoso 1973; Evans 1979). The appeal to the US and the multinational corporations of authoritarian regimes in developing countries was in their greater political capacity to insulate themselves from particularistic demands (Haggard 1990). They were less dependent on popular support and less concerned with electoral cycles.[45] Democracy, on the other hand, was believed to unleash pressures for immediate consumption, threatening profits and investments and consequently retarding economic development (Galenson and De Schweinitz 1959, Huntington and Dominguez 1975).

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[44] For an overview of this debate, see Mancur Olson, *"Dictatorship, Democracy and Development,"* APSR 87 (1993): 567-76 and Adam Przeworski, Democracy and the Market (New York: Cambridge University Press, 1990.)
[45] Jose Maria Maravall, *"The Myth of the Authoritarian Advantage,"* in Diamond and Plattner, eds., Economic Reform and Democracy (Baltimore: The Johns Hopkins University Press, 1995),14.

With the fall of Latin American dictatorships in the 1980s and the East Asian economic crisis of the 1990s, many scholars started to point to the weaknesses of authoritarian regimes in sustaining reforms. Accordingly, not only do these regimes lack the accountability and legitimacy needed to rally populations behind economic reforms, but also they are more prone to corruption. Democracies, by contrast, are seen as more capable of implementing economic reforms. Scholars argue that the predatory state can only be constrained by democratic institutions (North 1990). Moreover, through welfare measures democracies mitigate the harmful impacts and shortfalls of capitalism and reconcile opposing interests, which makes possible the survival of both capitalism and democracy. It is also easier for democracies to legitimate economic reforms if the policy process is transparent and accountable than if decision-making is secretive and corrupt. Finally it is easier for democracies to implement economic reforms if there is public confidence in the legitimacy of government itself.

Even though the question of relative merits of authoritarian and democratic regimes continues to evoke intellectual analysis, as well as political passion, the general picture is inconclusive and contradictory. A growing body of cross-national empirical research on the economic effects of regime types has produced highly ambiguous results.[46] As the three cases in this dissertation also demonstrate, the

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[46] Some of the examples of this cross-national quantitative literature on the relationship between economic performance and regime type are Larry Sirowy and Alex Inkeles, *"The Effects of Democracy on Economic Growth and Inequality,"* Studies in Comparative International Development 25 (1990):126-57; Adam Przeworski and Fernando Limongi, *"Political Regimes and Economic*

distinction between dichotomous categories of authoritarianism and democracy does not adequately explain the variation in the ability to create stable and attractive investment environments. The findings of this dissertation show that both the authoritarian regime in Azerbaijan and the democratic regime in Norway were able to formulate and sustain stable policies and thus attract significant amounts of investment into their oil sectors.

One reason why the relationship between regime type and economic performance is found to be weak and ambiguous in the literature is the problem with the definition and categorization of regime types. Most scholars, usually for purposes of measurement accuracy, have been treating political regimes as dichotomous categories without taking account variations within each.[47] As the recent literature on political regimes also points out, there are variations among democracies as well as among authoritarian regimes.[48] The minimal electoral definition of democracy to

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Growth," Journal of Economic Perspectives 7 (1993): 51-69; and John Helliwell, *"Empirical Linkages Between Democracy and Economic Growth,"* British Journal of Political Science 24 (1994):225-48.

[47] Prezorwski, Alvarez, Cheibub, and Limongi in Democracy and Development: Political Institutions and Well-Being in the World (Cambridge: University of Cambridge Press, 2000) admit that they prefer the procedural minimum standard definition of democracy for purposes of measurement accuracy.

[48] According to Collier and Levitsky (1997), there are more than 550 subtypes of democracy. Some of these subtypes identify specific institutional features or types of full democracy. Examples of some of these subtypes are parliamentary, presidential and federal democracies. There are also 'diminished subtypes' such as limited democracy, oligarchical democracy, controlled democracy etc. As for variation among authoritarian regimes, Juan Linz, in Totalitarian and Authoritarian Regimes (Boulder:Lynne Rienner, 2000) argues that authoritarian regimes range from sultanistic, and bureaucratic-military authoritarianisms where there is few if any channels of political participation to 'organic statism', mobilizational authoritarianism in post-democratic societies, post-independence mobilizational authoritarianism and finally post-totalitarian authoritarianisms with limited, controlled or privileged political pluralism.

distinguish between these two regime types is increasingly questionable.[49] Despite free or relatively free elections, some regimes have authoritarian tendencies.[50] Such variation in the degree of democracy and authoritarianism has brought a new wave of scholarly attention to the analytical importance of hybrid regimes. It is apparent to many now that a great deal of new regimes are not democratic or any longer 'in transition' to democracy (Carothers, 2002). In recent years, there has been an unprecedented growth in the number of regimes that are neither clearly democratic nor authoritarian.[51]

To better understand the qualitative differences between democracy and authoritarianism, I view them as specific types in relation to the overarching concept of regime. Rather than distinguishing them in terms of the existence or lack of electoral contestation, I use a criterion that places regime types according to the degree of institutionalized competition they provide. This alternative criterion serves both to introduce finer differentiation and to avoid conceptual stretching. Even though classificatory schemes impose an uneasy order on an untidy empirical world and are often blurry, these ideal types of political regime on a continuum of institutionalized

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[49] The minimal standard definition of democracy presumes full contested elections with full suffrage and the absence of massive fraud, combined with effective guarantees of civil liberties, including freedom of speech, assembly, and association.

[50] According to Collier and Levitsky, the concern with these authoritarian tendencies has led to the inclusion of other criteria that measure the effective power of governments to rule (Karl 1990, Valenzuela 1992) effectiveness of legislatures (Bollen 1980), checks on executive power (Schmitter and Karl 1991, O'Donnell and Schmitter 1986) or social and economic equality (Jackman 1974, Muller 1988).

[51] Larry Diamond, *"Thinking about hybrid regimes,"* Journal of Democracy 13:2 (2002): 21-35.

competition have significant analytical utility in explaining the variation among different states in the ability to attract foreign investments.

V. Institutionalized competition and types of investment environment

A regime is a system of rules and practices that determines who has political rights, how they can be exercised, and their effects for controlling the state. In this dissertation, I distinguish among regime types along the degree of institutionalized competition that they provide. This variable is especially important in understanding the stability of policies because it demonstrates the relative strength of opposition groups, the level of their political participation and the institutional mechanisms that shape their interaction with the decision-makers. Hence the ability to use exclusion, co-optation to overcome opposition depends to a large extent on the degree of institutionalized political competition in each regime.

I measure the degree of institutionalized competition by looking at two variables: the strength of veto players and the strength of 'mediating institutions'. The first variable, the strength of veto players measures the degree of political competition and pluralism in the state. More specifically, it demonstrates the constraints imposed on the decision-makers. These veto players could come from legislatures and regional administrative units. Depending on their numbers and strength, they can oppose government investment policies and act as barriers to the formulation and implementation of investment terms with foreign companies.

The second variable, the strength of mediating institutions, on the other hand, measures the ability of political parties, interest group associations, and bureaucratic organizations to aggregate different interests, form enduring coalitions, reconcile differences among the veto players through negotiations, and reach compromised policy outcomes that would ensure a stable investment environment for investors. In addition to providing links between state and society, highly institutionalized political parties and interest groups serve integrative functions between different branches of government as well as between central and regional/ local governments. [52] Not only do they provide formal channels of communication between veto players but they also facilitate bargaining and negotiation among them. By use of these mediating institutions, decision-makers can co-opt veto groups into government policies by creating new opportunities and incentives for them. Similarly, a centralized, hierarchical and coherent bureaucracy can overcome divisions over government policies by mediating between the branches of government as well as between central and regional administrations. A strong cohesive bureaucratic organization can also build coalitions among legislators and interest groups and provide decision-makers with institutional mechanisms to reach policy equilibriums. Consequently, the strength of these mediating institutions is indicative of the capacity of the state to govern effectively.

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[52] Mainwaring (1998) offered "party institutionalization" as a new way of thinking about parties other than their number, the degree of ideological polarization (Sartori 1994) or fragmentation (Haggard and Kaufman 1995.)

An interaction of these two variables produces four theoretically possible investment environments (see Table 2.1). I call the first type of investment environment "imposed". In this situation, the decision-makers do not face any opposition to their policies from any veto groups within the state. Legislatures either do not exist or are so thoroughly controlled by the ruling party that conflict between legislative and executive branches is virtually unthinkable. Rulers are invincible since "the electoral arena is little more than a theatrical setting for the self-representation and self-reproduction of power".[53] With no accountability, this type of a setting insulates the rulers from group pressures, expands their range of directive powers and increases their capacity and flexibility to formulate investment terms that are favorable to investors and acceptable to themselves. Moreover, the weakness of the mediating institutions frees them from the need to co-opt opposition groups and makes it easier for them to impose on the rest of the society the investment environment that they formulated with foreign investors.

The second possible investment environment is a 'chaotic' one. Here there are veto players in the state that challenge the policies of the government. However, lack of strong mediating institutions leaves pluralism unchecked and unconstrained. The rulers are insecure because the electoral arena is a genuine battleground in struggle for power. Legislatures occasionally become focal points of opposition activity. In some cases, veto players are not limited to legislatures but are also seen in regional administrative units and bureaucratic agencies that pose significant challenges to

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[53] Andreas Schedler, *"The Menu of Manipulation,"* Journal of Democracy 13:2 (2002):43.

government policies. In these settings, the weakness of these conciliatory institutions is a detriment to coherent policymaking as well as to working relations between the executive and legislative branches. Decision-makers cannot overcome opposition of the veto players by totally excluding them because the challenges tend to be both formally legal and widely perceived as legitimate. What is worse is that decision-makers cannot easily co-opt these veto groups either since they lack the institutional mechanisms for building enduring coalitions and facilitating negotiation and bargaining. Consequently, veto players within the state engage in jurisdictional power struggles to the detriment of compromised solutions. The result is oftentimes 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 third possible investment environment is 'negotiated'. There are strong veto players that challenge and constrain the power of the government. Despite the high degree of political competition and pluralism in the state, however, strong mediating institutions like political parties, interest groups and centralized bureaucracies help achieve the goal of building policy majorities as well as maintaining them. This is in line with the conclusions of the social choice theory. Using Arrow's general possibility theorem (Arrow 1951), social choice theorists argue that enduring institutions that form long and durable coalitions can solve the collective action problems by reaching structure-induced equilibria (SIEs) (Riker 1962, Shepsle and Weingast 1982, Aldrich 1995.) In this setting, coexistence of high

degree of political competition with strong enduring institutions provides decision-makers with opportunities to co-opt competing veto groups into investment policies. The result is a negotiated, compromised investment environment that is acceptable to both foreign investors and domestic players.

TABLE 2.1 Types of Investment Environment

		Strength of Veto Players	
		Weak	**Strong**
Strength of 'Mediating' Institutions	**Weak**	*IMPOSED*	*CHAOTIC*
	Strong	*STRUCTURED*	*NEGOTIATED*

Finally, the fourth category of investment environment is 'structured'. In this setting, there is a relatively institutionalized ruling party and centralized state bureaucracy that monopolizes the political arena, using coercion, patronage, media control and other means to deny veto players any real chance of competing for power. In comparison to first type of investment environment, in this setting, centralized

elites are able to co-opt a reasonable range of social groups and form coalitions that support their policies. Investment terms are imposed on the rest of the society by institutionalized party structures and bureaucracy rather than by a single person holding almost all power in the system. The result is a structured and controlled investment environment.

VI. Continuum of Regime Types

Based on the two variables discussed above, I place political regimes that correspond to these investment environments on a continuum of low to high degrees of institutionalized competition (See Figure 2.1). At one end of the spectrum, there are authoritarian regimes that impose a stable investment environment. There are actually very few closed authoritarian regimes that are left in the world in the most conventional meaning of the term. Today most authoritarian regimes hold some sort of elections and try to obtain at least a semblance of democratic legitimacy, hoping to satisfy external as well as internal actors. That is why most recently scholars started calling these façade democracies 'electoral authoritarian regimes' (Diamond 2002, Shedler 2002, Levitsky and Way 2002, Carothers 2002). For purposes of parsimony, I simply use the term 'authoritarian' to depict political regimes that produce very little to none institutionalized competition.

At the other end of the continuum, there are highly competitive democratic regimes. In the literature, these types of inclusive regimes where the "rules of the game" are institutionalized are called consolidated democracies. Consolidation is the

process of achieving broad and deep legitimation by a normative and behavioral commitment to the specific rules and practices of the country's constitutional system (Linz and Stepan 1997.) In a consolidated democracy, not only governance is improved by horizontal accountability, but also representative functions are improved by strengthening of political parties and their linkages to social groups. This type of a regime produces a negotiated investment environment that is stable and attractive for foreign investors.

In between these two extremes, however, there are hybrid regimes. Most regimes today are neither clearly democratic nor authoritarian; they are hybrid regimes.[54] They inhabit this 'twilight zone' between a consolidated democracy and uncompetitive authoritarianism. To order this universe of ambiguous regimes, scholars have been working with broad intermediate categories such as quasi democracy, semi democracy, and pseudo democracy. Others have been developing lists of more specific diminished subtypes such as illiberal, delegative, limited, unconsolidated democracies etc.[55]Certainly, this scholarly treatment of hybrid regimes is not entirely new. "It has intellectual foundations in the transitions paradigm and in other earlier comparative work on democracy."[56] However, in the recent years many scholars started to emphasize the importance of hybrid regimes as specific types of regimes rather than in terms of transition to democracy. Rather than

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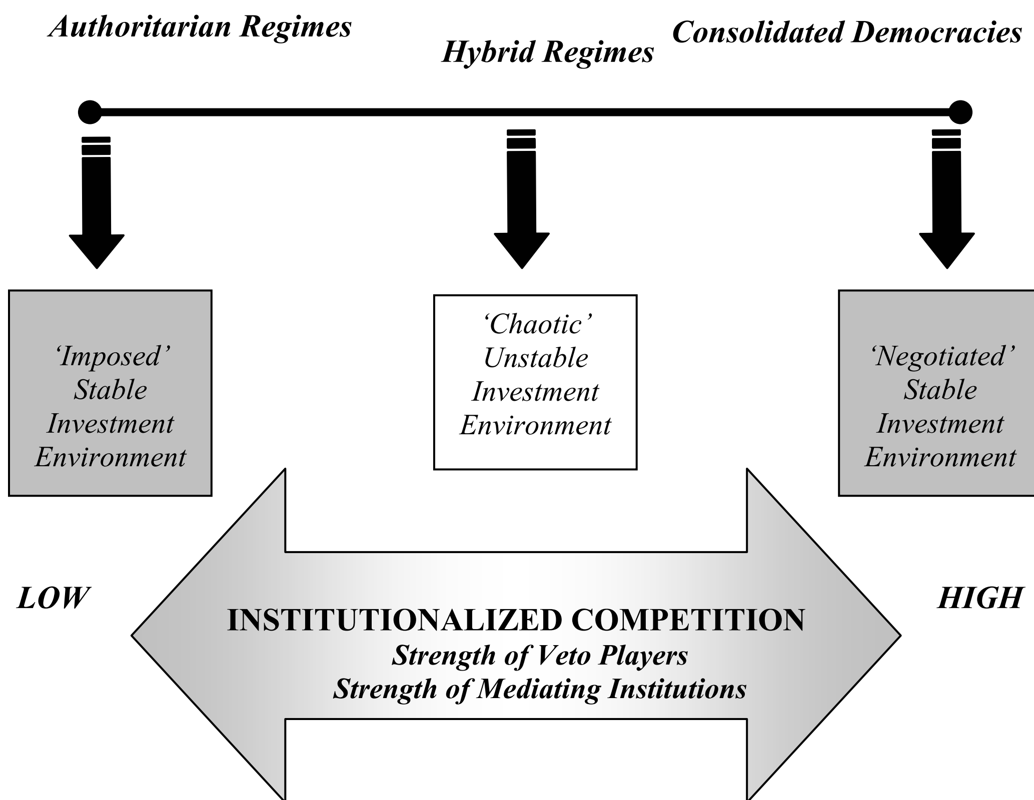
[54] According to Larry Diamond (2002), about 36.9% to 53% of all countries have pseudo democracies.
[55] See David Collier and Steven Levitsky, *"Democracy with Adjectives: Conceptual Innovation in Comparative Research,"* World Politics 49 (April 1997): 430-51.
[56] Diamond, p.23.

seeing it as a diminished type of democracy, some in fact consider it a diminished form of authoritarianism and call it 'competitive authoritarianism' (Levitsky and Way, 2002).

Figure 2.1: Continuum of Regime Type and Investment Environment



This new literature on hybrid regimes, however, focuses mostly on the nature of electoral contests: the degree of fairness, inclusiveness and meaningfulness of

elections. Levitsky and Way (2002) for instance argue that political systems descend into electoral authoritarianism when violations of the minimum criteria for democracy are so serious that they create an uneven playing field. In this dissertation, I focus on the interaction of two variables other than elections to define hybrid regimes. Even though free and fair elections are a necessary condition for democracy, they are not sufficient. As Schmitter and Karl (1991) point out, elections occur intermittently and only offer narrow choices to voters. In between elections, however, the strength of veto players and mediating institutions has a significant impact on the policy environment. Hybrid regimes are not different from consolidated democracies and authoritarian regimes only by the nature of their electoral contests; they are also different in terms of the level of institutionalized competition they provide in between elections.

The second and fourth investment environments that I discussed earlier correspond to hybrid regimes. In this dissertation I focus on hybrid regimes that produce 'chaotic' investment environments. Even though 'structured investment environment' is beyond the scope of this dissertation, I believe that it has analytical utility in pointing to institutional characteristics that distinguish among hybrid regimes. Such an investment environment corresponds to a description of 'hegemonic authoritarian regime' (Diamond 2002), 'bureaucratic authoritarian regime' or 'democracy with dominant party system'.[57] More research needs to be done to

[57] According to Larry Diamond (2002), Mexico is a good example of such a regime. I would argue that China is another good example.

clearly demonstrate the effects of this regime on the stability of investment environment and the ability to attract foreign investment. Future research on this category can contribute significantly to the recent scholarly interest on the varieties of hybrid regimes.

To sum up, given similar external pressures from global markets, I argue that uncompetitive authoritarian regimes as well as highly competitive consolidated democracies are likely to be more successful in creating stable policy environments that facilitate the attraction of significant amounts of foreign investment. On the other hand, hybrid regimes with limited degrees of institutionalized competition make it difficult for governmental elites to overcome opposition to investment policies. Consequently, hybrid regimes, regardless of their economic endowments, may pose major political risks for foreign investors. Distinguishing among different political regimes in terms of the degree of institutionalized competition is a useful way to analyze the relationship between regime type and investment environment.

VII. Political Effects of Foreign Capital

My second argument in this dissertation is that the flow of foreign capital as well as the need to attract it has significant effects on political regimes. There is a significant body of political economy literature that looks at the effects of foreign capital on political structures. In general, two competing views can be found. The first centers on the logic of modernization, which assumes an inherent link between increased economic interdependence and democracy. This neoliberal approach

focuses on the liberalizing effects of foreign capital. Neoliberal scholars contend that foreign capital sows the seeds of democracy by bringing prosperity to countries. More specifically they argue that foreign capital has the power to curb discretionary powers of authoritarian governments by disciplining the business environment, cutting patronage, promoting institution building and strengthening civil society (Lindblom 1982; Mahon 1995; Stallings 1995; Rogowski and Frieden 1995; Block 1996; Henry 1996/98; Winters 1996; Maxfield 1997).[58] Foreign capital is also regarded as providing technology that allows for the more efficient use of local resources, creating a greater ability to promote reform over time (Gilpin 1975).

The second view in the literature points to the anti-democratic properties of foreign capital. The "new wave' of dependency theory provides an example of how foreign capital causes distortions in the political system of host countries.[59] According to Peter Evans (1978), one of the pioneers of this theory, dependent development creates a particular transnational class coalition, a 'triple alliance' between state elites, foreign firms and local firms, all of whom share a common interest in rapid

[58] A seminal contribution to this idea is Albert Hirschman's Exit, Voice, and the State (1978) in which he outlines the role of "movable property" as a restraint on the government's freedom of maneuver by checking on despotic and predatory rule. Slyvia Maxfield's Gatekeepers of Growth (1997) is another good example of the need to make institutional changes to get credit and investment from international investors. She proposes an investor-signaling model of central bank interdependence according to which governments cede authority to central banks in order to signal their creditworthiness. Rogowski and Frieden (1996) also depict the pressures exerted on governments in regard to trade policies. They argue that as transaction costs decline, governments face increasing pressures from internationally oriented sectors to liberalize trade. The prospective winners of trade press for institutional reforms that reduce access to groups seeking exemptions.

[59] Dependency theorists who developed their thinking primarily with reference to the large Latin American NICs share many basic assumptions with writers on imperialism, proponents of a world-systems perspective, and some structuralist theories of international political economy. For a more detailed description of the main tenets of this theory, see Stephan Haggard, Pathways From the Periphery (Cornell University Press, 1990).

accumulation.[60] "This in turn dictates a predictable political and sociological configuration, involving authoritarianism and inequality."[61] Since its position of social dominance is guaranteed by the support of its multinational ally, the local elite has little incentive to institute reform to improve the conditions of the masses (Magdof 1976; Rubinson 1977). Without mass legitimacy, the host government must rely upon repression to hold on to power.

In a variant of this second view, the literature on rentier states, or more specifically petro-states,[62] contends that oil rents reinforce authoritarian tendencies in a country and create obstacles for political change (Mahdavy 1970, Gelb 1986, Hughes 1975, Delacroix 1980, Shafer 1994, Chaudry 1997, Karl 1997). As Michael Ross (2001) in his seminal article summarizes, 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 argues 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

[60] Peter Evans, Dependent Development: The Alliance of Multinational, State, and Local Capital in Brazil, (Princeton: Princeton University Press, 1978). Other dependency theorists are Fernando Henrique Cardoso, *"Associated-Dependent Development: Theoretical and Practical Implications,"* in Alfred Stepan, ed., Authoritarian Brazil (New Haven: Yale University Press, 1973) and Douglas C. Bennett and Kenneth E. Sharpe, Transnational Corporations versus the State: The Political Economy of the Mexican Automobile Industry (Princeton: Princeton University Press, 1983).
[61] Haggard, Pathways From the Periphery, 18.
[62] According to Terry Lynn Karl in The Paradox of Plenty: Oil Booms and Petro-States (1997.) petro-states can be considered a special subset of mining states. The natural characteristics shared by all petro-states are 1) dependence on a single resource, 2) dependence on an industrial sector that is highly capital-intensive and an enclave, 3) reliance on a primary commodity that is depletable, 4) dependence on a resource capable of generating extraordinary rents, and 5) the fact that mineral rents accrue directly to the state.

minerals fails to bring about the social and cultural changes that tend to produce democratic government."[63] I argue in this dissertation that there is a fourth causal mechanism that can explain the anti-democratic effects of oil. Using Ross' expression, this might be considered the 'globalization effect' that impedes democratization by creating an alliance between foreign investors and authoritarian leaders. Foreign investment not only provides new resources for the governing elite, but it also gives legitimacy to it.

In addition to contributing to rentier causal mechanisms, this dissertation also points out to the shortcomings of neliberal and dependency theories in explaining the variation in political responses to foreign capital. Both of these approaches assume these effects to be unidirectional: either democracy-enhancing or democracy-impeding. However, as scholars are increasingly pointing out, these effects are not uniform. For instance, many scholars distinguish the effects of different *types* of foreign capital on political regimes.[64] As opposed to portfolio investments, they argue that foreign direct investments (FDI) can have only limited effects on political structures due to their lack of liquidity. While international investors in government bonds or equities can normally sell them immediately on news of an unfavorable change in the political environment, FDI investors are limited in influencing policy

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[63] Michael Ross, *"Does Oil Hinder Democracy,"* World Politics 53:3 (2001): 326.

[64] In most of these analyses, the variation among the types of global capital is determined by factors such as risk structure, access to local information and number of investors. Another distinction among different types of global capital, according to Kiren Chaudry in Price of Wealth (1997), involves variations in the degree of control that different public-private sector groups exercise over the allocation and the extent to which that control is dispersed or centralized within these groups. To prove his point, she shows the different effects of remittances and oil rents on Yemen and Saudi Arabia respectively.

once they have invested in a physical plant. Hence, FDI's role in promoting institution building remains confined to areas related directly to the security and profitability of foreign investment.

Others also distinguish between different sectors in which foreign capital is invested. Accordingly, holders of foreign capital in manufacturing industries are most affected by the circumstances found in the host country because they rely on the local market for sales, they maintain extensive contacts with local firms that operate as suppliers and distributors, and they require access to large number of local workers (Reuber 1973; Vernon 1977; Richardson 1978; Caporaso 1980; Frieden 1981). By contrast, holders of foreign capital in the mining and other commodity sectors are more insulated and have fewer contacts with the host country. Foreign capital is concentrated in small enclaves, with its primary interest centering on extracting resources for international markets (Vernon 1971; Sklar 1975; Mahler 1981). In light of these considerations, it is argued that investors in this sector have few incentives to play an especially significant role in domestic politics, or to assist in institution building.

Moreover, there are those who argue that the relative market and bargaining power of host governments vis-à-vis multinational corporations determines the extent to which political structures will be affected by FDI (Vernon 1971; Moran 1974). Unlike dependency theories, these bargaining models see the international environment not as a rigidly determinate structure but, rather, as a set of shifting constraints within which states have a range of maneuver. According to Vernon, the

"obsolescing bargain" captures the repercussions of product-cycle and market changes for bargaining between host governments and multinational corporations. The power of two parties is linked to the stages of their relationship and power shifts over time. Accordingly, the vulnerability of host governments to the political effects of foreign capital depends on their relative market and bargaining power vis-à-vis multinational corporations.

Despite these attempts to refine the neoliberal and dependency theories to account for different political effects of foreign capital, there is no systematic analysis of political systems in the literature as an explanation for this seemingly obvious variation. The missing variable in all of these explanations is the political regime prior to the flow of foreign capital. As the three cases in this dissertation demonstrate, depending on the political regime prior to investments, foreign capital can have both democratic and anti-democratic effects. By making the causal connections between regime type and foreign capital, this dissertation contributes significantly to the aforementioned debate over the political effects of foreign capital.

Along these lines, Terry Lynn Karl in Paradox of Plenty emphasizes the importance of institutional settings prior to the inflows of foreign capital. She argues that 'stateness' is a crucial determinant of how oil rents will affect domestic politics. Challenging the determinism in the rentier state literature, she contends that oil profits do not necessarily always make a state more rent seeking and authoritarian. Even though she emphasizes the importance of certain political variables-such as a professional bureaucracy, effective courts and regulatory institutions- in mitigating

the anti-democratic effects of oil rents, she falls short of providing a causal model for why political effects of oil rents are different across oil-rich countries.[65]

I argue that political regimes not only help determine whether there will be foreign investment in the first place, but they also mediate the effects of foreign capital once it is invested (See Figure 2.2). In both authoritarian regimes and consolidated democracies, foreign investment has a 'reinforcing effect' on the political regime. The success of attracting significant amount of foreign capital into the economy strengthens and consolidates the existing regime regardless of its nature. Foreign capital provides not only additional resources to state coffers but it also gives legitimacy to the ruling elite.

As the Azerbaijani case in this dissertation demonstrates, foreign capital has contributed to the further strengthening of the authoritarian regime by providing Aliev and his clique additional resources to suppress the opposition groups and buy off supporters through patronage. As opposed to the democracy-impeding effects of foreign capital in Azerbaijan, however, in a consolidated democracy like Norway economic success brought on by the inflow of foreign capital increased the legitimacy of decision-makers and strengthened the foundations of the democratic welfare state. Foreign capital in this context has had a positive effect on further consolidation of democracy.

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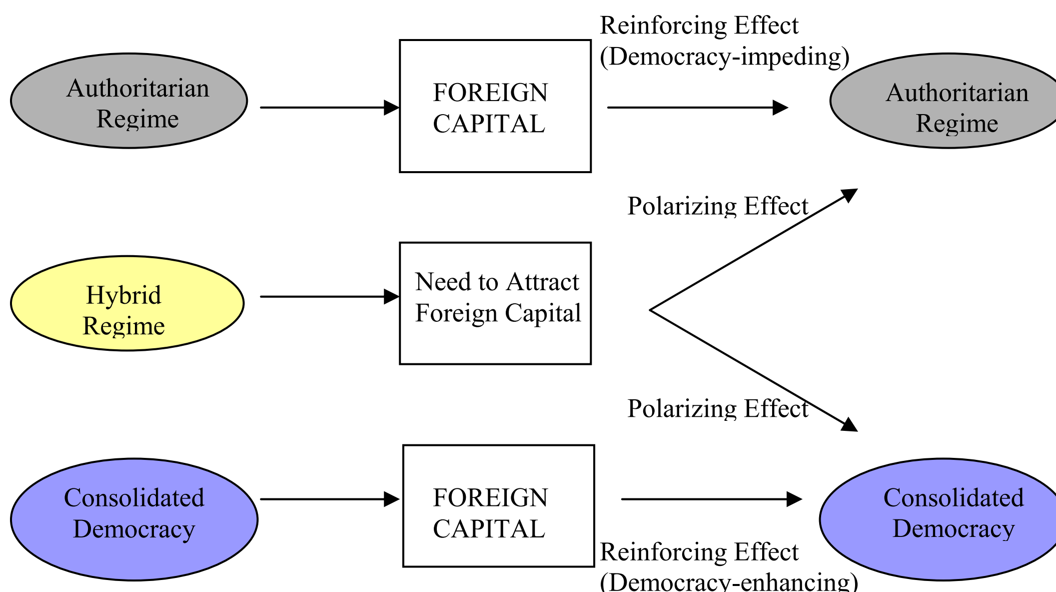
[65] Similarly, Michael Ross in his analysis of the political effects of oil rents fails to account for political regimes. Just like Karl, he acknowledges the variation in political responses to oil rents but explains it with differences in per capita income. Results of his empirical test demonstrate that "large oil discoveries appear to have no discernible antidemocratic effects in advanced industrialized states, such as Norway, Britain, and the U.S., but may harm or destabilize democracy in poorer countries."(p.333)

Figure 2.2: Political Effects of Foreign Capital



Finally, I argue in this dissertation that foreign capital has 'polarizing effects' on hybrid regimes. Hybrid regime is one regime category where the political effects of foreign capital have not been studied at all. The Russian case in this dissertation contributes to the literature by suggesting that pressures from foreign investors for a stable investment environment induce certain institutional changes in hybrid regimes that face dire economic problems. Elites that are in power have the option of creating policy stability either by excluding or co-opting opposition groups. In doing so, they move the regime towards either more democracy or authoritarianism. The political

adjustments that Russian president Vladimir Putin has been making in order to attract foreign investment further uncovers the effects of globalization on hybrid regimes.

VIII. A Comparison of Political Regimes in Norway, Azerbaijan, and Russia

Norway is a perfect example of a consolidated democracy. Norwegian government was able to create a stable investment environment for foreign investors by including opposition groups in the policymaking process and by mediating among them. High levels of political competition in Norway produce many veto players in the policymaking process. First of all, the parliament comprised of strong, coherent parties acts as a significant check on the executive branch. Second, regional governments and legislatures exert important 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. Historically, the central bureaucracy has constituted a strong source of state power in Norway. In addition to government ministries, numerous parastatal organizations, with different agendas and interests create a highly competitive policy environment.

Despite this high degree of competition, 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 groups. An extensive

corporatist structure and a strong centralized bureaucracy have further mitigated collective action dilemmas by institutionalizing bargaining and cooperation among diversified veto actors.

In the oil policy arena over the last three decades, the powerful representation of societal interests, such as environmentalists, labor unions and business groups, has given Norwegian governmental elites institutional mechanisms to mediate between different interests and make compromises in shaping investment policies. 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 derived from negotiations and compromises made among veto groups. A 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 examples of compromises made by Norwegian political elites to co-opt different veto players into investment policies aimed at attracting investors.

Azerbaijan, by contrast, is a typical example of an uncompetitive political regime. It has achieved policy stability not by including opposition groups in policymaking, but by excluding them. Even though there is electoral contestation, the regime has many characteristics of 'sultanism'.[66] Control of the state apparatus is vested in a small group of personally connected individuals, at the core of which sits a

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[66] According to Linz, sultanistic regimes are a type of autocratic regime in which "the ruler exercises his power without any restraint at his own discretion and above all unencumbered by rules or by any commitment to an ideology or value system. In many respects the organization of power and of the staff of the rule is similar to traditional patrimonialism as described by Weber (1968). But the lack of constraint derived from tradition and from continuing traditional legitimacy distinguishes it from the historical types of patrimonial rule.

presidential clique. This clique consists of president Heidar Aliev's most trusted kinsmen, who monopolize the most sensitive and lucrative positions. There are no veto players within the state because the parliament is a symbolic and inchoate institution, and because regional state administrations have no voice in policy-making. Moreover, societal interests lack organizational capacity to overcome collective action problems and resist exclusion by the dominant political elite. To the extent that there are any interest group organizations, they are either weak and powerless or dependent heavily on the autocratic state. Finally, party organizations are too weak and too detached from society to aggregate different interests into policy coalitions and constrain state policies.

This regime has had a profound impact on the ability of Azerbaijan to attract a significant amount of foreign investment in its oil industry during the 1990s. First, parliament has rubberstamped every PSA contract into law without discussion or delay, while the bureaucracy had little input to the PSA process. There was not even a Ministry of Energy until June 2001. The near monopoly role of the state oil company, SOCAR, of which Aliev's son is vice president, prevents bureaucratic interference at the higher levels of government and provides policy insulation. Such insulation creates a conflict-free environment in which political elites operate. With no critical institutional checks on their despotic rule from the Azeri parliament, bureaucracy, regional administrations or business groups, the ruling political elite has been able to negotiate with foreign investors with the utmost discretion and flexibility. Foreign

investors, for their part, have enjoyed the stable guarantees and incentives provided to them.

In contrast to both Norway and Azerbaijan, Russia is an example of a hybrid political regime. Institutionalized competition is more tolerated than in Azerbaijan, but it is much more limited than in Norway. Despite president Yeltsin's significant powers in the formulation and execution of policy, the federal and regional legislatures, regional and local governments in addition to different bureaucratic agencies have at times exerted important veto powers over executive decisions throughout the 1990s. Offsetting this limited pluralism and competition within the state, however, was the lack of strong mediating institutions to build policy coalitions and resolve conflicts among veto players. In contrast to Norway, Russia's party system lacked high degrees of institutionalization. Their financial and organizational weaknesses prevented them from mobilizing different interests in society. Their weak ties to their constituencies made it difficult to aggregate different interests into policy coalitions and constrain the behavior of legislatures, government officials engaged in severe jurisdictional struggles. In contrast to the Norwegian centralized, professional bureaucracy, the Russian bureaucracy could not mediate between different interests and provide compromised policy alternatives. The divisions among government ministries and bureaucratic agencies constrained the policymaking authority of the decision-makers and contributed to the chaotic and incoherent policy making process during the 1990s.

Given this institutional mix and the enormous stakes in controlling oil resources, a PSA regime was presented as the only solution to oil industry's investment problems. Despite its importance, the PSA issue immediately became what observers have called a 'political football' in Russia. State actors had conflicting interests over the procedure of assigning subsoil rights in PSAs and the control over the PSA tax revenues. The institutional system that assigned significant veto power to the parliament and the regions made strategies of co-optation or exclusion for political elites who championed PSAs less likely. The PSA process, which crystallized the problems associated with the creation of a stable investment environment, has thus far failed in Russia due to the weakness of a hybrid regime that gave formal powers to veto players without strong mediating institutions to keep their powers checked.

IX. Conclusion

In this chapter, I first discussed the analytical utility of structural and cultural variables in explaining sources of stability in investment environments. Culture, socioeconomic development, ideology, geostrategic considerations and even the size of a country help explain why some states are more successful in creating stability for investors than others. They certainly shed light on the interests and preferences of certain groups in society or within the state apparatus. However, these variables cannot account for the outcome of political struggles over investment policies. Evidence in the following chapters will clearly demonstrate why institutional

variation, rather than cultural and structural variables, provides a better analysis for differences in state responses to foreign investment.

In this chapter, I demonstrated the causal link between regime type and stable investment environments. I argued that the formulation and implementation of investment terms is a political process. Policy stability requires resolving conflicts of interests among winners and losers of foreign capital either through exclusion or cooptation. The ability to use either strategy depends on the extent of institutionalized competition in a polity. Institutionalized competition measures the strength of the veto players and the institutions to mediate among them. I argue that in both authoritarian regimes and consolidated democracies, decision-makers are usually able to respond to the demands of foreign capital by reducing political risks. However, in hybrid regimes- given the potential instability of partial institutionalization- they are more constrained in their ability to overcome opposition to foreign investment and thus create an attractive investment environment for foreign companies.

In this chapter, I have also briefly outlined where my three empirical cases are located on a regime continuum. In the following chapters, I analyze each case separately and in more detail to show how their political regimes affect the ability to formulate and implement attractive investment policies in the oil sector. In the final chapter, I discuss the implications of this theory in general for the literature and specifically for countries that face similar challenges of globalization.

CHAPTER 3

NORWAY: 'ISLAND OF STABILITY' IN STORMY WATERS

I. Introduction

Oil came as a surprise to Norway. In 1962, when Phillips Petroleum Co. announced its intentions to explore the Norwegian coastal waters, many were skeptical of the idea even to the extent that a geologist, in disbelief, said that he would drink oil if found.[67] With no prior experience and expertise Norway, in less than a decade, established a broad national competence in oil and has used the proceeds for the benefit of the society at large. Norwegian crude oil production increased significantly from 1981 to 2001 (see Figure 3.1). In 2000, Norway ranked as the world's sixth largest producer and third largest net exporter of oil. Government revenues from the oil sector have varied from 20% of the total state revenues in late 1970s and early 1980s to around 33% in 2001 (see Figure 3.2).

Foreign companies have greatly contributed to the build-up of the oil industry through their provision of capital, expertise and technology. Between 1971 and 1996, a total of $200 billion was invested in exploration, construction, and operations on the

[67] Author's interview with Bjarne Moe (the Director General in the Norwegian Ministry of Petroleum and Energy) in Oslo, Jan.15, 2001. He also stated that Trygve Lie- the former General Secretary of the United Nations and then the representative of the Department of Industry- when approached by a delegation from the Phillips Petroleum company said that the company was mistaken and that there was no oil or gas in Norway.

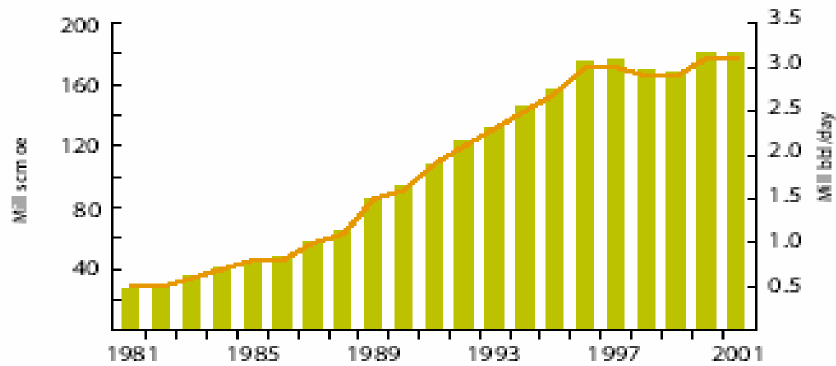
Norwegian continental shelf.[68] Calculations based on FDI figures from UNCTAD Handbook of Statistics show that Norway received 92 cents of foreign investment per barrel of its proven oil reserves between 1994-2001. This figure is very high when compared to the amount of FDI that many other oil-producing countries get for their oil reserves. Most of the major multinational oil companies have been involved in the development of Norwegian oil, among them BP, ExxonMobil, Royal Dutch/Shell, TotalFinaElf, Phillips Petroleum and Conoco. Over time, the balance between Norwegian-owned and foreign companies has changed. In the first offshore licensing round in 1965, the foreign share of the oil fields was 91%. Today, foreign companies operate about 20% of the oil resources in producing fields. Even though Norway, through its resource management model, eventually took control of its own oil operations, it has consistently encouraged the participation of foreign oil companies. Many consider the development of the Norwegian oil industry as a 'grand-scale clubbing together' between the Norwegian state and the world's biggest oil companies.[69]

The potential oil resources of the North Sea were the main reason why multinational oil companies got interested in Norway in the first place. With 0.9% of world's total proven oil reserves, the country is the 13th largest oil province in the world.[70] Trends in the international oil market also contributed to Norway's

[68] International Trade Administration. *"Oil and Gas Services Update: Norway,"* International Market Insight (06/21/2001.)
[69] U.S. Department of Energy. *Country Analysis: Norway (2001)* Energy Information Administration, (www.eia.doe.gov).
[70] BP Statistical World Energy Review 2001 (www.bp.com)

attractiveness. High oil prices and problems of supply on a global scale during the 1970s were important reasons why companies found it strategically compelling to invest in Norway. Oil embargos imposed by OPEC countries compelled multinational oil companies to secure access to new oil resources and thus reduce their dependency on the Middle East. On top of this, Norway's proximity to major European markets and consumers made it geographically suitable for investment. Finally, its merchant marine was a strong domestic industry that increased Norway's competitiveness among other oil producing countries. Norway has been and is still heavily engaged in tanker trade, transporting oil for the international oil companies.

Figure 3.1 Norwegian Crude Oil production (1981-2001)

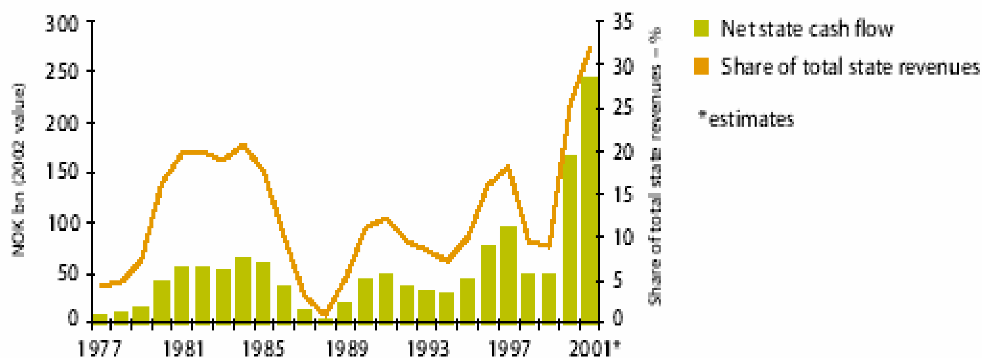


Source: Norwegian Ministry of Energy

While its potential resources in the North Sea, its geographic proximity to markets and strong domestic industries ensured the interest of foreign companies, the

harsh weather conditions, the difficulty of drilling in North Sea's deep offshore waters and high government taxes dramatically increased the costs of oil development for them.[71] Despite these commercial risks, however, investors continued to invest significant amounts in the country (see Figure 3.3.) I argue that this was due mostly to the ability of the Norwegian state to create a stable investment environment.

Figure 3.2 Net cash flow from petroleum operations (1977-2001)



Source: Norwegian Ministry of Energy

The Norwegian political setting was a totally new one for the major oil companies. In neither the Middle East nor North America, did they have to cope with governments that were actively concerned with resource policy and prone to

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[71] Water depths and weather conditions make development of offshore oil resources in the North Sea very difficult and risky. The Gulf of Mexico and Middle East are considered less risky places to produce oil. According to Energy Information Adminsitration's Country Analysis in 2001, the cost of oil production is about $12-14 per barrel in Norway, while it is $3-4 in the Middle East.

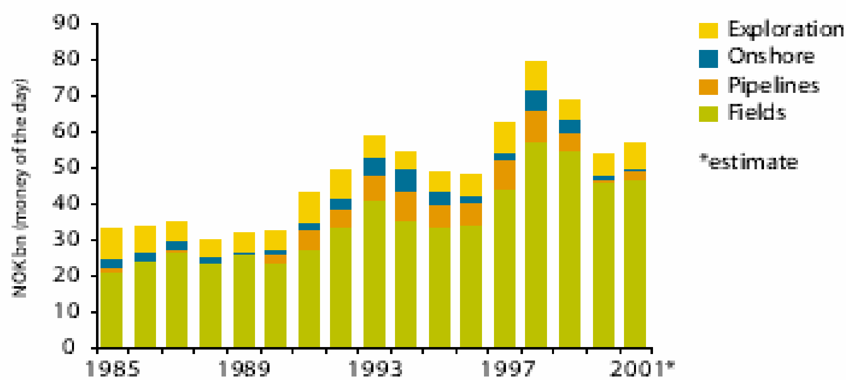
intervene directly in industry.[72] But with its strong state and social welfare traditions, Norway from the beginning of its oil industrialization was determined to use foreign oil companies to build national competence in oil and increase the welfare of its society. This meant significant state participation, regulation, and revenues from the oil sector as the state gained experience. It also meant modest rates of return for the oil companies. However, companies tolerated decreased short-term profits in return for long-term investment stability. In a period when major oil producers around the world were nationalizing their oil industries or imposing harsh terms on foreign investors, Norwegian demands made to the companies were relatively modest. While putting financial and operational burdens on the foreign companies to develop the national oil industry, the Norwegian state was able to provide enough incentives for them to continue investing.

Domestic politics have played a crucial role in shaping the terms of this investment relationship. The government is central to the concession process, key decisions have to be approved by parliament and many domestic interest groups have a stake in oil development. Despite the multiplicity of actors in the policymaking process and their often-strong disagreements about certain issues, the investment environment has remained very stable, benefiting both domestic interests and foreign investors. The division of responsibilities among state institutions, regular consultations with the government and interest groups, and conflict resolution

[72] In the U.S companies had experienced tough anti-trust regulation, but no direct government intervention. In the Third World, governments were generally weak and companies had privileged positions and were often exempted from national law.

mechanisms have given oil companies the means to influence policy and ensure the security and profitability of their projects. Throughout, the Norwegian decision-makers were able to balance different domestic and foreign interests through negotiations and compromises.

Figure 3.3 Investment Levels in Norwegian Oil Sector (1985-2001)



Source: Norwegian Ministry of Energy

Finally, the Norwegian investment regime has ensured that investors' rights are not infringed. Despite major fluctuations in the international market for oil during the 1970s, and despite some subsequent changes in the economic terms of the investment relationship, the basic principles of engagement between the Norwegian government and the oil companies that were established in the late 1960s have remained intact throughout the three decades of oil development. Norwegian policy towards investors has been characterized by clarity, consistency, and continuity. The

stability of this investment environment has been an argument for oil companies to accept the terms offered them, even when they became less favorable.

In the first part of this chapter, I discuss the historical evolution of the investment relationship between foreign investors and the Norwegian state. I examine alternative explanations for the stable investment environment and discuss their limitations. Then, I discuss how the highly competitive and institutionalized democratic regime has contributed to the stability that investors have so long enjoyed in Norway. Finally, I emphasize the role foreign investments played in the consolidation of the democratic welfare state, as well as in the creation of an important player in international affairs.

II. History of Relations Between Investors and the Government

i. The initial phase: 1960s

In the mid-1960s, Norway enjoyed strong economic growth and full employment. It ranked seventh in gross domestic product per capita among the OECD countries. High living standards prevailed and poverty was virtually abolished. With no pressing need for oil revenues, the Norwegian government could initially afford not to give in to all the demands of foreign investors. In addition to this economic flexibility, a cautious policy towards the multinationals resulted from the traditional sensitivity of Norwegian society to the question of sovereignty. Having been dominated by Danes and Swedes for 400 years, Norwegians have always resisted exploitation by foreigners. Moreover, the experiences of hydropower

production in the beginning of the 20th century taught Norwegians important lessons about doing business with foreigners. Hence, from the outset of oil development it was crucial to set up a broad framework to regulate foreign company operations closely and provide a base for state control and capture of ground rents.

In 1964-65 a group of professionals, led by Jens Evensen[73], formulated the first comprehensive regime for exploring and producing oil from the North Sea. A Royal Decree was passed and the first production licenses were awarded based on the concessionary model.[74] In 1965 a Labor government granted 78 licenses to nine groups of foreign companies.[75] These licenses provided an oil company or group of companies with exclusive rights to exploration, drilling and production within geographically defined areas. These concessions were much more restrictive than the "traditional concessions" at the beginning of the 20th century in terms of the limits they applied to geographical areas and the duration of permitted operations. Moreover, they were granted by an administrative procedure, in which the state used

[73] Jens Evensen was the main architect behind the Norwegian offshore strategy. He was then the Director General of the Ministry of Foreign Affairs. Chaired by Evensen and comprised of three scientists and two more civil servants, the committee deliberated for fifteen months to draft a set of regulations that were eventually promulgated by the Royal Decree of 1965. These civil servants worked very closely with the foreigners in coming up with this draft.

[74] The concessionary licensing regime was firmly rooted in the nation's long tradition of regulating foreign investment in the hydropower production. Beginning in 1906, the Norwegian Parliament passed a series of laws that eventually created the Concession Act of 1917. The national control was a sensitive issue and so the state introduced strict concession terms to control the activities of the foreign companies.

[75] In September 1965, the Labor government was defeated and a liberal-conservative coalition took over. Oil policy was basically left unchanged, as was the administration of oil. Only the criteria for license allocation were modified, with provisions of state participation being included. In 1969, the government granted 14 new licenses that provided for state participation in the form of 'net profit sharing' and 'carried interest'.

its discretion to choose companies that met certain criteria.[76] In this first licensing round in 1965 even though control of entry was strong, the Norwegian state had but limited control over operational matters. As such, it was not in a position to demand much from the companies. "The state had neither the expertise nor the capacity to follow up its ambitious goals beyond the entrance gate."[77] Without any prior experience and technological edge, the government initially had to rely on foreign oil companies and provide them with enough incentives to invest.[78] As a well-known Norwegian analyst put it, this period down to the early 1970s was one of 'wait-and-see.'[79]

ii. 'Norwegianization of oil': The 1970s

The discovery of a major field, the Ekofisk, in 1969 changed the dynamics of the relationship between the Norwegian state and the multinationals. When it was realized that the Norwegian part of the North Sea was an area with potential for huge resources, a strategy for 'Norwegianization' of oil industry was developed. This entailed gradual increases in national control, participation and revenues. The

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[76] In this discretionary method of allocating licensing, the applicants were not allowed to form license groups on their own. They were chosen by the authorities on the basis of specific criteria.
[77] Svein S. Andersen and Maja Arnestad, *"The Taming of the Shrewd: Small State Meets Multinational Oil Companies"* in Helge Ole Bergesen and Anne Kristin Sydnes, eds., Naïve Newcomer or Shrewd Salesman? Norway- A Major Oil and Gas Exporter (Fridtjof Nansen Institute, 1990),54.
[78] The competition with the British for companies willing to explore in the North Sea was another reason that led the Norwegians to offer easier terms to the investors.
[79] Svein S.Andersen, The Struggle over North Sea Oil and Gas (Scandinavian University Press, 1993),61.

increased bargaining power of host governments around the world during the 1970s was used as pretext to impose new demands on the multinationals.

State participation in a Second Licensing Round between 1969-71 was the first indication of this change. Oil companies accepted a minor degree of state involvement, either as an agreed percentage of net profit, or as an option to participate directly if commercial discoveries were made.[80] Another indication of change was three *White Papers* that the government presented to the Norwegian parliament (Storting) between 1968 and 1971. Based on these proposed principles of oil exploration and production, the Storting Committee on Industry in 1971 put forth the *"Ten Oil Commandments,"* which spelt out the ambitions of national control, developing a new Norwegian industry, paying heed to existing businesses and to the environment, and creating a state-owned oil company.[81] During the 1970s it became very important to develop a broad Norwegian-based competence in offshore oil activities, and over the long run reduce the role of the foreign oil companies to that of consultants, developers and minority partners.[82]

Pursuing these objectives, Norwegian government gradually began to assert managerial, operational, fiscal and ownership control over the industry. For the management of oil operations, as mentioned earlier, the government used administrative licensing rather than auctioning fields to the highest bidder. In this

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[80] Ole Berrefjord and Per Heum, *"Political Governance of the Petroleum Industry- The Norwegian Case,"* in Bergesen and Sydnes, eds., Naïve Newcomer or Shrewd Salesman? (Fridtjof Nansen Institute, 1990), 28-49.
[81] Ibid.,36.
[82] *Government White Paper* 25, 1973/74.

way, bureaucratic discretion took precedence over obtaining a maximum share of economic rent. The Ministry of Industry was able to encourage the exploration of less attractive areas by smaller companies and to insist that foreign companies use Norwegian goods and services as a condition for license approvals.[83] The government also restricted leasing policies to speed up oil extraction. By dividing offshore areas into small blocks rather than large areas, the government speeded up exploration. In addition, in 1972, the government reduced concession periods for licenses to thirty-six years from the traditional ninety years to encourage a timely development of resources.[84] Finally, the government increased its managerial control through a depletion policy, which determined the rate at which oil resources were extracted. In 1973, it imposed a yearly production ceiling of 90 million tones of oil. The goal was to have a moderate and conservative pace that reduced the relative influence of foreign oil companies over production policy. In this way, the Norwegian oil companies and offshore suppliers would have time to develop sufficient capacity to play a major role in oil development. As a result, between 1973-1979, only thirty-one blocks were licensed in contrast to ninety-two during the first seven years of licensing.

As for regulatory control, a set of national safety regulations was passed with a Royal Decree on August 27, 1967. Established within a year of the commencement

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[83] Merrie Gilbert Klapp, The Sovereign Entrepreneur: Oil Policies in Advanced and Less Developed Capitalist Countries (Ithaca: Cornell University Press, 1987), 77.

[84] In Kuwait the original 1934 concession to the Kuwait Oil Company was granted for 92 years. The D'Arcy concession in Iran was originally granted for 60 years.

of the first drilling activities, this decree addressed safety issues related to seismic explorations, drilling and the use of floating rings. In addition to the decree, the Petroleum Directorate was set up to be responsible for enforcing safety and environmental precautions. In developing the 1967 regulations, Norwegian authorities did not blindly submit themselves to the demands put forth by the oil companies. The Oil Advisory Board stated that while the oil companies possessed expertise on the exploration and production side of the drilling industry, the Norwegian authorities themselves were experts on maritime activities. And as a result, the Norwegian Directorate of Shipping and Navigation came to exert a dominant influence on the regulations that were to be developed even though many of the proposed regulations encroached upon the normal working practices and procedures of the oil companies.[85]

In terms of revenue control, the government was able to carve out a significant share of public oil revenues through taxation. In the beginning, due to the uncertainties about its actual oil reserves, the government hesitated to tax companies too heavily and thus discourage them from investing. Between 1965 and 1972 the government collected a public revenue share composed of royalties, area fees and taxes on the posted prices that OPEC had established above market prices to assure minimum revenues for producer governments. The initial taxation rate in 1965 was 10% for oil and was changed to a sliding scale of 8-16% by 1972.

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[85] Helge Ryggvik, *"Offshore Safety Regulations in Norway: From Model to System in Erosion,"* New Solutions 10:1-2 (2000): 67-116.

After 1973, however, the government became more concerned about getting its fair share of profits as a result of OPEC price increases. In 1974 and 1975, the government reached agreement with the companies. The companies would be now taxed at a substantially higher rate of 70%. In 1975, the government also created a new excess profits tax of 25%-the Special Tax- on residual profits after income taxes and royalties.[86]

At the same time that it was increasing its tax revenues, the Norwegian state was getting less and less satisfied with having revenue control only through taxation policies. Revenues from royalties and taxes provided the government only with a 20% share of total returns from oil production. To increase state revenues, government control was carried one stage further to ownership control. First, the government took a 51% controlling interests in a domestic oil company, Norsk Hydro. In 1969-70 the government also introduced state profit-sharing participation in leases to foreign oil companies. The participation percentage was based on the net profits of foreign oil companies. For instance, state participation increased from 5% in the Frigg field in 1969 to 40% in the Heimdal field in 1971.[87]

Norwegian state's involvement in the oil industry reached its peak with the creation of a 100 percent state oil company, Statoil, in 1972.[88] This direct income

[86] Klapp, The Sovereign Entrepreneur, 78.
[87] Ibid.
[88] Policymakers generally agreed on the need to establish a state owned company but there was some dispute over the form it would take. Many on the political right thought that Norsk Hydro, Norway's largest and most powerful manufacturing company was already well situated to take on this role. Another proposal was the creation of a government holding company that would service smaller state

from the oil operations supplemented the fees, royalties and taxes that the government received from foreign oil companies. In addition to giving more economic power, this arrangement provided the government with enough political power to guide and control oil activities according to state principles and interests. The Ministry of Industry comprised its general assembly. The creation of Statoil was the government's first entrepreneurial policy.

These organizational arrangements that were established in 1970s, reflected a strong political wish to Norwegianize the petroleum industry. The concession rules were changed by the parliament to give Statoil a minimum of 50% share in all licenses. "In all the licenses after 1973 (the Statfjord field) Norwegian ownership interests have been more than 60% on the average, compared to some 10% in the pre-1973 period. In addition to Statoil, the two other Norwegian oil companies, Norsk Hydro (51% state-owned) and Saga (100% privately owned), were also given operatorships of highly promising licenses. Since 1973 Norwegian oil companies have served as the operator for more than 60% of the licenses that have been awarded, compared to none before."[89]

To develop Statoil as a fully functioning oil company, the State required that the foreign companies bear all the exploration expenses in the licenses. The foreign oil companies agreed to a sliding scale scheme, in which Statoil's shares could be

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companies in joint ventures with foreign companies. It was believed that there was greater flexibility and economic efficiency in a small holding company.

[89] Berrefjord and Heum, *Political Governance of the Petroleum Industry: The Norwegian Case*, 36.

increased up to 75% if major discoveries were made. Furthermore, the state wanted oil companies to contribute to the development of Norwegian industry through the industrial and technology agreements and to give preference to Norwegian suppliers of goods and services if these were competitive. To monitor compliance, the ministry established a system of reporting that opened the bidding process to government scrutiny. These measures broke traditional supply patterns of the foreign companies and raised the Norwegian share of offshore business from 28% in 1975 to 62% in 1978.[90]

The beginning of the 1980s was 'harvest time' for the Norwegian government.[91] Increased national competence further reduced dependency on multinational corporations. Statoil had developed into a vertically integrated oil company and almost achieved the capabilities of a multinational oil corporation. However, during this period, the Norwegian economy became increasingly dependent on oil revenues. The Norwegian government also became heavily indebted due to investment requirements and inflationary effects of oil.[92] To compensate for economic difficulties, the government offered 70 offshore blocks for development between 1980-85 as opposed to the 31 that were offered during the period 1973-79.[93] This increase in production coincided with the price hikes in 1978-79, bringing

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[90] Brent F.Nelsen, The State Offshore: Petroleum, Politics, and State Intervention on the British and Norwegian Continental Shelves (Praeger, 1991), 71.
[91] Andersen, The Struggle over North Sea Oil and Gas, 149.
[92] Since 1973, many of the Norwegian industries became less competitive because of oil-induced inflation and currency appreciation. Companies were near bankruptcy and industries were in decline in shipbuilding, fishing, farming and textiles. Committed to full employment, the government heavily subsidized these industrial sectors-to a total of $14 billion between 1973 and 1980.
[93] Andersen, The Struggle over North Sea Oil and Gas,144.

government revenues from NOK 18 569 billion to NOK 46 694 billion (see Figure 3.2.) The increase in the special tax from 25% to 30% in 1980 further increased government revenues, bringing the oil sector's share of GNP from 9.4% in 1979 to 19.1% in 1984.

iii. The late 1980s

By the mid 1980s internationally, the relative power of host-governments vis-à-vis multinationals changed once again. Oil prices started to drop, and they collapsed in 1986. OPEC was losing its grip on the international oil market. Demand for oil had been subsiding because high prices in the previous decade had stimulated production in non-OPEC countries. This advantaged consumer countries but for producing countries with high costs it spelled trouble.

Norway as a high cost producer was no exception. The Norwegian economy had by this time deteriorated significantly. Because of the great importance of the oil sector as a source of government revenue and as a stimulus for the national economy, Norway was among the first to be hit by the oil price collapse. There was a dramatic fall in government revenues from oil and gas production. Economic growth fell two percent from 1986 to 1987. In the following years, Norway was hit by the strongest recession since the 1930s. GNP decreased while unemployment increased form 2 to 4.5%. The balance of trade went from record surpluses during the first half of the

1980s to record deficits.[94] The oil and gas share of Norwegian exports dropped from 38% to 29%.

Due to these economic hardships, the Norwegian government recognized the need to have multinationals bear a large share of the financial risk, contribute to lower production costs through technological innovations, and help secure market outlets. Some foreign companies had close links to decision-makers in gas importing countries and therefore were important for negotiating large-scale gas contracts.[95] To reduce the financial costs for companies, a new tax regime was proposed in 1986 by the Labor government. Under this regime, foreign companies no longer had to bear the government's and Statoil's shares of exploration costs. Moreover, a ban on year-round drilling in the far north, originally imposed for environmental reasons, was lifted. These measures were aimed at encouraging exploration, especially in the risky northern area. In 1990-1991, there was another tax reform based not on changes in the oil sector but on improving the general investment climate. The ordinary tax rate was reduced from 50.8% to 28.0% and the royalties for oil and gas production were eliminated after 1996.

Even though multinationals' revenue shares and operational controls in licenses often changed- sometimes for the worse- during the 1970s and 1980s, they were still willing to invest. This was mostly because compared to other oil producing countries in this period the politically determined costs imposed by the Norwegian

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[94] Ibid.,114.

[95] Andersen and Arnestad, *"The Taming of the Shrewd: Small State Meets Multinational Oil Companies,"* 57.

government on companies remained relatively modest. The government almost always ensured that the investors had enough after-tax profits to make it worthwhile for them to continue. Fluctuations in government demands were in line with the fluctuations in oil prices. For instance, the government increased taxes only when the oil prices increased, and it reduced taxes when the prices went down. This regular adjustment to the market ensured a decent return for investors. The government was also able to maintain a balance among different societal interests to ensure that no radical decision would be taken to threaten the profitability and security of investors' projects.

Moreover, stable legal, administrative and regulatory rules gave investors incentives to stay. The terms of licensing that were formulated in 1964-65 were intact, and they provided a clear set of rules for investors. In addition, a clear division of responsibility between the institutions of the state presented investors with equally clear negotiation and influence channels. Finally, all government policies regarding oil production rates, taxation and state involvement in the oil sector were consistent with the Ten Oil Commandments introduced in 1971. Hence, investors operated in a very predictable administrative and regulatory environment. Overall, this stability and predictability attracted much FDI in the oil sector.

III. Sources of Stability in the Investment Environment

To explain why there has been so much stability in the Norwegian investment environment, many analysts have emphasized culture. They have argued that

Norwegian culture in particular and Scandinavian culture in general promotes egalitarianism, consensus building, and harmony within society. Norway is depicted as being especially fortunate for not having inherited an aristocracy. The political mobilization of the peasantry in the nineteenth century, as well as the socialist workers' movement in the twentieth century, is seen as a factor contributing to the egalitarian values and goals of the Norwegian society. Following Eckstein (1966,) Norway is considered a 'community system' where social divisions are largely neutralized by 'overarching sentiments of solidarity.'[96]

Others find the sources of policy stability in Norway in strong elite unity and consensus. Scholars have identified three main elite settlements that have contributed to political and economic stability in Norway since the end of the 19th century. The adoption of parliamentarism in 1884 as a strategic move to distance Norway from the colonial governance of Sweden is regarded as the first of these settlements. Subsequent settlements in 1905 and 1945 united Norwegian elites against the occupation of Sweden and Germany, respectively, by joining forces to work for national reconstruction. "All of these three events in Norwegian history have decisively contributed to the creation of a basic consensus among the elites about the main features and norms of the Norwegian political system and about the necessity of refraining from too strong political partnerships."[97] It can be argued in general that

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[96] See Neil Elder, Alastair H. Thomas and David Arter, The Consensual Democracies? The Government and Politics of the Scandinavian States (Basil Blackwell, 1988), 9.
[97] John Higley, G. Lowell Field, and Knut Groholt, Elite Structure and Ideology: A Theory With Applications to Norway (Columbia University Press, 1976). Engelstad Fredrik, Trygve Gulbrandsen and Oyvind Osterud, *"Elite compromises in a stable democracy: the case of Norway,"* paper presented

this consensus among political elites facilitated the resolution of major conflicts over policies and prevented unpredictable fluctuations in policy environment, reducing political risks for investors.

Finally, there are those who argue that the country's geographic location and its historical openness to international markets helped create a market-oriented culture in Norway even before the multinational oil companies arrived. For instance, Peter Katzenstein argues that states in small West European and Scandinavian countries have historically been dependent on the international economy to survive, and therefore they have never been hostile to doing business with the outside world.[98] Being such a small country, Norway has of necessity been heavily involved in foreign trade and exposed to international competitiveness. For instance, some 40% of the total output of its goods and services was exported in 1970 and imports exceeded exports by 52%.[99] In 1990 the value of all Norwegian exports in commodities and services was as much as 44 % of GNP.[100] Moreover, experience with the foreigners at the beginning of the century in developing hydroelectric power and aluminum industry, in addition to the important maritime sector, gave Norwegians an understanding of the market economy.[101] All these factors are seen as contributing to the positive attitude of the Norwegians towards foreign investment in oil and lack of

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in the 1999 Annual Meeting of the American Political Science Association, Atlanta (September 1-5, 1999),3.

[98] Peter J.Katzenstein, Small States in World Markets: Industrial Policy in Europe (Ithaca, NY: Cornell University Press, 1985).

[99] Walter Galenson, A Welfare State Strikes Back (University Press of America, 1986).

[100] Knut Heidar, Norway: Elites on Trial (Westview Press, 2001),97.

[101] Author's interview with Daniel Heradstveit (a professor of international relations in the Norwegian Institute of International Affairs) in Oslo, Jan. 17, 2001.

politicization of these issues in the later part of the century. Being historically exposed to foreign influence, many have concluded that Norway posed little risk in terms expropriating or nationalizing foreign operations.

As convincing as these arguments sound, they are not sufficient to explain the sources of stability in the Norwegian investment environment. They all assume consensus over investment policies based on culture, geography and elite configuration, though in fact there was never really a consensus regarding oil politics in Norway. These explanations take for granted the conflict and struggle among different interest groups over oil policy. Only in the early years of oil development, however, there was little politicization of oil issues due mostly to the fact that the Norwegian society was very skeptical and uncertain about the actual levels of oil resources it had. By early 1970s, however, with the discovery of the Ekofisk field, oil investment policy became an integral and contested part of Norwegian politics.[102] While some groups that historically benefited from economic openness were in favor of foreign investment, others displayed considerable mistrust and suspicion towards foreigners, especially because of being exposed to foreign domination for so many years. Such groups believed that industrial growth should be owned and managed by Norwegians consistent with cultural values. The influx of foreign oil companies caused various groups to worry that their socialist, environmental, and conservationist

[102] The early 1970s was a period of great political upheaval in the country. The debate over Norwegian membership in the European Community had created an intense questioning of general values and societal goals. This general political climate together with the oil crisis in 1973-74 strengthened interest in the oil industry. This period also corresponds to Labor Party's taking office again.

values might not survive.[103] The role of the state oil company, the rate of oil production and oil taxation were the principal issues over which fierce political struggles unfolded between different interests.

An analysis of the interests and preferences of those groups who benefit and lose from foreign investments is necessary but not sufficient to understand the stability of the investment environment. The institutional structure within which these groups interact is also essential in understanding investment policy outcomes. I now turn to a discussion of the political regime in Norway and its ability to create a stable policy environment.

IV. Political Regime and Stability

Norway is clearly a consolidated democracy. There is a high degree of institutionalized political competition. First, there are many groups with veto power over the executive branch. Pluralism in the state coexists with strong mediating institutions. Conflict among veto players is institutionalized and regulated in Norway by strong political parties, interest group organizations, and a professional bureaucracy. These institutions aggregate different interests, build policy coalitions and pressure the government to be accountable and responsive to different demands. Decision-makers are able to defuse potentially divisive political issues by co-opting

[103] There were in fact major cultural clashes between foreign and domestic businesses. For instance the 'cowboy mentality' that the American companies brought into labor relations was seen as quite problematic. Author's interview with Kjell Roland (the Managing Director of Center for Economic Analysis) in Oslo, Jan 22, 2001.

veto players into government policies through negotiations and compromises. The resulting balance of forces moderates political divisions and promotes consensus and stability.[104] As such, Norway's institutional setting reduces the potential political risks that foreign companies might otherwise face in their investments.

The Norwegian parliament, the Storting, is an important veto player in the state.[105] It is called a 'working' parliament because it does not only say yes or no to government proposals but it also gives the opposition a chance to criticize and present alternative policies. The Storting's committees and party groups actively participate in reworking government proposals to meet objections of the parliamentary majority. Between 1945 and 1970 the Labor Party's majority government ruled in the face of an opposition divided among four small parties. Since the 1970s successive minority and coalition governments have enabled Storting veto power to have greater control over oil policies.

In addition to the Storting's veto power, the regional and local governments have been able to constrain central government policies. Norway is a unitary state but local government -consisting of municipal and county levels- has a long and strong tradition of participating in policymaking. Opposition to the center, or as some people call the Oslo elites, has been crucial in shaping policies. Municipalities are led by elected councils and headed by boards composed in proportion to the local parties'

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[104] Neil Alder, Alaistair H. Thomas, and David Arter, The Consensual Democracies? The Government and Politics of Scandinavian States (Oxford: Martin Robertson, 1982).

[105] The Storting consists of two chambers and this division is used only when the parliament debates new laws. This semi bicameralism does not have many implications other than making the minimal time to adopt a law in parliament three days.

electoral strength. There are also county councils that are popularly elected but do not enjoy the same grassroots support and interest as the municipal councils. Known as 'local democracy', or 'community democracy', this aspect of Norway's political structure contributes to political competition. Moreover, the number of representatives of peripheral districts in the Storting is disproportionately great. Because constituency size is not adjusted, the 'one vote, one weight' principle is violated and this gives peripheral interests heigtened weight in decision-making.[106]

Such high extent of pluralism in the state often produced significant constraints on the decision-makers in Norway. For instance, since the 1970s the fight for new jobs in the periphery strongly affected decisions on the location of new supply bases for the oil industry and the depletion policy. The government has also been on many occasions pressured by the parliament to change its tax and regulatory policies regarding oil activities.

This political competition in the state, however, is institutionalized through strong political parties, interest groups and a bureaucracy. Political parties are the traditional instruments of mobilization and participation in Norwegian politics. They offer the voters political alternatives at elections, recruit state's political personnel and control the commanding heights of executive power.[107] Individual politicians either rise through the parties or with the help of parties and they depend almost

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[106] Author's interview with Trygve Gulbrandsen (Researcher in the Institute for Social Science) in Oslo, Jan 22, 2001.
[107] Heidar, 91.

entirely on their party for future political careers. Politics in Norway is by and large party politics.[108]

Even though most parties are political coalitions in the sense that they encompass more than one cleavage, the left-right cleavage has always been the most important in defining the Norwegian political battleground. In broad terms, the Labor and the Socialist Left parties have been on the left; the Center, the Christian, and Liberal Parties have been in the middle; and the Conservative and Progress parties have been on the right. From 1945 to 1968, Labor was the dominant party, defining the broad contours of state policies, including oil policy. Since 1968, however, there has been a two-bloc competition for power. Although party membership has been in decline in recent years, political legitimacy within most parties has rested with the party organizations. Especially, since 1970s, there has been a rise of professionalism in party organizations. Public subsidies have provided parties with a financial basis to employ party members and party sympathizers with organizational and media qualifications.[109]

Despite the importance of political parties, many believe that interest groups play a more crucial role in Norwegian democracy. Political scientist Stein Rokkan argued that crucial economic decisions were seldom taken by the parties or by parliament, but occurred instead over the bargaining table where public authorities met directly with trade union leaders, farmers, fishermen, and the Employer's

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[108] Katzenstein (1985) argues that partisan politics in small countries like Norway play the crucial role of narrowing differences between interest groups.
[109] Heidar, 72.

Association.[110] Considering the degree of interest group activity in Norway, this claim may not be that far from the truth. In Norway, during "the early 1990s, roughly 2,400 national organizations claimed 17 million members (in a country of 4 million inhabitants.) More than half of the population is a member of at least one national organization, and about half of these organizations operate within the field of industry."[111] Moreover, such organizations operate at the regional and local levels. "According to surveys in 1975, about half the voters had at least once taken part in a political action group. Later studies show that the proportion having signed at least one political action petition was 56% in 1981 and 61% in 1990."[112]

Political participation by interest groups in Norway has been conducted through what many have called societal corporatism (or corporate pluralism).[113] Under this configuration, interest organizations within a free, pluralist private sector bargain with public authorities and with each other in order to influence public policies. The public authorities in return consider private organizations both useful and legitimate partners and feel accountable to them. To accommodate these interest groups, decision makers use institutional devices such as co-optation to advisory committees or study commissions or they consult extensively when preparing

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[110] Stein Rokkan, *"Norway: Numerical Democracy and Corporate Pluralism,"* in Robert Dahl, ed., Political Oppositions in Western Democracies (New Haven: Yale University Press, 1966.)
[111] Heidar,76.
[112] Ibid.,78.
[113] For a distinction between societal and state corporatism, see P.C. Schmitter, *"Still the Century of Corporatism,"* in P.C. Schmitter and G. Lehmbruch, eds., Trends Towards Corporate Intermediation (London: Sage, 1979).

legislation (the 'remiss' system.)[114] In this corporatist structure, a centralized and concentrated core of interest groups and informal, voluntary bargaining partners have forged consensus among interest groups, the state bureaucracy and political parties.

Finally, the Norwegian bureaucracy serves important integrative functions between different branches of government, as well as between societal interests and the state. In many scholarly accounts the bureaucracy in Norway has been given credit for being extremely professional, autonomous and efficient, thereby contributing to stability. As in the Weberian ideal bureaucracy, recruitment has been based solely on merit and civil servants have been the best-educated elite group in society.[115] Moreover, bureaucrats have been insulated from group pressures and, thus, corruption. They were able to pursue state goals independently and with utmost efficiency. The behavior of civil servants in Norway was predictably cautious and incrementalist and is based on expertise and strong organizational routines.[116]

Bureaucratic competence in oil has been achieved as a result of the vertical differentiation and specialized organization of the oil administration, and clear delineation of rights and responsibilities among bureaucratic agencies (Noreng 1980; Andersen 1993). The Ministry of Oil and Energy has been exclusively devoted to

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[114] Gerhard Lehmbruch, *"Introduction; Neo-corporatism in Comparative Perspective,"* in Lehmbruch and Schmitter, eds., Patterns of Corporatist Policy-Making (London: Sage, 1982),4.
[115] For the features of civil service in Norway, see John Higley, Karl Erik Brofoss, and Knut Groholt, *"Top Civil Servants and the National Budget in Norway,"* in Mattei Dogan ,ed., The Mandarins of Western Europe (New York and London: Wiley, Halsted Press, 1975); and Johan P. Olsen, Organized Democracy: Political Institutions in a Welfare State: The Case of Norway (Oslo: Universitetsforlaget, 1983).
[116] Terry Lynn Karl, The Paradox of Plenty: Oil Booms and Petro-States (Berkeley: University of California, 1997), 217.

policy functions, with control functions being delegated to the Petroleum Directorate. "The reason for delegating functions of control in Norway was to ensure that a rather independent body could exercise control and collect relevant information relatively independently from the Ministry, and thus be relatively immune to political pressures."[117]

While these agencies constitute the primary government structure pertaining to oil, other agencies comprise a secondary structure. The Finance Ministry, the Central Tax Board, Ministry of Environment, Ministry of Social Affairs, and Ministry of Communal Affairs are all secondary structures in the vertical administration of oil. Finally, the tertiary structure of government consists of permanent or ad hoc public bodies and committees with advisory or consultative functions, such as the Special Committees on Petroleum Taxation, The Petroleum Council etc. This basic institutional arrangement, established in the 1970s, has remained intact throughout the period of oil development in Norway. No major changes have been made in the principles, rights, and obligations distributed among public authorities and companies.

In addition to bureaucracy's vertical organization, close relations between bureaucrats and business contribute to a stable environment. The process of continuous consultation and debate over oil issues has provided a regular flow of information between bureaucrats and business groups and created coherence on

[117] Oystein Noreng, The Oil Industry and Government Strategy in the North Sea (Boulder: International Research Center for Energy and Economic Development, 1980), 141.

policy issues. For instance, when civil servants led by Jens Evensen were formulating the concessionary regime in 1965, they worked very closely with foreigners to create a system that was attractive to them. Even though oil policy became more contested in the 1970s and there were many nationalist slogans, the bureaucracy continued its regular consultations with foreign companies.[118]

Another example of close links between bureaucracy and business is the composition and mobility of the staff serving in various state bureaucracies and companies. Some studies show that almost 60% of the staff in the Ministry of Energy moved into jobs in the private sector, more than half of those into the oil industry in 1984.[119] The same situation also applied to the Petroleum Directorate. More than 80% of those who left the Directorate in the 1980s found employment with companies in the petroleum sector. This movement from the public sector to oil companies implies that the state bureaucracy has worked as trainers and suppliers of qualified personnel for the industry. This transfer of bureaucratic values to the oil industrial complex created a mutual understanding, a 'cognitive coalition' that made for smooth functioning of the industry.[120] High bureaucratic capacity has been complemented by Norway's open and participatory democracy. The existence of non-oil based vested interests who were able to present their concerns in a democratic context "prevented Weber's dictatorship of the bureaucrats."[121]

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[118] Author's interview with Helge Ryggvik (researcher at University of Oslo) in Oslo, Jan 22, 2001.
[119] T.Dyrstad, *"Farewell, Mr. Minister"* Admisnistrasjonsnytt, nr. 4/1984 as quoted by Berrefjord and Heum,40-41.
[120] Ibid., 41-42.
[121] Karl, 217.

Now I turn to a discussion of the political competition over three oil policy arenas: the role of the state oil company; the rate of oil production; and oil taxation. All three issues were important for foreign investors since they determined the extent of their operational involvement and the profits they could reap. These cases are also illustrative of the way conflicts between different veto players have been contained and resolved in Norway's democratic setting.

V. Political Competition Over Oil Policy

Historically, there has been a tradition of strong state involvement and regulation in the Norwegian economy. Industrialization in Norway was late, getting seriously underway only between 1890-1910. At that time, Norway was one of the poorest countries in Western Europe with a weak capitalist class. Hence, an active government role was deemed necessary to speed industrialization. Moreover, with only one short intermission between 1968-1972, Labor Party coalitions governed Norway from 1945 to 1981, when they were unseated by a coalition led by the Conservatives. The Labor Party governing goals of full employment and economic growth without sharp price rises or balance of payments problems could be achieved only with public sector involvement in investment, consumption and trade.

Despite this record of heavy state involvement in the economy, over time the role of the state in the oil industry, as well as some of the government policies that facilitated this role, became increasingly disputed. Since 1973, the 50% share requirement for Statoil meant that Statoil was in a position to determine what should

be done with a large number of licenses on the Norwegian shelf. It could by itself veto any major proposal in every license. Moreover, other companies, especially the foreign companies, were obligated to finance Statoil's share of exploration and production. The increase in Statoil's power was attributed to the political ambitions of the Labor Party and Labor governments. Statoil was always considered the "Labor Party's baby." The government used it to assert national and public control of domestic oil production, but it also used it to serve its partisan interests in keeping Conservative Party oil interests at bay politically.[122]

With the increase in oil prices during the 1970s, opposition parties became increasingly concerned that Statoil was becoming too powerful economically with its ability to dispose of huge cash flows.[123] Especially the conservatives were worried that "instead of having Statoil as an instrument in national petroleum policy, politicians could become the instruments of oil in enforcing the company's business interests."[124] As a result, a split between the Labor government and Statoil emerged, on the one hand, and the Conservative party opposition and the Petroleum Directorate, on the other. The ministry of Petroleum and Energy was caught in between.[125]

Private domestic and foreign business groups were equally suspicious of Statoil's role in the oil industry. Foreign companies did not want to lose their relative

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[122] Klapp, 80.
[123] According to some projections, Statoil accounted for 25% of the Norwegian gross national product.
[124] Berrefjord and Heum,34.
[125] Andersen, 146.

shares to the state. Similarly, various domestic business groups were unwilling to give up oil-related contracts or industrial opportunities so that the public sector could make gains in oil. Alarmed by the growing role of Statoil in the 1970s, many Norwegian industrialists, especially in the shipping industry, aggressively sought to gain larger share of oil profits. Being one of the most important and profitable earners of foreign exchange in the country, the shipping companies were in an advantageous position. Shortages on the world tanker market brought major tanker profits in 1970 and 1971 and provided Norwegian ship owners with capital to challenge government policies. Fifty shipping companies and forty companies from other industries pooled their capital to form their own oil company, Saga Petroleum, in 1972.[126] Meanwhile, Norway's corporate giant, Norsk Hydro, also began to oppose the role of Statoil by organizing an independent advisory organization known as the Oslo Group to offer the government advice on petroleum policy.[127] Comprised of business leaders and politicians from a variety of parties, including Labor, the Oslo group articulated militant criticism at Statoil.[128]

In addition to Statoil's proposals to invest in shipping, its advantageous position of controlling at least 50% of all the fields, in comparison to Saga's 8%, caused these industrialists to join ranks with foreign companies and mobilize in the Storting against government policies. Using their influence with the Conservative and

[126] Klapp, 82.
[127] Statoil's rapid growth brought it into conflict with Norsk Hydro as it tried to expand into some of that company's traditional industries.
[128] Nelson, 79.

Liberal parties, ship owners created an impasse for Statoil. Because the Storting controlled the company's budget, the coalition among these parties in 1976 cut Statoil's request for share capital to finance its Statjford development by 14%. The government was also forced to concede control of domestic subcontracting operations, such as supply boats and drilling rigs related to oil production, to private shipping interests. Moreover, it had to promise Norwegian ship owners that state companies would not invest in shipping-related operations.[129] Institutionalized powers in the Storting were thus able to constrain government policy regarding Statoil and force compromises.

In 1984 the government made another compromise by creating the State's Direct Financial Interest (SDFI) so that the state could be directly involved financially in oil projects at the expense of Statoil. The financial base of Statoil was reduced and its share of licenses was weakened by changing voting rules.[130] A clearer distinction was made between Statoil and the state. With the state directly financing oil activities, the government exempted the other two Norwegian-owned oil companies from the obligation to finance Statoil's exploration expenses. And this obligation was abolished for foreign investors in 1986. The conflict over the proper role of Statoil and its impact on the activities of other business groups, including foreign ones, was resolved through compromises among the government, the major parties in the Storting, and business groups. Those who supported a strong role for the government

[129] Klapp, 82.
[130] Berrefjord and Heum,34.

reduced the power of Statoil and gave concessions to domestic and business groups as well as to other political groups concerned with too much state regulation. In exchange for these compromises, they created the SDFI, which ensured that the state would still be the major investor in oil production. Overall, high degrees of interest representation and mechanisms of accountability in Norway produced these compromises among different veto groups and protected the interests of foreign companies against Statoil.

The democratic regime also created an institutional setting in which foreign companies and domestic interest groups together challenged government policies and pressured it to protect their interests. In addition to allying themselves with foreign companies to reduce the role of Statoil in the oil industry, industrialists such as ship owners, who depended on open access to foreign markets, also supported foreign companies in their efforts to challenge the government's offshore goods and services policy of Norweginization. Fearing foreign retaliation against them, the Norwegian Ship Owners' Association charged that this policy fostered inefficiency in Norwegian industry and raised costs on the continental shelf far above those in other areas of the world. Against the Norwegian Engineering Industries and the Norwegian Iron and Metalworkers Union (which rejected free trade in offshore supplies,) the Ship Owners' Association staunchly defended the rights of foreign companies.[131]

Another major political debate surrounding oil issues occurred over depletion policy, which is the rate at which oil is to be extracted. This policy is crucial for

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[131] Nelson, 103.

shaping the bargaining position of the host government in relation to foreign companies.[132] 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 rate of development and the need for public control over important aspects of the oil industry.[133] A moderate rate of development was seen as a level of production of approximately 90 million tones of oil equivalents per year. The parliamentary debate in 1974 expressed concerns about inflationary pressures and structural change from too much oil revenue. The implication was that controlling production volume was essential for avoiding the economic and social consequences of the 'Dutch Disease' in Norway.[134] Moreover, there were worries that necessary adjustments in sectoral and regional distribution of employment would threaten the Norwegian style of living.[135] Even though this 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

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[132] 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.
[133] The Norwegian Ministry of Finance, *Parliamentary Report* no.25 (1973-74).
[134] Andersen, 99.
[135] Kenneth Dam, Oil Resources: Who Gets What, How? (University of Chicago Press, 1976),66.

domestic and foreign- and again 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.[136]

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 that was announced was too high. The Socialist Electoral Alliance, for instance, claimed 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.[137]

Another interest group that was adversely affected by oil production was the fishing industry. By 1970, 40% of Norwegian fish was coming from the North Sea, but about 50% 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 activities.[138] By

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[136] Noreng, 50.
[137] Nelsen, 42.
[138] 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.

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.[139] The strength of these interest groups once again made the government responsive 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 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 Parliament to prevent future northern oil operations. Also supported by the Agrarian, Christian and Socialist parties, this "Green Opposition" called attention to oil spills,

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[139] Klapp, 85.

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."[140] 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 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 return, the labor organizations of two northern fishing counties, Troms and Finnmark, decided to support northern drilling but at a much slower rate.[141]

One complicating factor for further oil development in the North was the blowout that occurred on the Bravo platform of the Ekofisk field. Despite its rather small proportions, the blowout had a direct effect on the depletion policy.[142] Due to the criticism from environmentalists, the government both increased safety

[140] Ibid, 85.
[141] Ibid.
[142] The blowout lasted eight days and poured 22,500 tons of oil into the ocean.

regulations that the oil companies were exposed to and postponed the opening of new areas for exploratory drilling in the northern waters until the 1980s. The blowout, slower licensing and thus delays in the development of new areas combined to reduce the level of oil activity in the Norwegian sector of the North Sea. In the south the government ensured oil production by compensating fishermen, but in the north fishing and environmentalist interests ruled. Nonetheless, some drilling was under way in northern waters by early 1981.

Taxation policy was another area where the democratic regime ensured compromises, and thus policy stability for foreign investors. This time, however, conflicts of interest were among different bureaucratic organizations and between the government and foreign companies. The Ministry of Finance, as protector of government revenues, has always wanted higher taxes imposed on profitable fields to be able to pay for welfare services. The Ministry of Energy, ship owners and domestic oil companies, on the other hand, have regularly petitioned the authorities to use tax concessions to maintain activity on the continental shelf. The Industry Association for Oil Companies (NIFO) and Ship Owners Association have pressured the government on behalf of foreign oil companies. The support for their positions among societal interests was also bolstered by the direct links foreign companies had with government authorities. In many cases, they pressed for favorable decisions often in a manner indistinguishable from that of the domestic groups. Direct consultations and meetings with the government authorities provided foreign companies with means to influence policy. The government assured the companies

every opportunity to present information and opinions regarding taxation rates. The companies knew that as long as they had open, transparent channels to the decision-makers, they could make their case.[143] An example of this was witnessed during tax policy discussions in November 1974. A specially appointed Petroleum Revenues Committee presented a plan to the companies that served as the basis for discussions between the oil industry and the Ministry of Finance. The committee's central proposal was an oil tax of 40% to be levied against oil profits. The companies strongly objected to parts of the proposal so the government rewrote the plan after extensive consultations with the companies.[144] It finally established new excess profits tax-the special tax- at 25% in 1975.[145]

Despite imposing one of the highest marginal rates of taxation on oil in the world, the Norwegian government has also given significant incentives to lessen the tax burden of foreign companies. The goal was to make it worthwhile for foreign companies to continue to explore. First, companies were allowed to deduct most of their oil-related expenditures anywhere on the Norwegian shelf over a six-year period.[146] Thus, companies could reduce or eliminate their tax bill on revenues generated from producing fields by investing in exploration or development work in

[143] Author's interview with Willy Olsen (Statoil) in Oslo, Jan. 20, 2001. He also stated that foreign companies expect to be taxed heavily but they are concerned about not having the opportunity to make their claims and prevent arbitrary political decisions to hurt their interests.
[144] Nelsen, 43.
[145] Noreng,168.
[146] This is a system where government takes most of the risk. So the foreign investor can deduct all expenses for exploration. As Gunnar Gjerde, the Deputy Director General of the Ministry of Petroleum and Energy, has stated during an interview with the author on Jan.24, 2001, "If there are no profits, there are no taxes for investors."

other parts of the Norwegian North Sea.[147] Second, the rules governing the calculation of the Special Tax provided for a deduction called an 'uplift.' The uplift provision allowed companies to deduct ten percent of the purchase value of all installations and equipment taken into use over the preceding fifteen years, thus permitting companies to deduct a total of 150% of their capital expenditures from their Special Tax bills over a fifteen-year period. This introduced a progressive element into the system by exempting from Special Tax companies with high capital investment and low North Sea income.[148]

Moreover, the government gave guarantees that levels of taxation would change only with the changes in the price of oil in world market.[149] In other words, changes in the tax regime were not aggressive policies aimed at exorbitant government takes but defensive measures to keep the existing distribution of income stable.[150] Furthermore, they were applied to domestic companies equally. The government also initiated a tax reform reducing the government-take considerably for fields where development had not yet been decided. As such the companies were over the long run guaranteed a decent return. What is more important, they were always reserved their place at the table to challenge and discuss state policies.

Since the discovery of the Ekofisk field in 1969, oil policy in Norway became very politicized. Political parties, many interest groups, local authorities, and

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[147] Author's interview with Willy Olsen.
[148] K.Ervik Leif, *"The 1986 Petroleum Tax Regime,"* The Offshore Digest 3(1987):18.
[149] Author's interview with Oystein Noreng (professor and oil analyst in the Norwegian Business School) in Oslo, Jan.22, 2001.
[150] Noreng,176.

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, the policy environment stayed stable and posed very little political risk for foreign investors.

To sum up, the stability of the investment environment was made possible by the characteristics of the political regime. The institutionalized competition among interest groups provided incentives for political elites to build policy coalitions and reach consensus through compromises. The result 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.[151]

This political competition among different groups in the society and the state also provided foreign companies with access to decision-making. By allying themselves with certain interest groups or political parties in society, foreign companies ensured that their interests were adequately represented in policy decisions. They were directly consulted by the government on a regular basis and their consent was required to make any major changes to the oil policy. The checks

[151] T.Lind and G.A. Mackay, Norwegian Oil Policies (McGill:Queen's University Press, 1979).

and balances among the institutions of the state and the resulting rule of law ensured that their rights would not be compromised even when their economic interests were.

VI. Political Effects of Foreign Capital

Norway was able to increase its oil production levels and thus its oil revenues with the help of substantial levels of foreign investment into the oil sector. Foreign companies have, not only brought expertise and technology to the Norwegian oil industry, but they have also shared the risks and challenges of oil development with the government during especially tumultuous times for international oil companies. I argue in this chapter that the democratic regime in Norway made it possible to create a stable investment environment that was attractive for foreign investors. Now I discuss how foreign investments, in return, have contributed to the political regime.

Oil revenues were instrumental in consolidating the democratic welfare state in Norway. To the extent that disagreements and conflicts arose over oil issues, the great disproportion of revenues to people made it quite easy for the governing elites to 'pay off' any group that was aggravated. In other words, foreign capital made it possible for elites to 'buy' political peace or at least acquiescence. In this respect, foreign capital indirectly greased an already smoothly functioning political system. It reduced the intensity of conflict over oil issues and provided the government with enough resources to make compromises to reach policy outcomes that were acceptable to all.

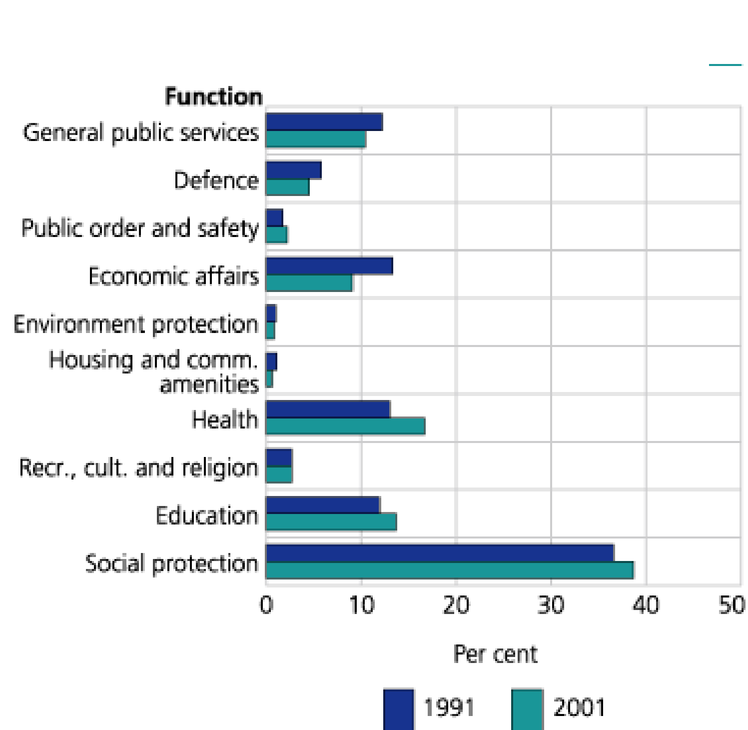
Foreign investments and ensuing oil revenues also entrenched the 'welfare state' in Norway. The influx of these resources permitted Norway to expand an already extensive social welfare programs. On U.N.'s human development index that measures broad well being, Norway ranked number one in 2000.[152] U.N. considers Norway the number one place to live. Social security and welfare services represents close to 40% of total governmental expenditures in 2001, a slight increase since 1991 (see Figure 3.4). In terms of government spending on health services and education, Norway also ranks very high among advanced industrialized countries. Unemployment level of 4% is very low when compared to the levels in other Western European countries.[153]

Finally, foreign capital has allowed Norway to become a significant player in the international arena. Norway is one of the few countries that donate millions more in foreign aid than the U.N. target of 0.7% of a nation's GDP.[154] Norwegians are committed to their role in international peace, environmental, cultural and economic affairs because it elevates an otherwise powerless country into the rank of global players. Nearly 1% of GDP is spent each year on foreign economic assistance. One third of Norwegian aid is routed via the UN system, which Norway considers an essential partner in the struggle for peace, human rights and democracy. Poverty alleviation, and equal rights for men and women are other key targets for aid, which

[152] U.N. Human Development Report, 2002. This index combines indicators of gross domestic product per capita, life expectancy, and education into a single index.
[153] IMF Economic and Financial Data for Norway 2002.
[154] Carol J. Williams, *"So this is heaven: Norway,"* The Los Angeles Times (Nov.8, 2001).

is directed to mainly the poorest nations around the world. Oslo also plays a mediating role in foreign conflicts, from efforts to reconcile North and South Korean conflicts to the Middle East peace process. Only last year, Norway with its population of 4 million, accepted 10,000 asylum seekers- the equivalent in U.S. terms of close to three-quarters of a million asylum seekers. These highly altruistic foreign and domestic programs were all made possible by foreign investment and the ensuing oil revenues. Foreign capital not only reinforced the democratic regime in Norway, but also turned it into an important player in international politics.

Figure 3.4: Percentage of government expenditures (1991-2001)



Source: Statistics Norway 2002. IMF Economic and Financial Data for Norway

VII. Conclusion

Despite its potential resources, Norway in the 1970s and 1980s was not an easy place to do business in. In addition to traditional strong state and strong societal interests, the 1970s posed many challenges for foreign investors. In line with the rise of their relative market and bargaining power, Norwegian governments increased taxation, imposed state participation, as well as, tougher regulations. These policy changes affected the economic attractiveness of the Norwegian investment environment. However, despite strict economic terms, investors continued to stay in Norway. First of all, the government ensured that companies would have enough profits and incentives even after high taxes and regulations. Second, the companies found stability in the policy environment and the basic principles of their investment relationship. As one oil company representative put it, "every company knows that it is going to be heavily taxed. What they are really concerned about is the predictability of the investment regime."[155] In Norway, that predictability and consistency was achieved when the Norwegian state announced in the "Ten Commandments" of 1971 that defending the macroeconomic interests of the country was a top priority and that government take and participation would change depending on the price and supply of oil in the international markets. As a result, the oil companies were faced with a trade-off. They got long-term stability in return for some short-term economic costs.

In this chapter, I discussed the sources of stability in the Norwegian investment environment. I argued that strong representation of interests in the

[155] Author's interview with Willy Olsen.

parliament and in the government through parties, interest groups and a competent bureaucracy, in addition to the competition among state institutions provided a policy environment that was stable and accommodating. Democratic institutions gave the governing elites incentives to negotiate between different interests and reach compromises as a result. High degrees of accountability ensured responsiveness to different interests and prevented any arbitrariness or overuse of executive power. Foreign investors could make use of this institutional environment by either allying themselves with certain domestic groups or behaving like one and pressuring the government directly. All throughout their presence in Norway, the investors were included in the political debate, had institutional means to influence policies and were supported in their interests by certain domestic groups. They were regarded as partners and given enough incentives to stay. The Norwegian political regime successfully balanced the need to serve the welfare of the society with the need for foreign capital to develop its oil resources. The consolidated democracy of Norway proved to be compatible with the expectations of the global economy.

The success of the Norwegian state can be attributed not only to its ability to attract foreign investors and pursue oil projects as partners. It is also due to the ability of the state to resist the overwhelming impact of the oil bonanza that became a curse for many other oil producing countries. The Norwegian state, unlike states in other petroleum-rich countries, was able to resist the temptation to spend oil revenues on corruption and white elephant projects. The state warded off the insidious rentier behavior that accompanied booms elsewhere. Moreover, unlike other states, it

managed to sustain its domestic tax base and protect its non-oil fiscal capacity. Norway put much of its oil revenues into a petroleum fund to store wealth for the time when oil starts to run out. Highly institutionalized networks of organized interests and significant opportunities for public debate prevented the symptoms of Dutch Disease from turning into an oil curse. As Johen P. Olsen (1988) has rightly argued, Norway's institutions managed to turn petroleum into "just another raw material."[156]

In the following chapters, I analyze the investment environment in two other major oil producers, Azerbaijan and Russia. Despite stark differences in their culture, history, economic development, and even size, all three of these countries faced the similar challenges of creating a stable investment environment for foreign oil companies in order to attract the much-needed investment capital into their oil industries. However, their abilities to meet the demands of foreign investors have varied considerably. In this chapter with the Norwegian case, I have demonstrated how a consolidated democracy was able to overcome opposition and provide stability for the investors. In the next chapter, I discuss how stability can also be achieved in an authoritarian regime like Azerbaijan. It is striking to see how two countries with very little in common had similar successes in the global economy.

[156] Quote taken from Karl, 221.

CHAPTER 4

Azerbaijan: 'One-Stop Shopping' For Investors

I. Introduction

Since the collapse of the Soviet Union, the former Soviet republics have been striving to become part of the global economy as new sovereign states. Among these states, Azerbaijan's performance in terms of attracting foreign investment has been the most impressive. According to UNCTAD World Investment Report 2002, on the foreign direct investment (FDI) performance index, out of 140 countries Azerbaijan ranked third highest from 1994-96 and eighth highest from1998-2000. Since the "Contract of the Century"[157] in September 1994, Azerbaijan signed oil contracts valued at $60 billion dollars with 33 companies from 15 countries around the world. According to some accounts, it has attracted the most foreign direct investment per head of any state in the former Soviet Union.[158] It is seen by many as the Former Soviet Union's 'showcase' for the art of doing business, the 'frontier of global capitalism' and a 'united nations of oil'.[159]

The commercial attractiveness of potential Caspian energy resources explains the initial interest of international oil companies in Azerbaijan. Some conservative

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[157] The 'contract of the century' entailed the development of three offshore fields Chirag, Azeri, and Gunesli with $8 billion foreign investment over the course of 30 years.
[158] Stefan Wagstyl, *"Oil Wealth Offers Many Opportunities*," Financial Times, (November 22, 2000).
[159] Jeffrey Goldberg, "*The Crude Face of Global Capitalism,"* The New York Times Magazine (Oct.4, 1998): 57.

accounts appraise Caspian at 30 billion barrels (around 3% of the world's oil supply) while the optimistic analyses of the U.S. Department of Energy and Caspian governments put the region as high as 200 billion barrels.[160] According to the British Petroleum Statistical Review, Azerbaijan's reserves are at least 7 billion barrels. While there are different accounts of Caspian Sea's potential, there is no question that this is a major oil province in terms of international oil market dynamics. There is considerable pressure from the oil companies to develop these energy resources relatively quickly considering that Iran, Iraq, and much of the Persian Gulf have remained closed to exploitation by western companies.[161] Competition among oil companies has made the Caspian energy resources very attractive.

Also geo-strategically the Caspian oil is very attractive for foreign governments, especially for the U.S. government. Extraction of oil from the Caspian is viewed as a potential counterbalance to excessive dependence on the Middle East. In the aftermath of the Cold war and now 9/11, the U.S. has seen the development of these resources as part of its national security objectives. In order to break the hegemony of Russia in the region, and isolate Iraq and Iran, the U.S. government in the last decade has encouraged U.S. based oil companies to invest in the region. And

[160] Figures concerning the volume of Caspian oil deposits vary to a considerable extent. In addition to the figures above, Geoffrey Kemp and Robert Harvey in their study *Strategic Geography and the Changing Middle East* (1995) speak of 8.8 billion barrels, whereas Daniel Yergin, Dennis Eklof and Jefferson Edwards in their *Foreign Affairs* (1998) piece, speak of 100 billion barrels in the Caspian.
[161] Terry Lynn Karl, *"Crude Calculations : OPEC Lessons for the Caspian Region"* in Robert Ebel and Rajan Menon, eds., Energy Conflicts in Central Asia and the Caucasus (Rowman & Littlefield Publishers, 2000),31. In addition, the relatively shallow waters of Caspian make it easier and faster to drill for oil. This is another reason why oil companies find the region attractive.

more recently the war on terrorism has made foreign investment more of a strategic tool to win allies in the region.

Even though home governments' geostrategic objectives are important, oil companies do not necessarily base their investment decisions on them.[162] Before companies make a decision to invest in a certain region, they consider and weigh many commercial risks involved in their projects. Even though the Caspian is a prospective oil province and companies need to secure a share of it to diversify their assets, there are many transportation and exploration risks facing oil projects in the region. First of all, the commercial attractiveness of the Caspian region is increasingly being questioned. There have been difficulties in locating new finds, making the initial optimistic assessments of the potential in this region far-fetched. Moreover, high production costs of oil in the region as compared to other oil provinces make investing in Azerbaijan less attractive commercially especially during low oil prices.[163] In addition, the Azeri sector of the Caspian is landlocked and the proposed oil pipelines to carry the oil to western markets are ripe with geopolitical struggles among the countries of the region.[164] Hence, building the 'politically accepted'

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[162] During his interview with the author, Gerald Tilk (Economy/Energy Officer in US Embassy in Baku) in Baku, on July 6, 1999 pointed out that there is a lot of tension between oil companies and the US government. He argued that companies make strictly commercial decisions- at times at the expense of the objectives of the US government- because they are accountable to their shareholders. They see it as a matter of economics rather than politics. Their decisions to invest depends on existence of markets, competition and the investment environment.

[163] Production costs for the Caspian is around $8 per barrel as compared to $3 per barrel in Saudi Arabia.

[164] For a detailed analysis of 'pipeline politics' in the Caspian, see Laurent Ruseckas *"State of the Field Report: Energy and Politics in Central Asia and the Caucasus,"* Access Asia Review no.2 (The National Bureau of Asian Research, 1998): 77; John Roberts, Caspian Pipelines (London : Royal Institute of International Affairs, 1996), 81; Robert E.Ebel, *"Geopolitics and Pipelines,"* Analysis of

pipelines means additional costs for the companies. Finally, the disputed legal status of the Caspian is another difficulty that oil companies need to overcome to be able to continue their operations. The interesting question, then, is what other factors counterbalance these commercial risks and make the region still attractive for foreign companies?

In this chapter, I argue that the stability of the investment environment in Azerbaijan has been an important factor in shaping investment decisions. The geostrategic interests of the foreign governments in addition to the commercial interests of the companies emphasize more the external actors' incentives rather than the ability of the Azeri government in creating such an attractive investment environment. Not every country with commercially and geo-strategically attractive oil resources is able to attract significant amounts of foreign investment. Even though there are also many cultural and geostrategic explanations for why Azeri leaders have been willing to open their oil industry to foreign investment, I argue that the ability to realize this objective depends on the political regime. In this chapter, first I briefly discuss the history of oil development in Azerbaijan and the relations of the Azeri government with foreign investors. Then I present alternative explanations for the stability in Azerbaijan's investment environment and discuss their shortcomings. After analyzing the relationship between Azerbaijan's political regime and its oil

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Current Events 9:2 (February 1997); Paul A. Goble, *"Pipelines and Pipedreams: The Geopolitics of the Transcaucasus,"* Caspian Crossroads 1 (Winter 1995); Rosemarie Forsythe, The Politics of Oil in the Caucasus and Central Asia: Prospects for Oil Exploration and Export in the Caspian Basin (London: International Institute for Strategic Studies, 1996).

policy, I finally discuss the implications of foreign capital on state-building and political regime.

II. History of Relations Between Investors and the Government

i. The Nineteenth Century

The history of oil in Azerbaijan is long and rich. In the thirteenth century Marco Polo reported hearing of a substance, which came from the ground near Baku that was 'good to burn'.[165] By the early nineteenth century, a small oil industry had developed in Azerbaijan. In 1806 there were 50 oil wells, by the middle of 1860s, the number reached 218. The first oil well to be drilled in Azerbaijan took place in the Bibi-Heybat field in 1844, 11-12 years earlier than those drilled in the US. In 1873, Baku's real oil rush began when the first gusher occurred on this field. This led to Baku's first oil boom- "the boom that was to make it the world's most productive oil province by the turn of the century."[166]

At the end of the nineteenth century, Baku became the center of attention for foreign investors. At this time a large refining industry also sprung up to turn crude oil into kerosene. Additionally, the completion of the Baku-Batumi railroad in 1883 connected Baku to world oil markets. During the 1870s and 1880s the famous Rothschild family and Nobel brothers financed the oil industry in Baku. By 1883, the Nobel Brothers' company owned half of Baku's oil exports. At the same time,

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[165] Daniel Yergin, *"Historical Overview of Azerbaijani Oil,"* USACC Investment Guide to Azerbaijan (1998): 50-51.
[166] Ibid. 50.

Russian and Armenian companies started to play an important role in the Baku oil business. Baku provided the primary oil source for the Russian empire. In 1890, 97.7% of Russian oil came from Baku.[167] Azerbaijan was the first in the world in the total amount of oil produced from 1899 to 1901, extracting 100.9 million tons per year, which made up more than 50% of the world's production. Oil production in the U.S. at that time amounted to only 9.1 million tons per year.[168]

Soon, however, oil production in Azerbaijan started to decline. Around the revolutionary year of 1905, strikes, ethnic conflict and general chaos in the Tsarist Russia engulfed Baku. Exports were cut off and local oil industry quickly lost its momentum. Between 1904 and 1913, the Absheron peninsula went from supplying 31% of the world's petroleum exports to less than 8%.[169] However, there was still enough attraction to Azeri oil during this period, especially from the Germans during World War I. Germans came all the way up to Georgia in June 1918 but the war ended before they could reach Baku.

ii. The Soviet Period

After a brief period of Azerbaijani independence (1918-1920,) the Soviet state took control over the Azeri lands in 1920. With communist take-over, the oil industry

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[167] Nasib Nassibli, *"Azerbaijan: Oil and Politics in the Country's Future,"* in Michael Croissant and Bulent Aras, eds. Oil and Geopolitics in the Caspian Sea Region (Westport: Praeger Publishers, 1999).
[168] Khoshbakht Yusifzade, *"Oil and Gas Industry in Azerbaijan,"* USACC Investment Guide to Azerbaijan (1999):63.
[169] Ibid.,50.

immediately became nationalized. Stalin abolished all joint ventures with foreign oil companies. Azeri oil, however, did not lose any of its significance. Seeing oil as crucial to fueling economic growth, the Soviet government increased the production levels to record high 23.4 million tons and built a new pipeline to export its oil to the West. During this period, Baku also became the center for production of oil equipment in the USSR. [170]

The World War II made Baku once again a prize for the Germans as Hitler became preoccupied with gaining control over these fields. Fearing a German victory in the Caucasus, the Soviet state ordered much of the region's infrastructure to be dismantled and sent north and east to more secure Volga-Urals region, which geologists had identified as a promising oil province. They called this new oil region the "second Baku.' Equipment, factories, skilled personnel and even the Baku-Batumi pipeline were moved to Tatarstan and Bashkiria, where they provided the basis for postwar oil boom.[171] With the discovery of various other fields, such as the Western Siberia in mid 1960s, the percentage of the Azeri contribution to total Soviet oil production dropped from 71.6% of Soviet oil output in 1940 to 39.2%, 12%, 5.7%, and 2.4% in 1950,1960, 1970, and 1980 respectively. In terms of oil output, production declined from 21 million tons between the years 1964 and 1968 to 13

[170] The first oil industry machine building works, now known as Sattarkhan Works, was founded in Azerbaijan in 1922. Between 1923-1925 they began construction of sub-surface pumps, rotary drilling rings, and blow out preventors. Large-scale production of rods began in 1925-26. For more details, see "*The Oil and Gas Industry of Azerbaijan"* Azerbaijan International (1999.)
[171] Yergin, 51.

million tons in subsequent years.[172] Due to the impoverishment of the oil fields onshore, the Soviet government started to extract oil in the Azerbaijani sector of the Caspian Sea in the 1940s. Despite the decrease in oil production however, Azerbajan remained the center for production of oil industry machinery in the Soviet Union. Baku was also famous at this period for training petroleum engineers and in conducting petroleum research. The city in fact was called the "Oil Academy."[173]

The relaxation of foreign economic relations during Gorbachev's perestroika opened the doors of Baku oil to foreign investors once again. The initial attention of foreign companies was in the three untapped offshore deposits, Chirag, Azeri and Gunesli, located in the Caspian Sea bed off of Baku. In January 1991, the Azerbaijani republic issued a decree soliciting bids for the exploration of these three fields and in June 1991 a consortium was formed under the leadership of Amoco to develop them.[174]

iii. Oil in a New State

With the independence of the Azeri republic from the collapsing Soviet Union in October 1991, a new era in Azeri oil began. The disintegration of the Soviet Union led to a breakdown of the all-union Soviet market, which had negative repercussions for the economy in Azerbaijan as well as in the other newly independent states.

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[172] Sinan Ogan, *"Baku Petrolleri,"* Yeni Forum 9 (1993):17.
[173] Nassibli,104.
[174] Ibid.

Disruption of trade links was in fact a principal reason for the very sharp fall in production, which was particularly intense in Azerbaijan. The economic slump resulted directly from the fact that this republic was strongly oriented towards the production of raw materials and thus heavily dependent on the other Soviet republics for other goods. Azerbaijan's economic troubles were compounded by a war with Armenia, over the disputed territory of Nagorno Karabakh. As a result of this macroeconomic instability inherited from the Soviet state, oil came to dominate the economy and became the industry on which hopes for a richer future were pinned.

Acknowledging the dismal situation the oil industry and the economy were in, the first democratically elected leader of Azerbaijan, Abulfez Elchibey, started to actively promote foreign investment in the oil industry. He believed that remittances from oil contracts in the form of direct investment, bonus payments, and oil sales presented the best hope for improving the industry and securing the much-needed capital for the economy at large. In May 1993, six agreements were signed creating joint ventures for the development of oil deposits. In the same month talks about the oil contracts and the possibility of having Elchibey sign them were planned in London. However, in June 1993, the expansionist circles in Russia, fearing Elchibey's close relations with Turkey and the West, forced him from power before he could sign the contracts.

After the coup against Elchibey, Heidar Aliev became the president of Azerbaijan in 1993. At first, he halted all talks with foreign oil companies, stating that he wanted to 'review' the agreement. Soon however, he began meeting with

representatives of the companies assuring them that the deal would go through. After three months of negotiations with foreign companies, in September 1994 Aliev signed, what was called, the "contract of the century" with ten foreign companies. The contract entailed the development of three offshore fields of Chirag, Azeri, and Gunesli with $8 billion foreign investment over the course of 30 years. To coordinate the consortium's joint operations, the Azerbaijan International Operation Company (AIOC) was created in early 1995.

The trend of constituting new consortiums continued after this first contract. To date, Azerbaijan has signed 21 contracts with 33 companies from 15 countries. According to U.N 2002 Handbook of Statistics, between 1994 and 2001, a little more than $3 billion have been invested in the oil sector and the annual investments in Azerbaijani oil sector are expected to reach $8 billion to $10 billion by 2005.[175] The PSAs that have been already signed are cumulatively valued at $60 billion.[176] Fueled by these contracts, the country began a period of steady growth in the latter half of the decade. Oil production increased from 180 thousand barrels/day to 280 thousand barrels/day in 2000, while consumption declined (see Table 4.2.) Azerbaijan's real GDP rose by almost 6% in 1997, 10% in 1998, 7% in 1999, and 11.4% in 2000. The oil industry currently accounts for 70-80% of total foreign investment, and 85% of

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[175] Stefan Wagstyl, Financial Times (Nov.22, 2000):11. Considering that Azerbaijan has a GDP of only $4 billion, this investment figure is substantial. As discussed in the first chapter, the ratio of FDI to Azerbaijan's proven oil reserves is 0.43, meaning that for each barrel of its proven reserves, Azerbaijan received 43 cents of FDI.
[176] U.S. Department of Energy. *Azerbaijan Country Analysis Brief (* May 2001) Energy Information Administration (www.eia.doe.gov).

Azerbaijan's exports.[177] Oil-related revenues make up nearly 50% of budget revenues.[178]

iv. Aliev's Investment Policy

Before analyzing the alternative explanations for Azerbaijan's success in attracting foreign investment, we first need to analyze the characteristics of its investment policy regarding oil industry in the last decade. The 1992 Law on Protection of Foreign Investments establishes the basic principles of foreign investment in Azerbaijan and guarantees unconditional legal protection to foreign investors. The basic concept is that foreign investment may be made in any type of activity unless it is prohibited by Azeri law. The legislation provides that foreign investments will not be subject to nationalization by the Azeri government. Additionally, if subsequent legislation adopted in the Azeri republic adversely impacts investment conditions, the legislation effective as of the time of the investment will be applied throughout the term of the agreement. And finally, the law provides for specific recourse to the International Center for the Settlement of Investment disputes if it is seen as a more effective dispute forum for foreign investors than the Azeri courts.

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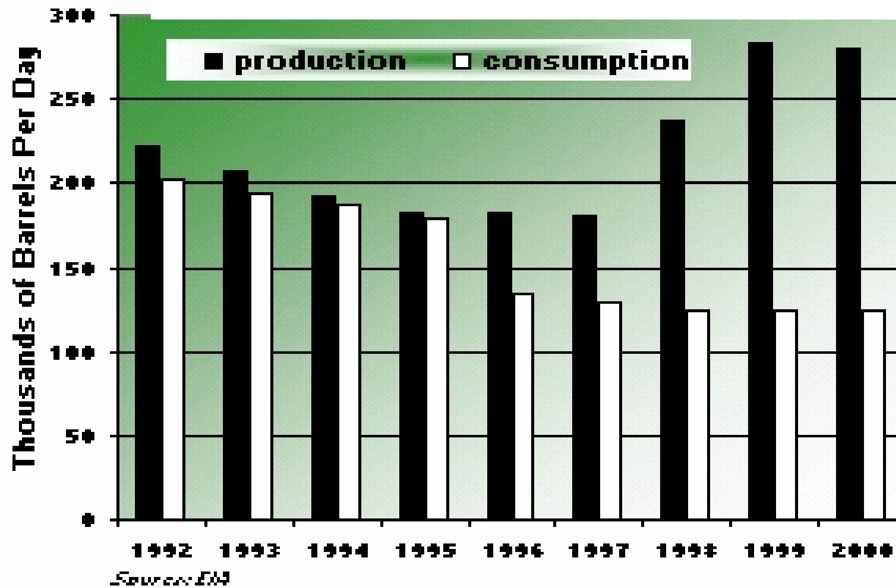
[177] Business Information Services for the Newly Independent States (BISNIS). *Azerbaijan: Commercial Guide 2000*, (www.bisnis.doc.gov/bisnis/country/azerbaijan) .
[178] According to BISNIS Country Commercial Guide 2000, with full development of the AIOC fields, oil production is projected to peak at between 1.5 and 2 million barrels per day between 2010-2020.

Table 4.1 Azeri Oil Production and Consumption, 1992-2000.



Despite this law and a number of other laws and regulations regarding foreign investments, Azerbaijan has created a different legal environment for investors in the oil industry in the hope of minimizing their risks and hence attracting more investment. As its investment regime regarding oil industry, the Azeri leaders chose the Production Sharing Agreements (PSAs,) principle mechanisms for attracting foreign investments especially in developing countries. These contracts outline the regulatory, financial, organizational, legal and compensatory relationship between investors and host governments. Under the PSAs, contractors are granted the sole and exclusive exploration, development and production rights within the contract areas. The PSA law and regulations, i.e. the PSA regime, provide that the state is bound by the contractual obligations to the investor and should be liable for breach of contract

(Blinn 1978, Smith and Dzienkowski 1989). Under a PSA, the scope of the state's obligations and investors' rights can be freely negotiated to the extent prohibited by law. This is characteristic of a civil relationship, where the parties act more or less as equals in a commercial context (Johnston 1994). 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 PSA secures for the investor the stability of the investment regime over the term of the contract's validity and an individual approach to particular projects.

There are many different PSA models used around the world. The "innovative" aspect of the Azeri PSA regime is that instead of a generic PSA law, each contract after being ratified by the Azerbaijan parliament (Milli Majlis) assumes the force of law and prevails over any other existing or future law or decree whose provisions differ from or are in conflict with the contract. Hence, each contract contains detailed stability provisions, assuring that the contractor's rights and interests under the contract are not 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.

Moreover, as opposed to standard tax and royalty schemes, PSAs provide physical 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. Finally, the only tax levied on the contractor is the profits tax payable at a fixed rate for each PSA. Currently all PSAs provide for profits tax at either 25% or 32% depending on when the agreement was signed. The PSA provides protection against future increases in the profits tax rate. The contractor is exempt from all other existing or future taxes, duties, excise taxes, etc. including export and import duties or taxes.[179]

Overall, then, the government of Azerbaijan has provided contractors with numerous guarantees, including but not limited to: exclusivity of rights to the contract area; protection against any infringement by the government in the rights and interests of the contractors; the right to full and prompt compensation of any right, interest and property of contractors expropriated, nationalized or otherwise taken by the Government; enforceability of the PSAs according to the terms thereof; obligations of the government to provide the contractors with licenses, approvals, visas and with any other permissions necessary for the investors to carry out their activities in Azerbaijan; and the right of contractors to access onshore construction and fabrication facilities, supply bases and all necessary transportation and infrastructure facilities.

[179] There are currently two different types of tax regimes that are applicable in Azerbaijan, which are the statutory tax regime and the oil consortia tax regime. The statutory tax regime applies to all foreign investors operating outside o production sharing agreements. The oil consortial regime applies to all foreign investors involved in PSAs, including foreign oil companies functioning as contractor parties and foreign service companies providing services to the contracting parties or the operating company.

PSAs also stipulate that all rights to sovereign immunity are waived by the government.[180]

Despite the generally-accepted importance of PSAs for creating a stable investment environment and attracting significant amounts of foreign capital, not all oil producing countries have been able to formulate and implement an effective PSA regime to reduce investment risks for investors. The Russian case, as will be discussed in the next chapter is a case in point. Now I turn to different explanations for Azeri success in achieving this stability in the investment environment.

III. Sources of Stability in the Investment Environment

Many analysts point to the cultural openness of the Azeri people and the broad consensus over country's oil policy as contributing to the success of creating a stable investment environment.[181] The common belief is that unlike some of the other post Soviet societies, Azeri public has a positive attitude to the notion of profit making by foreign investors. There are no major groups that are ideologically against private capital or foreign initiative.[182] In search of its identity, the Azeri society strives to learn as much as it can from the West and therefore is open to all the help and support

[180] James IV Baker and Natik Mamedov, *"Oil and Gas Production Sharing Agreements,"* Investment Guide to Azerbaijan (1998): 60-61.

[181] For instance, Vitaly Begliarbekov (SOCAR department manager) during his interview with the author on July 15, 1999 argued that the general attitude in the country is very positive regarding the contracts signed with foreign investors and that this positive environment is what ensures stability.

[182] Assim Mollazade (Popular Front Party of Azerbaijan) during his interview with the author in Baku, July 13, 1999, gave an example from the Communist party of Azerbaijan. He argued that when old communists gathered in the center of Baku for a demonstration in May 1999, they only could find 200 people to support their cause.

it can get. It is also argued that even the opposition groups believe that oil development remains Azerbaijan's best hope of distancing itself from the domination of Russia. It seems to many that there is broad consensus over Azerbaijan's inability to develop these resources on its own.

In addition to cultural characteristics, the political objectives of the Azeri leaders explain the warm welcome and encouragement given to foreign investors in the last decade. [183] It is argued that with every PSA, Azeri leaders sought to achieve one or more of five political objectives: resolution to the conflict with Armenia over Nagorno-Karabakh, a resolution to the dispute over the legal status of the Caspian sea, a reversal of US policy on official aid to Azerbaijan, a resolution of geopolitical blockages for pipelines to export oil to world markets, and a diversification of countries and companies in order to gain a broad base of support for the country and a broad base of 'vested interests' to help maintain political stability in Azerbaijan.[184] By allowing foreign investors to take part in the development of oil, the Azeri elites have converted investment relationships into diplomatic currency.[185] Aliev, it is argued, was extremely keen to secure both strong international allies to fortify himself against internal and external enemies, and a ready source of hard currency for

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[183] Mancur Olson in his book Power and Prosperity (2000,) argues that there is a strong and robust relationship between the time an autocrat has been in office and the quality of property and contract rights in his domain. He argues that an autocrat with a short-term horizon has no reason to consider the future output of his society and that his incentives are those of a roving bandit. However, an autocrat with a long-term tenure usually cannot gain from confiscating capital assets, because it normally means that there will be less investment and less income, and therefore less tax receipts in the future.

[184] Julia Nanay, "*Azerbaijan's Offshore Oil Consortia,"* USACC Investment Guide to Azerbaijan (1998):54.

[185] David I. Hoffman, *"Azerbaijan: The Politicization of Oil"* in Robert Ebel and Rajan Menon, eds., Energy and Conflict in Central Asia and the Caucasus (Rowman & Littlefield Publishers Inc., 2000), 55-79.

the reeling Azerbaijani economy. Internationalization of the Caspian was seen as a national security priority.[186]

Even though these explanations are useful in understanding the motivations and objectives of state elites, they assume consensus over a broad range of issues regarding oil development. In fact, the policy objectives of the ruling elite are not representative of the interests of the Azeri people in general. The secrecy of negotiations with foreign oil companies, high number of oil contracts (pace of investments,) mysterious disappearance of bonus payments, unfair terms of the contracts for Azeri people, and low tax rates for oil investors are some complaints that opposition groups increasingly voice in this country.[187] Even though opposition parties are not against foreign investment in principle, they have serious objections to the terms and procedures of oil agreements.[188] Therefore, these alternative arguments explain policy design on the basis of elite preferences but do not take into account the institutional capacity of the elites to overcome opposition and carry out these policies.

[186] The investor portfolio of the country is a good example of this. Over 33 companies from 15 countries were invited to take part in the Azerbaijan oil development. The high number of embassies in Baku is proof to the saying that flag follows trade.

[187] Magerram Zulfugarov (National Independence Party) during his interview with the author in Baku, July 3, 1999 argued that the terms of the contracts that were signed during the Elchibey presidency were much more advantageous to the Azeri society than the contracts under Aliev. A common argument that is shared by all opposition parties is the squandering of oil bonus payments by the incumbent regime. They complain that the bonuses are never reported to the parliament and that there are no official documents stating on what these bonuses are spent. They all suspect that the bonuses "end up in the pockets of several top officials." Assim Mollazade (Popular Front Party) during his interview with the author also criticized the secrecy of the government in its relations with foreign investors and wonders why the government is hiding these documents from opposition groups if there is nothing wrong in them for the Azeri society. Moreover, most of the opposition parties believe that the revenues from the first contracts should be used to improve the national oil industry and that Azerbaijan should be able to develop these resources in the future on its own.

[188] Author's interview with opposition party representatives, Magerram Zulfugarov and Nazim Imanov from National Independence Party, Sulhettin Akperov, (Musavvat), Ali Kerimov, Assim Mollazade from Azerbaijan Popular Front Party, and Mahir Asedov from Azerbaijan Democratic Party.

In order to explain why Azeri leaders were able to create such an attractive investment regime, I now turn to an analysis of the political regime in Azerbaijan.

IV. Political Regime and Stability

Given the importance of oil for Azerbaijan, it is not surprising that oil industry and politics are closely linked. The success of the Azeri state in attracting significant amounts of foreign investment over the last decade can be attributed to the stable investment environment its political regime has provided for investors. Azerbaijan is a typical example of an authoritarian regime. Institutionalized competition for power and influence in the political system is very limited. Absence of significant veto players and representative institutions insulate the ruling elite from any opposition to investment policies. Moreover, this regime offers foreign investors easy and direct access to decision makers. As such, the regime provides a 'one-stop shopping' for investors in which they can negotiate the terms of the investment agreements with a few actors and bypass any potential opponents to these terms.

First of all, the state power is very concentrated. The political order is dominated by the figure of President Heidar Aliev.[189] Since he came to power in 1993, he has consolidated his position through skillful manipulation of state institutions and formal political structures. While the Azerbaijani constitution of 1995

[189] Heidar Aliev spent his early career in the KGB, eventually becoming the first Azeri to head the KGB of Azerbaijan. A Brezhnev protégé, he served as first secretary of the Communist Party of Azerbaijan from 1969 to 1982 and then under Yuri Andropov, was elevated to the central party leadership as a full member of the Politburo. In 1987, under Gorbachev, he fell from favor and was removed from his post. He returned to Azerbaijan and for a time headed the local parliament in his home province of Nakhichevan until his presidency in 1993.

established a system of government based on a nominal division of powers between a strong presidency, a legislature with the power to approve the budget and impeach the president and a judiciary with limited independence, in reality these state institutions have been deliberately engineered to reinforce rather than moderate the power of the executive.[190] The three nominally independent high courts-the Constitutional Court, Supreme Court, and High Economic Court- are extremely susceptible to executive influence, and moreover are staffed primarily with judges beholden to Aliev.[191] Similarly, the parliament (Milli Majlis) exercises virtually no legislative initiative or oversight independent of the executive. The 'flawed' parliamentary elections in 1995 resulted in a total of eight political parties gaining representation in the parliament. Of the 125 seats, only eight were occupied by the political opposition, the rest going to President's Yeni Azerbeycan party, allied pro-government parties, and primarily pro-government unaffiliated candidates.[192] Moreover, within the state, lack of regional distribution of power prevented any bargaining between the political center and other regions of the country. Azerbaijan is divided into 76 administrative districts, but their governors are directly appointed by the president. Absent a voice in state decisions, regional authorities have no formal powers to keep the executive branch in check.

[190] The president himself presided over the Commission charged with drafting the Constitution and many articles related to the powers of the executive seem to reflect Aliev's own preferences.
[191] Hoffman, 61.
[192] Pro-government parties included the Azerbaijan Democratic Independence Party, the Motherland Party, the Democratic Entrepreneurs Party, the Alliance in the Name of Azerbaijan, and the Azerbaijan National Statehood Party. The Popular Front, the Musavat Party and the Azerbaijan National Independence Party provided the main opposition.

Lack of political competition within the state is mostly due to the fact that elections are neither free nor fair. The parliamentary elections of 1995 were seriously flawed and many violations were reported. Almost three quarters of the candidates who represent opposition groups were denied registration. In rural areas, proxy voting and block voting were common. Even in urban areas, there were incidences of one member of a family voting on behalf of all its members. In 1998, when Aliev stood for reelection, he won with a suspicious 75% of the vote. There were widespread reports of fraud, and one electoral district announced a voter turnout well in excess of 100%.[193] The 2000 parliamentary elections was another missed opportunity for democratic development in Azerbaijan. As the U.S. based National Democratic Institute (NDI) stated, the 2000 elections represented "a continuation of a pattern of seriously flawed elections in Azerbaijan that fail to meet even minimum international standards."[194] One of the major problems with the election was the registration of candidates. Even though a total of 13 parties presented the 50,000 signatures necessary for registration in the party list election, the Central Election Committee rejected the applications of eight of these on dubious grounds. The situation was not different for the single member constituencies, where more than half of the candidates were refused registration.[195] In addition, numerous abuses were noted on election day, from ballot-stuffing, intimidation of voters and opposition members of electoral

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[193] Pope Hugh, *"Autocracy is Spreading in Former Soviet States,"* Wall Street Journal (Oct. 14, 1998.)
[194] Quote taken from Svante E. Cornell, *"Democratization Falters in Azerbaijan,"* Journal of Democracy 12:2 (April 2001):128.
[195] Ibid.,126.

commissions. As a result, leaders of the main opposition parties were left out of the new parliament. While the ruling party received more than 70% of the votes, only one opposition party was announced to have passed the 8% threshold. The situation led to unanimous opposition boycott of the parliament. The regime reacted by reducing the ruling party's official election results and acknowledging that two other opposition parties had passed the threshold.[196] Azerbaijan now has three opposition parties in the parliament.

In addition to a lack of political competition within the state, institutions that can mobilize opposition groups into policy coalitions and provide mechanisms to regulate conflict among them are also very weak in Azerbaijan. Parties tend to be centered around an individual with a strong personality and/or sufficient wealth to establish a power base. The political scene is characterized by seeming inability of many individuals to subordinate themselves to a party led by someone else. Programs and party platforms, insofar as they are discussed at all, are generally vague, consisting of little more than idealistic platitudes. Few parties have developed nationwide party organizations. Party membership is almost always very small and restricted in its social range, drawing predominantly on a network of personal contacts and acquaintances.[197] Party politics do not play a significant role in either parliamentary or presidential elections: candidates at both levels are elected as

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[196] Ibid., 128.
[197] Shirin Akiner, *"Emerging Political Order in the New Caspian States,"* in Bertsch, Craft, Jones and Beck, eds., Crossroads and Conflicts: Security and Foreign Policy in the Caucasus and Central Asia, (Routledge, 2000), 90-129.

independents rather than as representatives of a particular party. All parties and other types of political groupings must be officially registered, otherwise they are declared illegal and liable to prosecution. The preconditions for registration are onerous and they are difficult to fulfill without government backing.[198] The notion of loyal opposition oftentimes is used to mean "non-critical" or "cooperative" opposition rather than indicating the opposition parties' loyalty to a democratic system. Toleration for opposition and criticism in the party system remains low.[199] The absence of a visible presence or organization outside parliament means that they tend to resemble parliamentary factions more than established institutionalized parties.[200]

Interest group institutionalization in Azerbaijan has a record similar to party institutionalization. The main interest group organizations are concerned with human rights issues, gender rights and ecological problems. In general, they are closely supervised by the authorities. Their activities are hampered by the fact that they have limited and often short term funding. Like the political parties, they attract very little public support and are frequently regarded with suspicion.[201] Their influence on the policies of the government is very limited. As for the media, a large proportion of the communication media, electronic or print, is either state-owned or state-run. Consequently they support the government and restrict themselves to reflecting official views. Due to the harassment from the government, the limited number of

[198] Ibid.,102.
[199] Audrey L. Altstadt, *"Azerbaijan's struggle toward democracy,"* in Dawisha and Parrott, eds., Conflict, Cleavage, and Change in Central Asia and the Caucasus (Cambridge: Cambridge University Press, 1997),110-156.
[200] Herzig, 34.
[201] Akiner, 103.

independent media outlets cannot provide an alternative source of information and a forum for national debate but rather end up reinforcing the official line.

Given the first few years of the newly independent state, perhaps it is not surprising that opposition groups are routinely excluded from participation. Until Aliev came to power in 1993, Azerbaijan was enveloped in political turmoil and instability. Between the independence in 1991 and 1993, Azerbaijani politics was characterized by a series of coups, ethnic conflict in Nagorno-Karabakh and several separatist movements in other parts of the country. During this period, the country had four presidents.[202] Having come to power in such a background of political instability, Aliev soon consolidated his power and started state building by systematically purging his opponents. Coercion was used to maintain public support for the regime through manipulation of the media and the selective use of laws as a means to curb incipient opposition. Instances of violations of human rights in connection with the suppression of political opposition were widespread. Opposition groups have had their rights abused through arrest and imprisonment, violent disruption of political rallies, and the arbitrary exclusion of individuals and parties

[202] On August 30, 1991 Azerbaijan's communist regime headed by Ayaz Mutalibov declared its independence. In September 1991, he was elected unopposed as president. At the beginning of March 1992 Mutalibov was forced to resign as president following the massacre of Azerbaijani civilians at Khojali in Nagorno-Karabakh. After him, Iagub Mamedov served as an interim president until June 1992 when Abulfaz Elchibey, the leader of the Azerbaijan Popular Front won new presidential elections with 57% of the votes cast. Moscow's discontent with Elchibey ended in a Moscow operated coup by Colonel Surat Husseinov in June 1993. Elchibey's departure paved the way for the ascension of Heidar Aliev. When new elections were held in October 1993, Aliev won by a landslide.

from the political process.[203] Freedom House notes that Azerbaijan is 'not free' and that the country has one of the lowest freedom scores in the world.

Finally the Azeri bureaucracy does not have the institutional power to act as a bridge between different branches of government or between interest groups and the state. It virtually has no input in decision-making. Policy-making remains essentially a presidential prerogative, with ideas and inputs coming from a close circle of senior ministers, advisers and aides around the president, rather than from government departments. Politically, clans, mafias, and extensive patronage networks dominate the various government ministries and provide powerful yet informal avenues for advancement and promotion. Membership in Aliev's political party, New Azerbaijan Party (NAP), became an important factor in administrative appointments and promotions.

Even though Azerbaijan on paper has elections, democratic institutions and a constitution, a deeper analysis reveals that political and economic power of individuals and groups is determined by their proximity to the president. Economically, a close relationship with President Aliev or his family can translate into favorable terms for business in terms of preferential contracts, tax exemptions etc. These networks may be based on regional clans, the most prominent being the regional tribe composed of Azeris from Armenia (Yeraz) and the Azerbaijani enclave of Nakhichevan. President Aliev himself is from Nakhichevan and most of his inner

[203] Edmund Herzig, The New Caucasus: Armenia, Azerbaijan, and Georgia (The Royal Institute of International Affairs, 1999.)

circle come from this regionally defined tribe. They may also be based on kinship. For instance, Aliev placed his family members in important positions. His two brothers and his son, Ilham Aliev, are in the political council of NAP and his son is also the Vice President of the state oil company (SOCAR).

Another important network consists of bureaucrats and new businessmen who were Soviet era associates of the president. Much of Aliev's political power in the earliest part of his presidency stemmed directly from strong and persisting ties forged during the Soviet era. Moreover, the direct guarantor of Aliev's political power ultimately stems from his control over the power ministries: the Army, the Ministry of Internal Affairs and the Ministry of National Security. These institutions protect the president from overt coup attempts and manipulate public political discourse in the president's favor through media censorship, suppression of political dissidents. The top levels of these institutions are in turn staffed with Azeris from Aliev's tribe and are also granted extensive leeway in pursuing profitable economic ventures. In short, the linking of economic and political networks in Azerbaijan provides incentives for the country's elite to support the president and his policies.[204] Finally, a massive personal cult has been orchestrated around Aliev, marked by numerous portraits in public places and adulatory commentaries in the official media. Aliev is often cast in the role of sage father to the young nation. Such an organization of autocratic power brings the Azeri system close to what Linz and Stepan define as a 'sultanistic regime'.

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[204] Hoffman, 62.

V. Political Competition Over Oil Policy

Given these characteristics of the political regime, it is not surprising that the mechanisms for controlling Azerbaijan's oil sector are tightly clustered around the president. Based on a presidential decree dated Sept.13, 1992, the State Oil Company (SOCAR) maintains a near monopoly over the management of the country's oil industry. Even though SOCAR has many departments and an extensive organization, only three main actors direct most of SOCAR's affairs: SOCAR President Natik Aliev, SOCAR Vice president Ilham Aliev and Valekh Alekperov, who conducts negotiations with foreign oil companies as the director of foreign relations department of SOCAR. As a practical matter, SOCAR functions as a vertically integrated state oil company and a government ministry.[205] The president of SOCAR acts as a minister reporting to the president directly. Between these three actors and Heidar Aliev, top-level decisions are made regardless of the formal government hierarchy. The ties that bind the Azerbaijani oil industry to the president's office also condition SOCAR's relations with other state bodies. 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.[206] This led to an absence of administrative turf wars and helped oil projects sidestep many potential administrative pitfalls and delays.

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[205] Until June 2001, there was not even a Ministry of Energy in Azerbaijan. The state oil company, SOCAR, had the responsibilities of a Ministry.

[206] Hoffman, 61.

The procedure of adopting PSAs is a good example of the power structure in Azerbaijan. PSAs are initiated by either SOCAR or the companies themselves. In the first method, SOCAR opens a tender and companies make a bid. Actually this option is rarely used. Unless SOCAR sees a high interest in a very attractive area, companies become proactive and show their interest in a field or structure.[207] Before both sides proceed with negotiations, the offer is taken to the President for his approval. Only after he gives his consent in the form of a decree, can the negotiations presume.[208] At this stage the three officials from SOCAR and foreign company representatives negotiate the terms of the agreement.[209] Once they reach an agreement, the President's approval is needed again before it is sent to the parliament for ratification. Meanwhile, for technical, legal and "grammatical" inspection, the draft is sent to the *Petrochemical Department of the Government*, which works in collaboration with the legal and tax advisors. Here except for some typo corrections, nothing actually gets changed. The only contribution of this bureaucratic agency is the signature of the chairman of the department on a statement of "government guarantees," which is already designed by the President and the foreign companies together.[210] After this

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[207] Author's interviews with Fred Marshall (Government Affairs Manager in Exxon) in Baku, July 6, 1999; Sabit Baygirov (first ex-president of SOCAR) on July 7, 1999; and Vitaly V.Begliarbekov (SOCAR) Baku, July 15, 1999.
[208] Author's interviews with Unal Bayram (Mobil)in Baku, July 2, 1999 and Vitaly Bagliarbekov (SOCAR).
[209] According to Vitaly Begliarbekov, the criteria that Azerbaijani side uses to award a license to a company are the size of the project area, the financial capacity of the company, the bonus payments it is willing to make and finally the Azeri content, i.e. company's presence in Azerbaijan, its premises, its desire to hire local personnel, to form joint ventures with local partners for infrastructure, and the social investment (in education, health etc.) that the company is offering to make.
[210] Author's interview with Rasim Dadasov (head of the Petrochemical Department in the Government of Azerbaijan) in Baku, July 3, 1999. Mr. Dadasov stated that the contents of the contracts were kept

procedure, the president sends the document to the parliamentary commission on *Mineral Resources, Energy and Ecology* the day before the ratification session in the parliament. The commission spends about half an hour, at most an hour on the draft.[211] Without making any changes, the chairman of the commission together with the head of the Foreign Investment Department in SOCAR give a briefing to the parliament on the terms of the agreement. Again in a very short amount of time the deputies are asked to vote only yes or no on the draft proposal after which the agreement is ratified.[212] Parliament, irrespective of the constitution, exercises virtually no oversight powers over the PSA process.[213] All along, the parliament has not once rejected or even returned for review an oil contract put before it.[214] The process does not end there. It once again goes to the president for final approval and then becomes law when the president signs and officially declares it. As it is, the process is set up so that nobody except those four individuals has any input in the decisions.

The absence of strong and relatively autonomous state institutions in Azerbaijan is seen as a blessing for foreign investors at least in the short run. SOCAR's strong position and proximity to the seat of political power makes it a

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secret from the media or opposition parties. He argued that this is due to a request from the foreign oil companies and not so much due to the intentions of the government to exclude opposition groups!!

[211] Author's interview with Asia Manafova (the chairwoman of Mineral Resources, Energy, and Ecology Commission in the Azeri Parliament) in Baku, July 8, 1999. Ms. Manafova is a member of the New Azerbaijan Party.

[212] Author's interview with Nazim Imanov (National Independence Party) in Baku, July 7, 1999.

[213] Magerram Zulfugarov (National Independence Party) during his interview with the author in Baku, July 3, 1999, depicted the parliament as "a branch of the president."

[214] Sulhettin Akperov (Musavvat Party) during his interview with the author in Baku, July 5, 1999, said that the contracts that are given to deputies are not the same as the original contracts. They are either a very short version or a narrowly selected part of it.

favorable partner to oil investors. During the negotiation and implementation of the contracts, foreign investors feel no pressure to defend their intentions to opposition parties or interest groups. Despite their many concerns with the format and content of the oil contracts, opposition groups do not have any institutional power to contribute to the decision making process, let alone pressure the government or the foreign companies.[215] The informal distribution of political power gives ruling elites the incentives and power to exclude these opposition groups and co-opt others through patronage networks.

Foreign investors, on their part, are satisfied with the simple power structure and absence of opposition to their contracts. They know where the political power resides in and whether or not they like it this knowledge gives them insurances that their voices will be heard.[216] The PSAs, as one company representative put it, provide them with "a suit of armor in terms of being able to walk through what would otherwise be dangerous and difficult."[217] He further stated that the single most attractive thing about investing in Azerbaijan- apart from the presence of hydrocarbons is the PSA framework under which companies and the government mutually set the rules. The PSA, according to foreign investors, isolates them from corruption and manipulation by petty officials and bureaucrats. The president's and parliament's signatures on the contracts "smoothes all those difficult barriers out of

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[215] Fred Marshall, during his interview with the author, stated that as a foreign oil company they have not had much of a relationship with the parliament and opposition parties. He argues that that responsibility resides with the government and that being a commercial entity, they try not to get involved in politics and take sides.

[216] Unal Bayram, Mobil.

[217] Author's interview with Peter Henshaw (BPAmoco representative) in Baku, July 20, 1999.

the way."[218] Even though, officially foreign companies claim that they have no regime preferences, they nevertheless have good relations with Aliev and his clique and praise them for being 'far-sighted individuals.'[219]

For their part, government officials are proud of their innovative and 'genius' style of doing business with foreign investors.[220] Even though, a generic PSA law has been and still is in stage of preparation,[221] Aliev and his oil team have chosen meanwhile to continue this process of turning each contract into law in order to win time and avoid any hurdles in the process of coming up with a general law.[222] This way, they also believe that they provide a significant amount of flexibility to both themselves and the investors. Each contract gives them opportunities to maneuver depending on the specifics of each project.[223] "Only if those in Russia were smart

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[218] *Ibid.* This is a very interesting comment considering that foreign investors regard corruption by lower level bureaucrats as disruptive and problematic but consider high level corruption as manageable and even to a certain extent acceptable.

[219] Fred Marshall (Exxon Government Affairs Manager.) Mr. Marshall has repeatedly commented on the importance of individuals and how they by themselves can make a difference.

[220] Author's interview with Rafig Abdullajev (SOCAR Assistant of President) in Baku, July 1, 1999.

[221] Mahir Asedov (Azerbaijan Democratic Party) during his interview with the author in Baku, July 16, 1999, argued that this generic law was prepared as a result of collaboration of several deputies, including opposition deputies like himself, in the first years of the republic but Aliev on purpose never allowed it to be discussed and passed in the parliament. Mr. Asedov further argued that this has nothing to do with inexperience or timing as some government officials claim. Instead, he said that this case by case process increased Aliev's control over the contracts and was an obvious attempt to bypass the parliament, which would have been responsible for developing this legislation. He finds it outrageous that an oil rich country like Azerbaijan still does not have a general legislation on oil.

[222] The difference between a generic PSA law and case by case contract law is that under a body of law, everybody is playing by the same rules, same criteria. However, in a case-by-case approach, each negotiation and contract is different. The terms of each contract may reflect different priorities. However, this does not necessarily mean inconsistency in legal provisions. Usually the differences among contracts are in the commercial framework. They have different models of profit distribution, participating interests etc. Otherwise they are very similar in the legal guarantees they provide.

[223] During the interview, Rafig Abdullajev also pointed out that this method gave enough flexibility for the government to increase its share of revenues with each new contract.

enough to do what we have been doing here" says a SOCAR official, "they would have reaped the benefits of foreign investment just like us."[224]

VI. Political Effects of Foreign Capital

Positive reinforcements from investors regarding this investment policy legitimize the importance of the political regime in the eyes of the ruling elites and give them incentives to entrench their power even further. The interaction between the political superstructure and the oil sector in Azerbaijan is not only confined to the influence of politics on oil deals. Causality runs in the other direction as well. The flow of investments and the political regime that makes it possible create a vicious cycle for Azerbaijani politics.

Oil investments shape state-building and political regime in Azerbaijan in several ways. First of all, "the exploitation of energy resources initially supports whatever regime type is already in place when new revenues come on stream."[225] There is a significant body of literature on how oil dependence reinforces authoritarian legacies and is reinforced by them.[226] In Azerbaijan, the onerous legacies from the Soviet Union makes the 'oil curse' even more formidable. As a former Soviet republic, Azerbaijan "inherited political institutions that entailed near-universal state ownership of property and a bureaucracy imbued with an autocratic

[224] Interview with Rafig Abdullajev.
[225] Karl, 44.
[226] See chapter 2, p.53.

and interventionist mentality." [227] This Soviet legacy of centralized power was further strengthened since independence in 1991. The persisting elites from the communist era have acquired the right to set the rules of the game for international oil contracts, and sought the active support of foreign capital in the further concentration of their own authority. Aliev has designed tax laws that gave the top echelons of government maximum control over the awarding and subsequent distribution of oil rents. Thus the ratification of each PSA allowed the government to negotiate a new tax regime, increasing its own leverage.

Even though the full impact of big oil wealth is still years away, oil related revenues pouring into a highly concentrated structure of power are leading to further concentration of power. SOCAR is likely to remain the primary mediator between the government and foreign oil companies. It will also continue to be SOCAR's prerogative to remit the resulting revenues to the state coffers. The way oil revenues are used is likely to remain opaque due to the continued absence of accountability. Much of this oil wealth will most likely be spent by the regime to buy the political support of strategically critical groups and to exclude those that are resilient.[228] As a result, rather than power sharing, exclusionary politics will increasingly become the

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[227] Gertrude Schroeder , *"Economic Transformation in the Post-Soviet Republics,"* in Bartlomiej Kaminski, ed., Economic Transition in Russia and the New States of Eurasia, (1996),12.

[228] The ownership and degree of concentration of the financial system is a good example of the jurisdiction of the state in terms of credit allocation. According to IMF Staff Country Report, as of 1998, 4 out of 99 banks were state owned and these state owned banks accounted for 83% of total banking assets, 83% of total outstanding loans, 82% of deposits, 67% of branches and 70% of employment in the banking system. For a more detailed analysis of the banking system in Azerbaijan and how oil revenues are likely to effect credit allocation, see Oksan Bayulgen, *"External Capital and Political Structures: The Case of Azerbaijan,"* The Anthropology of East Europe Review 17:2 (Autumn 1999).

norm in Azerbaijan. Even though some still hold out the possibility of democratic elections and more inclusive politics in the future, it seems more likely that the patronage networks that Aliev's regime has so meticulously created will rally around his son Ilham Aliev as the successor to the 'throne.' The already divided and squabbling opposition, which Aliev calls 'the children,'[229] offers little hope in terms of breaking the autocratic cycle and leading the country towards democracy.

In addition to concentration of power, dependence on oil rents and revenues also produces a distinctive type of institutional setting, which weakens accountability. This is because oil revenues precipitate the decline of the extractive and regulatory institutions. "Unlike welfare states, which are redistributive, rentier states do not exist by extracting surplus from the local population because oil revenues enable governments to stop taxing altogether."[230] Hence, "with no revenue-gathering motive, these states are financially autonomous from their citizenry and therefore are not accountable to them."[231] Even before the inflow of significant oil rents, fiscal accountability, which creates a separation between public and private in state income has been very low in Azerbaijan. The weak fiscal structure in Azerbaijan delays the development of a modern consciousness of the state and contributes to the perpetuation of traditional concepts of authority as the personal patrimony of the ruler.

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[229] David Stern, *"Elections confuse a fuzzy picture,"* Financial Times (November 22, 2000.)

[230] H. Mahdavy, *"The Patterns and Problems of Economic Development in Rentier States,"* in M.A. Cook, ed., Studies in the Economic History of the Middle East (London: Oxford University Press, 1970.)

[231] Kiren Aziz Chaudry, The Price of Wealth: Economics and Institutions in the Middle East (Cornell University, 1997.)

Moreover, development based on energy resources produces a classic alliance between foreign companies and local rulers to sustain each other's interests.[232] This alliance and oil revenues in Azerbaijan are seen as fortifying a preexisting network of nepotism and corruption within the state.[233] Secretiveness of PSAs has created suspicion in society that foreign oil companies sustain a corrupt and unaccountable system. The bonuses that foreign companies pay when contracts are signed are a perfect illustration of corruption for Azeris. Many believe that even though there is a Special Oil Fund set up to keep oil revenues from being inappropriately used, a comparison of figures from oil contracts and from the figures of the National Bank of Azerbaijan clearly indicate a misbalance.[234] It is claimed that some bonus payments are pocketed by corrupt officials and that foreign companies are turning a blind eye to this process even though they are very well aware of it. According to the common elite perception of the Western Oil Companies in Azerbaijan, the Western oil industry is aggravating rather than ameliorating the culture of corruption since collaboration with a corrupt regime is itself corrupting.[235]

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[232] The stability that is so consistently praised by foreign investors, is not seen as real stability contributing to the welfare of the society by opposition groups. Magerram Zulfugarov from the National Independence Party, during his interview with the author, called it the "police stability."

[233] The bonuses from oil contracts is the most visible example of this. As discussed earlier, many believe that these payments do not get included in the budget but instead end up in the pockets of a few individuals. Assim Mollazade from the Popular Front Party states that due to this corruption, there has been a capital flight of $80 million from Azerbaijan in the last few years.

[234] *"Pocketing Caspian Black Gold"* CEE Bankwatch Network (April 2002). According to IMF, which oversees the organization of the Special Oil Fund, this arrangement has been deficient due to a lack of formal and clear operating rules, and sole authority of the president on the use of the funds.

[235] Daniel Heradstveit, *"Elite Perceptions of Ethical Problems Facing the Western Oil Industry in Azerbaijan,"* Norwegian Institute of International Affairs (NUPI) Report (2000).

Corruption is of course nothing new in Azerbaijan. In fact it is a legacy of the old Soviet regime. In its declining years the communist system lived on bureaucratic fiddling. In addition, the transition to a market economy without the necessary regulatory institutions has led to a burgeoning of corruption. Ranking compiled by the EBRD suggests that Azerbaijan is the fifth most corrupt country in the region but other sources disagree on the order, claiming that oil-rich Azerbaijan is even more prone to corruption than the rest.[236]

Finally, many in Azerbaijan see foreign capital's alliance with the regime as resulting in high levels of income inequality and poverty. There is a common saying among Azerbaijani people: "The name of oil belongs to us but the taste of it belongs to others"[237] meaning that the Azeri people own significant amounts of oil resources but the benefits of oil accrue to others: the ruling elites and foreign companies. The discovery of oil has rarely meant immediate or long-term prosperity for the Azeri people. While the government estimates that the economy has grown significantly over a decade as a result of oil revenues, the UNDP report clearly states that the lives of 60% Azeris have not improved. The average per capita income is $40 per month for a population of 8 million, with the official poverty line set at $89 per month.[238] Despite considerable foreign investment in Azerbaijan's energy sector, most of the country's population suffers from high unemployment of 18-19 % since 1997 and a

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[236] *'Central Asia Survey'*, The Economist, Feb.7th 1998, pp. 3-18.
[237] Author's own translation of *"Neftin adi bizimdir, tadi baskalarinindir."* Interview with Ismayil Musayev (a political science professor from Baku State University) in Baku, on July 14, 1999.
[238] *"Pocketing Caspian Black Gold,"* CEE Bankwatch Network (April 2002.)

low standard of living. As such, foreign capital has not improved the living standards of ordinary Azeris. On the contrary, it enriched those in charge of oil contracts and their patronage networks. Consequently, foreign capital has contributed to the zero-sum nature of Azerbaijani politics and widened the gap between elites and masses.

Without professional institutions capable of discharging the regulatory, extractive, and redistributive duties of the state, it is highly unlikely that the effects of large volume oil money will extend beyond a small, politically and regionally connected circle of the Azerbaijani population. With state institutions deformed in order to insulate presidential power, the Azerbaijani government has displayed little inclination or ability to develop the mechanisms necessary for channeling oil wealth into the national economy. Furthermore, exaggerated popular expectations of oil wealth can be destabilizing especially where the distribution of wealth is uneven. Sudden oil-generated wealth can upset the regional and international balance of power.

Empirical evidence from other oil-producing countries also shows that resource wealth tends to have a negative effect on economic growth, and on other economic indicators as well.[239] The current path of state and regime development in Azerbaijan points to a strong susceptibility to Dutch Disease.[240] This occurs when

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[239] The negative economic effects of oil revenues are analyzed extensively in the literature. See especially Alan Gelb, *"Adjustments to Windfall Gains: A Comparative Analysis of Oil-Exporting Countries,"* in J. Peter Neary, ed., Natural Resources and the Macroeconomy (Cambridge, MA: MIT Press, 1986); Terry Lynn Karl, The Paradox of Plenty: Oil Booms and Petro-States (Berkeley: University of California Press, 1997.)

[240] This was so called because it was first identified when the Netherlands became a major exporter of natural gas in the late 1950s.

disproportionate investment into a specific extractive industry causes wage and price distress in other sectors, ultimately leading to the distorted growth of services, transportation and other non-tradeables. In Azerbaijan, oil exports, which made up only 33.9% of total exports in 1994, soared to a stunning 66.4% two years later.[241] The production of virtually non-oil related industrial items on the other hand has slipped substantially between 1992-96. Upon the encouragement of the IMF and World Bank, only very recently in 2001, a new State Oil Fund was created to prevent the state from catching the Dutch Disease. It is meant to serve as an instrument for both macroeconomic stability and future economic development. The fund, with assets in excess of $430 million as of August 2001 will receive all profit oil revenues belonging to the Azeri state, oil bonus payments and selected other oil and gas revenues.[242] However, given the way oil bonuses of the first contracts have been squandered by the ruling elites, it yet remains to be seen whether or not there is enough resolve to transfer these revenues to a transparent institution.

Therefore, the success in attracting foreign investment in the oil sector does not necessarily translate into success in the efficient use of petrodollars. "Successful efforts to use petrodollars wisely depend on the presence of countervailing political and social pressures strong enough to curb 'petrolization', a process by which states become dependent on oil exports and their polities develop an addiction to

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[241] *"Country Profile: Azerbaijan,"* The Economic Intelligence Unit (London: The Economist 98/99.)
[242] "*Country Report: Azerbaijan*," The Economist Intelligence Unit (London, The Economist 2002).

petrodollars."[243] Such countervailing pressures include transparent democratic institutions, which are powerful enough to rein in the alliance between multinational oil interests and political leaders. A democratic regime can constrain the centralizing and concentrating tendencies that petroleum exploitation leads to and limit the powerful alliance between rulers and oil companies that initially takes place when oil revenues circulate without strict controls. Hence lie the differences between Azerbaijan and Norway.

VII. Conclusion

The economic attractiveness of the Caspian Sea oil resources has been a necessary but not a sufficient condition for attracting significant amounts of foreign investment. A stable legal, regulatory and administrative investment framework was also crucial in turning the potential interests of the oil companies into actual investment projects. Even though cultural characteristics and geostrategic concerns can explain the preferences of ruling elites, they cannot explain differences of interest and the policy outcomes that result from the interaction of these interests. The initial euphoria in the Azeri society towards foreign investment in the first years of independence has over time left its place to increased discontent and hostility. Today there is less broad consensus among Azeri people than the government wants to believe. The lack of politicization of oil issues has been due more to the strategies of

[243] Karl,38.

exclusion by a few elites than to the existence of consensus in the society over the terms of the relationship with foreign investors.

In this chapter, I have argued that the political regime in Azerbaijan contributed to the stability in the investment environment. As a result of weak institutionalized competition, Aliev and his clique were able to exclude opposition groups and equip themselves with the utmost discretion and flexibility to negotiate with foreign investors. The sultanistic regime created a perception of stability for foreigners and reassured that the terms of their investment relationship would be guaranteed by the president and a rubber stamp parliament through the life of their contracts. The Azerbaijani case demonstrates that authoritarian regimes that provide for policy stability can be as successful in getting a share of the international investment as consolidated democratic regimes. The Azerbaijani case provides a great conundrum for those who see an inevitable relationship between globalization and democracy.

Having said this it is also important to point out to some caveats. The favorable conditions and legal protection created for foreign investors in the oil sector are noticeably absent in other sectors. It would be plausible to argue that the oil investments have been ring-fenced through production sharing agreements signed with the government. This special framework has kept these big oil companies immune to the difficulties of everyday business life experienced by other smaller companies. Azerbaijan in fact has proved to be a minefield for other foreign companies trying to establish operations in the country. Investors in other sectors face

many difficulties with outdated legislation, corruption and bureaucratic hurdles. Hence, the success in the oil sector demonstrates the partial capacity of the Azeri state in attracting selective foreign investment. An authoritarian state is useful only to the extent that it can provide isolated stability for certain industries that generate enormous rents. Azerbaijan's shot at globalization is sector-specific.

Moreover, given its negative impact on the political and economic development of the country, as discussed above, Azerbaijan's ability to attract significant amounts of foreign investment in a very short amount of time should be approached with skepticism and not be considered a success that should be emulated by other oil producing countries in the post-Soviet region or in other developing countries. One of the dilemmas of global capitalism for developing countries lies in the choice between immediate economic success, i.e. the ability to attract foreign investment, and long-term economic and democratic development. Even though globalization poses such a dilemma for developing countries, the experience of Azerbaijan should at least provide a sobering example of the trade-offs involved in such a decision.

In the next chapter, I analyze the investment environment in another oil producing country, Russia. Considering that both Azerbaijan and Russia, as newly independent states, started the development of their oil resources at the same time, the differences in their performance over the course of a decade are striking. With equally rich resources and similar needs for foreign investment, Azerbaijan has been able to

create favorable working conditions while Russia, to date, is still trying to set up a stable investment regime that would finally be acceptable to foreign investors.

CHAPTER 5

RUSSIAN INVESTMENT ENVIRONMENT: "TWO-STEPS FORWARD, ONE-STEP BACK"

I. Introduction

The oil and gas industry in Russia is the largest single sector of the Russian economy, accounting for 40% of its exports, and 13% of its GDP. Together, oil and gas production generates between 40-70% of government revenues and is the source of approximately 60% of foreign exchange earnings.[244] Paradoxically, the industry is both the country's best hope of achieving significant economic growth through new investment and at the same time, the sector that has historically received the least encouragement to realize its potential.

Following the collapse of the Soviet Union, Russia's oil industry, which accounted for approximately 90% of the former Soviet Union's oil output, fell upon hard times due to decreased domestic industrial demand and a decline in drilling and capital investments. From 1992 to 1998, the country's oil production plummeted 23% from 7.86 million barrels per day (bbl/d) to just 6.07 million bbl/d (See Figure 5.1). Russia's oil industry, which was largely privatized in the mid 1990s, has bounced back over the past few years, posting strong profits and healthy increase in production. Buoyed by high world oil prices in 1999 and 2000 as well as a decline in production costs following the August 1998 devaluation of the ruble, Russian oil

[244] *Country Report: Russia,* U.S. Energy Information Association (November 2002).

companies ramped up production and by 2001 the country was pumping out an average of 7.29 million bbl/d, a 20% increase over the 1998 level. Russia is now the world's second largest crude oil producer, behind only Saudi Arabia. With continued high oil prices, Russian oil production increased in 2002, reaching 7.8 million bbl/d. The Russian government has set a target of reaching and maintaining 7.83 million bbl/d of oil production in the next few years.[245]

In order for Russia's oil producers to achieve this production level, however, the country's oil industry needs an estimated $1 billion in annual investments according to Russian Energy Minister Igor Yusufov. [246] Analysts believe that the Russian oil sector needs to raise vast sums of money, both short- and long-term, to undertake neglected capital expenditure programs to arrest future production declines, rehabilitate existing well bores, upgrade inefficient refining facilities, increase refining depth, alleviate export bottlenecks, and repair or replace an aging pipeline system.[247] Russia's rate of oil production is exceeding its rate of discovery of new reserves by a significant margin, and the depletion of existing oilfields in West Siberia has raised fears that Russia's current oil boom will be followed by a sharp decline in the next few years. Although Russian oil majors like Yukos, Sibneft, and Lukoil are producing more oil in West Siberia from well 'workovers' and technological applications and are benefiting immensely from high world oil prices, a

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[245] Ibid.

[246] According to a World Bank study issued in 1995, the combined operating and capital expenditures required to maintain Russian oil production at healthy levels is USD 13 billion annually. A director at the Fuel and Energy Ministry, Irik Amirov, puts this amount between $5-15 billion/year.

[247] Mark Gyetvay (Partner, Global Energy and Mining. PriceWaterhouse Coopers) *"The Russian Dilemma,"* Oil and Capital X (1999): 13,14.

decline in Russia's oil production from the mature West Siberian oil province is less a question of "if" than of "when." Thus, in order to sustain and increase Russia's oil production from current levels, large amounts of capital will be needed to develop new fields and to extend the life of existing oilfields with exhausted and low-yield reserves. Even though some Russian oil producers are using their profits to invest in exploration and new drilling projects, capital requirements to develop new technologically-challenging offshore deposits is expected to come from external sources, especially in the form of foreign direct investments (FDI) from international oil companies.

Yet despite the obvious need for foreign capital and explicit efforts by the government to attract foreign capital to reform its oil industry and sustain high production levels, in the first decade of its existence Russia has received far less foreign investment than it could, both relative to the size of its economy and in comparison with other emerging markets. In 1998 for example, according to the *Moscow Times*, Russia’s FDI averaged a paltry sum of $1.5 billion, equating to 1% of GDP or $10 per capita, roughly equal to Macedonia, Tajikistan and Belarus.[248] Between 1994-2001, Russia received about $ 21.5 billion in total FDI, of which $3.2 billion went into the oil sector. As discussed in the first chapter, with almost 6 times the oil reserves of Azerbaijan, Russia received 7 times less FDI for each barrel of its

[248] Mark Gyetvay, *“Restructuring, consolidating top solutions for Russia’s major oil companies’ woes,”* Oil and Gas Journal 98:11 (March 13, 2000).

oil reserves than Azerbaijan.[249] According to the same UNCTAD FDI Performance Index, Russia ranked the 108th and 104th highest among 140 nations during 1994-96 and 1998-00 respectively. Even though there are positive signs of increasing FDI in Russia today, there is still suspicion and hesitation on the part of the investors to make long-term commitments.[250]

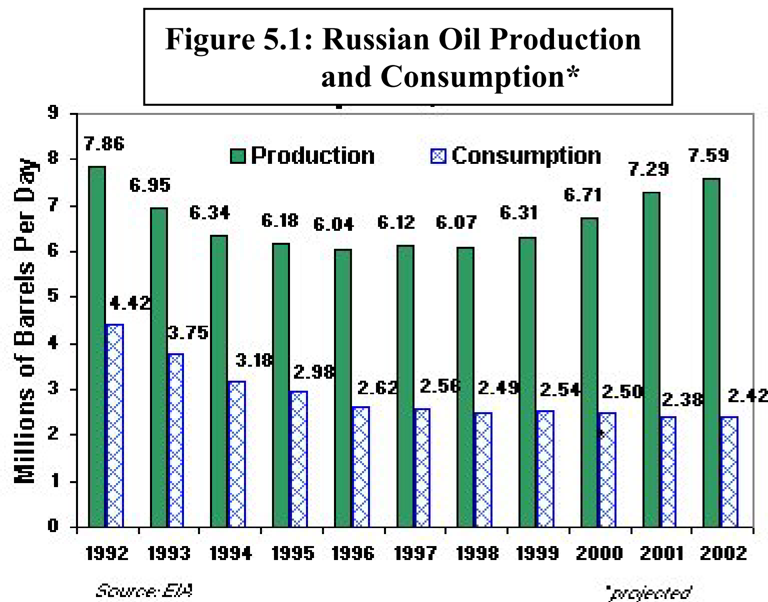

Figure 5.1: Russian Oil Production and Consumption*

Economic factors cannot account for the dismal levels of FDI going into the Russian oil sector. The potential of the oil sector is enormous: proven reserves alone

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[249] Author's own calculations based on UNCTAD 2002 Handbook of Statistics, U.S. Energy Information Administration Country Reports and BP Statistical Review 2002. These figures are calculated by dividing total FDI in oil over total proven oil reserves in that country. While Azerbaijan received 43 cents of investment per barrel of its proven reserves, Russia received 6 cents between 1994-2001.

[250] For example, in February 2003, BP agreed to pay $6.75 billion to form a new Russian oil company. This deal is considered the largest single investment in post-Soviet Russia.

are 48 billion barrels, representing approximately 4.6 % of the world total.[251] Moreover the proximity of some of the Russian oil regions to growing markets in the Asia-Pacific region makes them very attractive for multinational oil companies to pursue oil development projects there. Finally, the skilled labor force and relatively low production costs put Russia at an advantage when compared to many other oil producers that similarly compete for foreign investment. Given the commercial attractiveness of the region, the foreign oil companies, since the beginning of the 1990s, have regularly announced their intentions to commit huge sums of capital to arrest the decline of Russian oil industry.

In this chapter, I argue that the instability of the investment environment in Russia explains the low levels of foreign investment into its oil sector. Russia falls short on investment conditions compatible with international practice. These conditions include clear and reasonable tax regime, which allows an equitable return on investment, a stable set of rules, and an equal opportunity to obtain and exercise rights to the oil fields. The creation of the Production Sharing Agreement (PSA) regime, which was offered as the only way for Russia to meet these conditions in the oil industry, has been a major test for the Russian state. Supporters of PSAs contend that the struggles over the PSA regime conservatively cost the oil industry billions of dollars of capital investments, let alone the lost revenues in tax collections to the country's federal and local coffers and the missed opportunities to create much

[251] U.S. Department of Energy, *Country Analysis: Russia (October 2001*), Energy Information Administration (www. eia.doe.gov).

needed employment.[252] The state's net revenue from fields already put on the PSA List Law and those whose eligibility for development on PSA terms is currently being considered by the State Duma may reach $100 billion.[253] No other source in the national economy can yield as much in the foreseeable future.[254]

Mikhail Subbotin, who leads the group of PSA analysts in the Russian Ministry of Energy, believes that 'optimistic investors' of the early 1990s and 'realistic investors' of the mid-1990s have been replaced in the late 1990s by 'observer investors', standoffishly monitoring new clashes around the fundamental PSA law. Investors have waited for years for 'normal' legislation that ensures a reliable mechanism for investment and return of investment, which has given them grounds for assuming a wait-and-see stance. When compared to other countries in terms of political risks, Russia has performed dismally. According to the World Economic Forum's Global Competitiveness Report in 1999, Russia was the last out of 59 countries in competitiveness rankings. The International Institute for Management Development's *World Competitiveness Rating* study placed Russia last

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[252] Gyetvay (2000), 4.

[253] Irik Amirov, *"Simplify PSA Law substantially- or investors will go"* Oil and Capital III (2000): 12. Since Sakhalin Energy's contract (the first grandfathered PSA) became effective in 1996, the private sector consortium has paid $40 million of a $100 million bonus due over five years to the local Sakhalin Development Fund. It also paid $45 million in pre-production to the Ministry of Fuel and Energy and Sakhalin governor I.P.Fakhutdinov's administration.

[254] Experience in other parts of the world shows that every dollar invested in oil projects generates four dollars to the economy. In economic jargon, this is called the multiplier effect.

out of 47 countries in its 1999 study. Finally, a survey in the *Mining Journal* (October 1999) gave Russia the lowest ranking among the emerging countries.[255]

In the first part of this chapter, I discuss the history of relations between foreign investors and the Russian state. After describing the state of the investment environment in the last decade, I discuss alternative explanations for why Russia fared so poorly in the international competition to attract foreign investment. Finally, I analyze the relationship between Russia's political regime and its oil policy and trace the sources of instability to the limited institutionalized competition that its hybrid regime has produced. In the conclusion, I discuss the political alternatives facing the Russian government today as it struggles to improve the investment environment and to finally attract the much-needed foreign capital into the economy.

II. History of Relations Between Investors and the Government

i. The Background: Oil Investment Policy in the Soviet Union

Early oil in Russia was produced in Baku (which was then part of the Russian empire) by Western investors, such as the Nobel brothers and the Rothschilds, who dominated the domestic Russian market and also supplied oil to Western Europe right up to the Russian revolution. After the revolution in 1917 and until 1987, overall there was a negative attitude towards foreign investment as part of the communist

[255] Glenn Waller, *"Russia needs to establish a track record- Waller demolishes Russian PSA Myths"* Oil &Capital III (2000): 16-18.

anti-imperial policy. Following the nationalization of foreign assets, foreign investors immediately fled Russia.[256]

Only during Lenin's New Economic Policy in the 1920s, there was a brief period in the history of the Soviet Union in which foreign investors were invited to form joint ventures with the Soviet state, but only in export-oriented sectors. While many Western oil companies protested forced nationalization and refused to cooperate with the Soviets, others, such as Standard Oil of New York, continued to invest in Russia. Western technology and investment enabled Russian oil production to recover and by 1923 Russian oil exports to Europe rose to their pre-revolution levels.[257] After Lenin, however, Stalin abolished these joint ventures and forbid the creation of such entities.[258] Not only was foreign capital strictly forbidden, but also even the mention of the word 'capital' was intolerable.[259]

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[256] Based on an interview with Ninel Voznesenskaya, professor at the Institute of State and Law, Moscow, April 20, 2001.

[257] Tina Obut, *"Roots of systemic woes in Russian oil sector traceable to industry's evolution,"* Oil and Gas Journal 97:4 (25 Jan, 1999.)

[258] Ironically even though the Soviet state did not permit foreign capital to operate in the Soviet Union, Russian capital was permitted to participate in joint ventures in several parts of the world. After the WWII for instance, the German shares in some of the companies in Eastern European countries were transferred to the Soviet state. Once again there were joint ventures with Russian participation, but outside of the Soviet Union. Even though eventually these shares were passed on to the host governments, it still was an interesting experience for Soviet capital operating in other countries as their foreign investment. Another such incidence took place in the 1960s with joint ventures in Africa during the de-colonization period. According to Ninel Voznesenskaya, many countries in Africa announced that their economic zones in the territorial waters were 200 miles and not only 12 and invited the Russian fleet to operate with them in joint ventures in fishing activities. In exchange for vessels, the Soviet state was given licenses to catch fish and then export. There were around 100 joint ventures formed and they were very successful.

[259] According to Ninel Voznesenskaya, if for instance a scholar had to use this word, he had to put it in a negative context by adding that foreign capital brings with it the exploitation of the workers. This is why in most of the Soviet texts of that period; one is likely to see other words such as "resources, income, funds" etc. instead of the word "capital." This clearly symbolized the pure political, negative attitude towards foreign investment during this period.

In the 1930s, 1940s, and 1950s, Russia's domestic consumption of oil grew rapidly, causing a reduction of Russian oil exports. The 1950s saw resurgence in Russian oil exports due to massive investments in the newly discovered Volga-Urals oil province. By the early 1960s, the Soviets had replaced the Venezuelans as the second largest oil producer in the world and had once again become major competitors with the West. In the 1960s and 1970s, the Russians discovered the Tyumen and Samotlar oil basins in Western Siberia. Production from these basins increased rapidly to make Western Siberia the major oil-producing region of the Soviet Union by 1980.

The Soviet state viewed an uninterrupted supply of oil as crucial to economic progress. Therefore, under the administrative command economy, the country's energy sector was bound by law to provide oil to domestic industries and consumers at prices significantly below that of the world market. Under Soviet rule, the oil industry was regulated by a group of Soviet ministries that wielded complete control. This centralized control of oil assets led to overproduction of existing fields to meet production quotas without regard for proper reservoir-management practices. The Soviet state favored the exploitation of big reservoirs rather than small ones with inefficient techniques, such as water flooding, that resulted in permanent damage to oil fields. Moreover, since there was no market-driven incentive to improve operating efficiency, the Soviet state chronically under-invested in technology. These systemic problems with Soviet era policy, combined with the continued deterioration of the

Western Siberia reserve base, resulted in a steady decline in Russian oil production from late 1980s onwards.[260]

To reverse the dramatic decline in oil production, on Jan 13th 1987, Gorbachev adopted a decree permitting the formation of joint ventures. It was a very short decree, outlining only the basic principles but not specifying the details of the legal relationship or many issues critical to the oil industry, such as taxation, freedom of export, transportation and the question of government participation.[261] Following Gorbachev's decree, two government acts, number 48 and 49, were issued. Government Act number 48 permitted the organization of joint ventures with the participation of socialist countries, while Act number 49 permitted the creation of JVs with the capitalist and developing countries. Not only was this arrangement problematic for situations when an investor from each group was included in a JV but it was also significant in depicting the lingering mentality of separating the socialist camp from the rest of the world. Even though from a legal standpoint, there was not much difference between these two acts, symbolically it reflected a continuation of the discriminatory attitude towards Western foreign investors.[262]

The Soviet Union had no laws regulating oil and gas development with the participation of foreign investors. A joint venture oil project had to get a special approval by a government decree issued by the then USSR Council of Ministers that

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[260] Obut, 30.
[261] David R. Nelson, *"Russia's Production Sharing Law-A Foundation for Progress,"* Oil &Gas Journal 94:5 (Jan.29, 1996): 106-108.
[262] Ninel Voznesenskaya, interview with author.

established the terms and conditions of the project. The first step in such a process was for the Soviet and foreign partners to draft an agreement with the advisory participation of either the Ministry of Oil and Gas (Minneftegaz) or the Ministry of Geology (Mingeo). The next step was to obtain approval of the Council of Ministers of the Republic where the deposit was located. The project then had to be submitted to the State Mining Supervisory Board and the USSR Council of Ministers, which finally issued the decree. After this, the joint venture could register with the Ministry of Finance.

Without any corporate legislation and any clear-cut specifications as to the type of the legal entity that was created and how it was organized, the initial interest by foreign investors turned into disappointment with many JVs forming, but very little capital actually entering the economy. As some people called it, the initial euphoria of partnerships at this period proved to be just 'foam.'[263] Examination of the oil development during the Soviet Union demonstrates how the pattern of 'lost opportunities' did not suddenly appear in Russia in 1991. As Thane Gustafson noted a decade ago, the dominant characteristic of the energy sector in Soviet times was that of 'crisis amidst plenty.'[264]

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[263] Ibid.

[264] Peter Rutland, *"Lost Opportunities: Energy and Politics in Russia,"* NBR Analysis 8:5 (NBR Publications, December 1997). Rutland here is quoting from Thane Gustafson's Crisis Amidst Plenty: The Politics of Soviet Energy Under Brezhnev and Gorbachev (Princeton: Princeton University Press, 1991.)

ii. Oil Investment Regime of the new Russian state

Despite a plethora of laws governing the oil and gas activities and foreign investment in general, Russia lacked comprehensive natural resource legislation.[265] The fundamental legislative act for natural resource development in Russia has been the *Law on Underground Resources* (LUR) adopted on February 21, 1992. In the early 1990s, except for some service contracts, the only regulated form of investment in the Russian petroleum sector was the establishment of a legal entity, typically a joint venture, which had to be granted a license to carry out all petroleum activities. The LUR provided a general framework for licensing exploration and development activities relating to minerals and other subsurface resources, including hydrocarbons. Under this law, petroleum exploration, development and production could take place as a result of a license issued jointly by the Russian Federation Ministry of Natural Resources and the legislative authorities of the territory in which petroleum operations were to be conducted.[266] In terms of the financial aspects, the LUR

[265] In 1991, the new Russian state passed the Foreign Investment Law (FIL), allowing the creation of other forms of investment in addition to joint ventures. Together with this law, there was a substantial body of other Russian laws and regulations that bore on oil exploration and production activities. Commercial relations were generally regulated by the Russian *Civil Code* of November 30, 1994, which set forth the applicable principles governing contracts, international transactions, forms of legal entities and other matters. Procedures for licenses were governed by a variety of regulations adopted on the federal and local level. Environmental issues arising from the exploration and production of oil were governed by the Russian law "On Environment Protection" of December 19, 1991 and the Russian Federation Law "On Ecology Expertise" of November 23, 1995. The use of land arising in connection with the exploration and production of oil was governed by the Land Code of the Russian Federation of April 25, 1991 and several Presidential decrees and numerous regulations issued by various federal and local bodies. Taxation was governed by a comprehensive set of laws and regulations. Financing exploration and production ventures from foreign sources was subject to foreign currency control regulations that are contained in the Laws "On Foreign Investments" of July 4, 1991 and "On Foreign Currency Regulation and Control" of October 9, 1992.

[266] In July 1992, the Supreme Soviet of the Russian Federation approved the *Regulations of the Procedure for Licensing the Use of the Subsurface*. These regulations addressed the licensing

contemplated various kinds of payments to be made by those who explored and extracted subsurface resources. Such payments included charges for the issuance of a license, payments for the right to use subsurface resources, payments for resource replenishment and excise taxes. On February 8, 1995, the State Duma approved amendments to the LUR, which took effect on March 15, 1995.[267]

The licensing regime depicted in the LUR, however, has not provided sufficient security, stability or predictability for private investors. In fact, it has raised a number of concerns for investors, which all stemmed from the fact that licenses and the licensing procedures were based on administrative law, rather than on contractual rights and obligations. This implied that the foreign investors were subject to state legislative action that could result in unilateral changes and modifications of the license, without granting the foreign investor any right to prevent or influence this process. The nature of a licensee's rights under a license was not very clear. These rights did not appear to be property rights and they were open to change by new laws and regulations with no provision for compensating the licensee. For instance, the existing law and applicable regulations allowed a license to be terminated by the licensing agency in a wide range of situations without compensating the licensee and without adequate protection against the abuse of these powers. The grounds for terminating a license included events that were beyond the licensee's control, i.e.

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procedure in greater detail than LUR. Accordingly, licenses were to be granted by means of competitive tenders or auctions. A license to engage in geographic exploration could be issued for a period of up to five years while a license to produce hydrocarbons for a period of up to twenty-five years.

[267] Levshov, 28.

force majeure circumstances. Adding to this difficulty were the provisions defining the duration of the license. The specified license term limited flexibility to provide for longer terms required by the difficulties of particular field conditions. The provisions for extension of the term did not provide adequate assurances that the extensions would be forthcoming.

Moreover, the legal hierarchy established under the 1993 Constitution was not very clear as to the distribution of authority between the Federation and the subjects of the Federation, where oil reserves were located. Article 72 of the Constitution assigned questions of ownership and use of subsurface resources to the jurisdiction of both federal and regional governments. Even though it also stated that regional laws falling under such joint jurisdiction could not contradict federal law, in reality there were ambiguities as to the power of the regions to bypass federal laws.

Finally, the severity of the tax burden under these laws was rivaled only by the frequency and unpredictability with which it changed. Many taxes-most notably the export tax- were levied not on profits, but on revenues. This was problematic for foreign investors who were often pursuing projects with high costs and low margins in those fields, which had been declared uneconomic by Russian production associations. A 1993 estimate suggested that the total tax burden on some Western oil producing operations was as high as 65-70% of revenues.[268]

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[268] James Watson, *"Foreign Investment in Russia: the case of Oil Industry,"* Europe-Asia Studies 48:3 (May 1996.)

In addition to heavy tax burden, the tax system was also too changeable, creating uncertainty and inconsistency.[269] Export duties have changed perhaps a dozen times under this regime. Exporters have struggled with cumbersome and restrictive quota and licensing requirements, only to be plunged into confusion when the restrictions were lifted with no clear procedures for fair access to overburdened pipelines replacing them.[270]

Many of the joint ventures that were established in early 1990s produced technical success in the sense that they succeeded in significantly raising production in the fields.[271] However, they were not considered an economic success for foreign investors. After nearly ten years, not any one of the joint ventures has recovered its capital costs, largely because the original fiscal terms on which the investments were made were later changed. As a result many of these joint ventures closed and some Western companies left Russia. There has been no major new foreign investment in non-PSA energy projects in Russia since then. As a joint venture senior executive told

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[269] For instance, when White Nights joint venture was formed in 1991 it was subject to only four taxes, but by early 1993 this had risen to eleven, radically altering the economics of the project. Similarly, Gulf Canada cut off all additional investment in an oilfield near the Arctic Circle, where it had already committed $60 million. The company stated that its Russian tax bill exceeded 100% of its total revenues.

[270]Kaj Hober, *"The Russian Law on Production Sharing Agreements,"* East/West Executive Guide (April 1997.)

[271] Some of the most important joint ventures were the US firm Phibro Energy's White Nights venture with West Siberian production association Vareganneftegaz; Conoco and Arkhangelskgeologiya's Polar Lights project to develop fields in the Timan Pechora region of northern Russia; and Occidental's partnership with the West Siberian company Chernorneft. In 1993 there were a total of 42 petroleum JVs registered in Russia, and by 1994 this figure had risen to 70.

Reuters in 1999, "the Russian government absolutely strangled the life out of every nascent joint venture right at the beginning."[272]

Given these problems with the existing legal and fiscal framework, the preferred form of investment in the petroleum sector soon became the production sharing agreements (PSA). The French company, Elf Acquitaine became the first company to sign a PSA with the Russian government in February 1992, when it contracted to develop fields in the Volgograd and Saratov oblasti. In 1994, Sakhalin Energy (a consortium comprising Marathon, McDermott, Mitsui, Royal Dutch/Shell and Mitsubishi) signed a similar contract (Sakhalin II) to develop oil and natural gas deposits off Sakhalin Island, and in July 1995, Exxon and the Japanese company Sodeco signed the Sakhalin I contract to develop other fields in the same island. Other major potential PSAs included the plans of Amoco and Shell to exploit large Western Siberian fields in cooperation with Russian partners Yuganskneftegaz and Evikhon respectively. None of these companies, however, was prepared to invest money in a commercial-scale production before the passing of a law to regulate PSAs.

The PSA law is preferred by foreign investors because it puts them in a much more secure position and protects their rights for the life of their projects.[273] Unlike

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[272] Quote taken from *"Firms wait on laws in Russia's black gold rush,"* The Russia Journal 21: 64 (June 5, 2000.)

[273] It is important to note that concessionary licensing is commercially more profitable for both the host government and the investors. Opting for a PSA regime is a political and psychological need for stability. If a reasonable tax system is in place and the investors trust that it will not be changed arbitrarily, then the investors prefer the concessionary licensing. PSA is, therefore, a developing country phenomenon.

the LUR, which provides a 'take-it-or-leave-it' arrangement between the licensee and the state in that the licensee's rights derive from a non-negotiable license, the PSA Law provides that the state is bound by the contractual obligations to the investor and should be liable for breach of contract.[274] It also provides a regulatory framework for oil contracts, in particular establishing which government agency would be empowered to conclude production sharing contracts with foreign companies and most importantly, how exactly the project would be protected from any subsequent changes in other laws. Finally it permits the investor to submit disputes to binding arbitration in an international tribunal.[275] Thus, investors can confidently commit billions of dollars to a project, knowing they have managed as much as possible the known manageable risks.

Just like the investor, the Russian state would also enjoy certain benefits under the PSA Law. The chief benefit for the state is the claim of greater national control over natural resources and oil companies.[276] Under PSAs, the state keeps title to the land and resources and retains a significant portion of the natural resource product. By creating a stable and transparent system, the state is provided with opportunities for collecting investors' payments into the stable budget- opportunities that cannot be

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[274] Note however that PSA investors and producers are still required to obtain a license. The difference, in theory, is now a mandatory formality on the part of the government, rather than a discretionary administrative act.

[275] Coudert Brothers, "*The challenge of international diversification in the oil and gas industry,"* International Financial Law Review (1997): 5-6.

[276] Author's interview with Daniel Lefebvre (Yukos) Moscow, April 23,2001.

yet secured by the current tax regime.[277] The PSA regime also provides direct support for domestic producers who are competing in the world market for capital intended for direct investment.[278]

Furthermore, with the enactment of the PSA law, new forms of relations between the center and regions emerge, opportunities for their cooperation on equal terms are created, and the real replenishment of local budgets is secured. Under the PSA law, the government of the Russian Federation and a body of executive power of the subject conclude a preliminary agreement stipulating the degree of their participation in a certain project, control functions, and the terms of the surplus of production sharing between budgets of various levels.[279]

Given these characteristics, the PSA law in Russia was designed to 'jump-start' the oil and gas investment process by immediately establishing a special legal regime for PSAs. It was meant to insulate investors from many risks that JVs faced. However, the PSA regime could not be developed timely and smoothly in Russia. In fact the struggles over its development proved more problematic than any of the attempts before it. It would be possible to argue that the restructuring of the oil

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[277] For instance, as of January 2000, investors in the only working PSA projects in Russia- Sakhalin 1 and Sakhalin 2- had paid more than $100 million to the federal and local budgets, and the state's revenues from existing PSA projects was around $350 million in 2000. Under the licensing regime, however, the host government receives no profit until the company as a whole makes a profit. PSAs, on the other hand, give governments profit share from the first production. Moreover, profits are allocated on a shareholder basis. PSAs give government increasing share of profits with project profitability or sometimes production.

[278] Mikhail Klubnichkin, *"Russia makes it easier to attract foreign investment,"* Oil and Capital III (1999) 15-17.

[279] Mikhail Subbotin, *"The Law 'On Production Sharing Agreements': Hindrances in the Way to Enactment,"* The Russian Economic Barometer 5:3 (Summer 1996).

industry, as reflected in the PSA process, has been one of the fiercest struggles that the new Russian state had to go through in its first decade of existence.

iii. The Evolution of the* PSA regime*: "*P*rogress* S*talled* A*gain"

Russia is a textbook setting for the use of PSAs. It is rich in hydrocarbon resources, but lacks the financial and technical means to develop them efficiently. Moreover its tax and legal regime have been too unpredictable and burdensome to attract large-scale, long-term investments. However, despite the immediate need for it, the creation of a PSA regime that encompasses the PSA law and the necessary regulations for its implementation has not been fully completed over the course of a decade.

Russian lawmakers had begun making provisions for PSAs even before the break-up of the Soviet Union. The concept first entered the legislative arena in July 1991, with the Foreign Investment Law (FIL). Article 40 called for the enactment of a specific piece of legislation establishing procedures by which foreigners could acquire concessions over natural resources.[280] However, such enabling legislation was not quick to follow. And rather than wait for PSA legislation, many foreign companies chose instead to pursue projects through the already established joint-venture framework. Almost all JVs have at one point or another been hit hard by the

[280] Craig Kennedy, *"Dream Law or Deal Killer? Russian PSA Legislation,"* Cambridge Energy Research Association (CERA) Private Report (Jun 1995).

very thing that PSAs are designed to protect against: fluctuations in the tax and legal regimes.

1994 was an important year for the PSA process. Galvanized by the continued reluctance of foreign investors, Russian authorities focused in earnest on creating an adequate PSA law. Already on December 24, 1993, Yeltsin had signed the Presidential Decree No. 2285, outlining the general features that PSA enabling legislation should contain, and called on the new Duma to pass a law embodying these proposals. Over the course of a year, no fewer than three special working groups answered the President's call and set to work drafting the new legislation.[281]

Under the direction of the head of the Legal Department of the Presidential Administration, Ruslan Gennadievich Orekhov, and his executive officer, Alexander Sergevich Pashkov, the first group came forth with an initial draft early in the summer. The draft was submitted for comments to a broad variety of groups, including foreign legal specialists. The second group came from the Ministry of Fuel and Energy (MFE). Deputy Minister Vadim Anatolievich Dvurechensky has been leading the Ministry's efforts to draw up draft PSA legislation. By the end of 1994, the MFE's group joined forces with the presidential administration group to author a single, common draft, which came to be known as the "government draft." The third group, on the other hand, was the inter-ministerial working group, led by Andrei Aleksandrovich Konoplyanik and technocrats from different ministers. In addition to drawing up enabling legislation, this group focused on drafting the normative acts, the

[281] Craig, 5.

instructions to be used by ministries in implementing the general precepts of a PSA law. This group also worked up a 'model' PSA contract to provide guidelines for actual contracts. Soon the Yabloko party in the State Duma sponsored this draft, which eventually became known as the "Duma draft." Both of these competing versions of a PSA law were submitted to the State Duma for debate in December 1994. The failure of the backers of these two drafts to reach an agreement was the key factor holding back initial parliamentary approval of the Law on PSA.[282]

The session of the State Duma of February 24, 1995, finally adopted the Duma's draft *Law On Production Sharing Agreements* in the first reading and voted down the government draft. Overall 162 members voted for it, 19 voted against it and 7 abstained. The PSA law that was adopted by the State Duma on June 14, 1995 simultaneously in the second and the third reading was not, however, approved by the upper house of the parliament, the Federation Council on October 3, 1995.[283] As the law did not gain the necessary number of votes (for –64; against-41; and abstained-4), it was voted down because of disagreement with some of its provisions and passed to the State Duma for a new consideration. At the same time, a Conciliatory

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[282] *"Too many cooks: Competing drafts slow progress of PSA legislation,"* Russian Petroleum Investor (February 1995): 13-16. The points in which these drafts differed include licensing regulations, taxation, and the entities to which the laws apply.
[283] While many individuals contributed to the passage of the PSA Law in the second and third readings, at the end, it came down to the actions of one man: Irik Amirov, executive director at the Russian oil company, Yukos. When the second reading was over, with only slightly more votes in favor, the Duma deputies hurried out of the hall without waiting for another round of dull proceedings. Amirov, who was one of the draft's authors, rushed to the doors and blocked the exit, loudly begging the deputies to stay for a few minutes more and cast their votes during the third reading. That's how the passage of the law was possible in a short amount of time. *"A Reason to Stay: Passage of PSA Legislation Important for Its Symbolism, Not Its Substance,"* Russian Petroleum Investor (July/August 1995): 15

Commission was set up to reconcile the differences between the two houses. Finally on December 6, 1995, the State Duma adopted the revised PSA law. On December 19, 1995, it was approved by the Federation Council and on December 30, 1995, it was signed by the President. The PSA law got published on January 11, 1996 and from this date on came into force.

Even though the basic PSA law was enacted in January 1996, foreign investors still did not find the investment environment stable enough to start their projects. For instance, Exxon released a statement 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 saying "it 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."[284] Western oil companies raised their concerns with Russian authorities and legislators at such forums as the Gore-Chernomyrdin Commission meetings, Petroleum Advisory Forum, the Congressional US-FSU Energy Caucasus and other institutions.[285]

Except for the three PSAs that were signed before the adoption of the law and that were grandfathered when the law took effect, no other project gained any momentum.[286] The reasons for this stalemate were the shortcomings of the core PSA

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[284] Scott C. Senecal and Elena L.Daly, *"Russia,"* International Financial Law Review (April 1996): 40-44.

[285] Lucian Pugliaresi and Anna C. Hensen, *"Improvements in progress for Russia's new PSA Law,"* Oil and Gas Journal 94:13 (March 25, 1996): 56-61.

[286] Sakhalin II, Sakhalin I and Kharyaga are the three PSAs that were signed before the passage of the 1995 PSA law. All three have been grandfathered by the legislation. A grandfather law for foreign investors creates a shelter against the vicissitudes of Russian legislation. It provides that any new

law on the one hand, and conflicts between the PSA law and various subsoil use, tax, customs, and foreign trade laws on the other.

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 resolutions. The drafters did not clearly classify the relationship between the state and the investor under a PSA as purely contractual. Article 1.3 of the draft provided that the ‘rights and obligations of the parties to a production sharing agreement which are civil in nature shall be governed by this Federal Law and the civil legislation of the Russian Federation.’ According to some, this implied that certain rights and obligations of the parties to the PSA are not civil in nature, and as such, would be governed by administrative law principles. On its face, the text of the law was unclear as to where the line was to be drawn and did not identify those provisions which were not civil in nature.[287]

Compounding this confusion was a provision of the law, added at the insistence of the Federation Council, stating that provisions of a PSA may not conflict with the provisions of the LUR. Since the LUR’s administrative approach fundamentally conflicted with the PSA law’s civil contract approach, there was no clear way of determining how disputes over critical issues such as issuance, suspension and termination of mineral rights were to be resolved. This ambiguity and

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regulations governing the operation of foreign enterprises shall not apply for a period a period of three years to such business enterprises already in existence at the time the new laws are enacted.

[287] Levshov, 15.

the possibility that certain provisions of a PSA could be governed by administrative law created the risk of broader administrative discretion by supervisory authorities, greater liability exposure for the investor and non-arbitration of disputes.[288]

A last minute amendment to the draft PSA Law imposing broad legislative approval requirements also caused concern among foreign investors. Accordingly, exploration and development under a PSA would be permissible only for fields and blocks named in a list that was approved by the legislature. In addition to this first approval, the law also envisaged a second and final legislative approval for any PSA that has been awarded without a tender as well as PSAs with respect to fields which are located on the continental shelf and fields involving 'special state strategic interests.' In essence, this meant that after the investor negotiated a deal with the federal and local authorities, the deal could be renegotiated on the demand of the Russian legislature as a condition for its approval. Given the difficult legislative path already faced by the PSA law, the requirements of legislative approval for each individual PSA and any amendments to them caused justified consternation among investors. For them, this requirement was unprecedented around the world in countries using PSAs.

Another shortcoming of the final draft of this law was the provision that regulated the export of oil production. One of the key benefits provided by the original draft of the PSA law was the unrestricted right to export an investor's share of production from the Russian Federation in accordance with the terms of the

[288] Hober,

agreement, free from any restrictions such as export quotas, licensing requirements or the mandatory sale of production through designated organizations. This protection was weakened in the final version of the law by the addition of the clause permitting export restrictions to be imposed in accordance with the law "On State Regulation of Foreign Trade Activity." This law permitted the introduction of export restrictions or prohibitions based on 'national interests', which were defined to include environmental protection, 'the necessity of preventing the depletion of non-renewable natural resources, if measures relating to this are taken simultaneously with the introduction of restrictions on domestic production and consumption of the relevant natural resources,' and 'protection of the external financial situation and support of the balance of payments of the Russian Federation.' The uncertainty introduced by this exception could have potentially raised the costs of financing a PSA, since lenders would demand a higher margin to assume the risk associated with a possible cut off of project revenue.[289]

Another significant benefit provided by the original draft PSA law was the ability to choose foreign law to govern the contractual relationship between the state and the investor, which was a significant step toward recognition of the realities of cross-border contractual relationship in the energy sector. The use of a foreign law to govern PSA would reduce political risks because it would prevent the state from obtaining an unfair advantage over the investor by manipulating its domestic laws. In addition to being neutral, the laws of a foreign country with a more highly developed

[289] Ibid.

legal system would be better suited to the specific requirements of multinational oil projects. However, the final version of the PSA law was amended in such a way to make it clear that PSAs were governed by the Russian law. Given the developing status of Russian law and the possibility of unexpected changes that might affect the interpretation of the liabilities under a PSA, this was a very unwelcome term for the investors.

Furthermore, the stabilization provisions of the PSA law were weakened by an amendment introduced by the Federation Council, which required the amendment of a PSA on the demand of one party 'in the event of a material change in circumstances in accordance with the Civil Code of the Russian Federation'. The Civil Code permitted juridical reformation of a contract in these circumstances, but the conditions that had to be met in order to grant such a unilateral amendment were very stringent.

Finally, the taxes and accounting provisions that would apply to PSA projects under this law could not be effectively put in force until additional legislative action, i.e. amendments to the Tax Code, took place. This conclusion was based on an old Russian Supreme Soviet Decree and the *Law on Fundamentals of the Budgetary System and Budgeting Process in the Russian Federation*, which stipulated that no changes could be made to the Russian tax system except through the adoption of new

tax laws or the amendment of existing tax laws. As a result, taxes could not be introduced or changed through non-tax laws.[290]

Given these shortcomings in the final version of the core PSA law, no PSA project was given a start during this period. The investors demanded further amendments to this law, including the elimination or curtailment of the role of the legislature and resolution of fundamental conflicts with the LUR. Moreover, regulations were needed to set forth detailed rules for taxation, determination of recoverable costs, accounting and other matters. Amendments to a number of other laws and regulations were expected to implement the PSA law's tax exemptions, to eliminate conflicts with the existing licensing system, to permit the use of internationally recognized technical and safety standards and thus harmonize the legal system. It had taken a long time, almost three years, and much difficulty before the basic PSA Law became effective in January 1996. It was, however, only a first step. There was still ahead the task of providing the list of fields to be developed under PSA as well as the amendments and enabling legislation to be adopted to allow the basic law to operate.

In 1996-97, the government, together with the regional authorities, prepared a number of bills with the lists of fields allowed for PSA and submitted them to the State Duma. The lists contained over 250 deposits, including 213 deposits of

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[290] John F. Sheedy, *"Special Tax Regime for Production Sharing Agreements in Russia,"* East/West Executive Guide (August 1997.)

hydrocarbons, located in 32 administrative regions of the Russian Federation.[291] After Duma's pro-communist majority rejected previous drafts, finally in July 1997, it approved only seven out of 250 deposits in the first List Law. [292] However, not a single project out of these legally permitted seven deposits was signed. The basic PSA law still proved to be insufficient without modification in the existing legislation on tax, customs, foreign investment, as well as regulations for the use of underground resources in the offshore zones.

First, in July 1997, a PSA Commission was created. Then a year later in July 1998 the Amendments Law, which became known as ' the ultra nationalist amendment,' was introduced. The Federation Council, however, returned this law to the State Duma on September 4, 1998, with a number of critical remarks. The Council was mostly concerned about the provision in this draft on the limit imposed on the share of discovered reserves that would be subject to development under PSA. This July version of the law, established this share for the oil sector at 10%, which had been already exceeded at that moment and would hamper future projects under PSA.

With the help of the conciliatory commission, which was set up to resolve the conflicts between the two houses of the parliament, the new Duma committee responsible for PSAs drafted a new version of the Amendment Law. Hence, after

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[291] The initial draft law that was introduced by the liberal Yabloko party also had 250 fields included in the list of fields to be subjected to the PSA law.
[292] Shane De Beer and Aydine Jebrailov, *"Production Sharing Agreements in Russia,"* East European Business Law XI (November 1997): 6-8.

another three years of debating, the *Federal Law on the Introduction of Amendments and Additions into the Law on Production Sharing Agreements* was signed on January 14th 1999 and shortly after it became effective as of 17 February 1999. The PSA Amending Law and the Enabling Law, together, resolved many of the legal uncertainties that had been retarding major work on the few PSAs already signed and that had been delaying the negotiation and signing of several others.

First of all, the contradictions between LUR and PSA Law as to whether PSAs would be treated as civil-law contracts under a special, self-contained PSA regime or would be subject to the general LUR licensing/administrative law regime, has been clarified in favor of PSA contract predominance. This fundamental improvement applied to such issues as bases for termination of rights, extension of the contract/license term, and field conservation measures.[293]

Second, the special, stabilized regime of taxes and other payments for PSAs, enacted by Article 13 of the PSA in 1995 but subject to question since then as to its legal validity, has been confirmed through the Enabling Law by specific amendments to the relevant tax laws. As with taxes, exemptions from tariffs also had to be reflected in the proper legal act to be guaranteed under Russian law. The Amendment to the Customs Tariff Law and the Customs Code provided for import tariff exemption on goods brought into Russia at the investors' expense for work on a PSA,

[293] Jonathan H. Hines and Dmitri V. Nikiforov, "*Russia Improves its PSA Regime: A Thumbnail Analysis,"* Journal of Energy and Natural Resources Law 17:2 (1999).

and export tariff exemption on goods taken out of Russia under the terms of a PSA.[294] Moreover, PSA investors' right to freely export their share of production was fortified by an addition to the *Law on State Regulation on Foreign Trade Activities*, clarifying that any qualitative restrictions on exports introduced by the Russian government must take into account the state's free-export obligation to investors under the PSA Law.

Finally, another amendment to the PSA law permitted conclusion of PSAs without the approval of the State Duma for projects involving relatively small reserves of oil and gas (up to 25 million tons of oil and/or 250 billion cubic meters of gas.) This would give regions a larger role in the PSA process and save certain projects from lengthy debates in the parliament. Such reduction of the role of the parliament's role in the PSA process was seen as a major accomplishment. In addition, the amendments largely abrogated the previous requirement that investors obtain Duma's approval for specific PSAs involving larger deposits. Even though such fields still had to be included by the Duma on list laws before they could be eligible for a PSA status, the Russian government was now permitted to negotiate and implement PSA terms for individual projects without parliamentary approval (unless the projects involve national security interests, the Russian continental shelf, or an exclusive economic zone of the Russian Federation, in which case the Duma's rubber stamp is needed). Along the same lines, the new legislation did not require Duma approval for conversion of previously existing non-PSA projects into PSAs in cases

[294] Ibid.

where the subsoil users had already obtained a license, or for development under PSA terms of unexplored acreage that the Russian government may put up for tender.[295]

Despite these positive steps, the PSA Amendments also introduced some new requirements, and restrictions that were not welcomed by foreign investors. Specifically, these amendments introduced quotas of 30% on the reserves that could be subject to PSA, 70% on the value of goods and services that must be purchased from Russian suppliers, and 80% as the minimum labor-force quota for Russian nationals. As the deputy chairman of the State Duma Economic Policy Committee, Svetlana Gvozdeva stated, with these conditions Russia was "creating a new iron curtain for investors.[296]

As for the 30% quota, foreign investors saw it as a major deterrent to investment because the huge old reserves that were put under the first field list already filled up the quota, which meant that the list of new fields would be virtually closed.[297] Investors likened this quota to Lenin's limitation of foreign concessions in Soviet Union to 30% of Russian resources. Moreover, the quotas on labor and goods and services caused some concern among investors since using Russian goods and technology that were not competitive in respect to reliability, safety, quality and delivery times could stall major investment projects. Even though the Amendments to the PSA law and the Enabling Law are significant steps in bringing the investment

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[295] John Webb*, "Russia Passes Key PSA Legislation: Too Little, Too Late?"* CERA Alert (February 26, 1999.)
[296] Quote taken from Peter Rutland, 24.
[297] According to Sergei Danilkin (Phillips Petroleum) during his interview with the author, Moscow, April 9, 2001, Russia is unique in having a 30% quota. This restriction exists in no other countries that use PSAs.

environment to a more favorable and workable position, some problems still remain. The fact that not a single PSA project has been started under this law is a proof of this fact.

First of all, 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, still remain to be finalized and adopted. These important acts are expected to cover and fill in gray areas and gaps on such fundamental matters as taxation, accounting, cost recovery, and supplemental procedures for tenders and fore entry into PSAs. Of the Normative Acts, without which there cannot be an effective PSA regime, none has been completed satisfactorily after more than two years of drafting.

Moreover, the PSA tax regime remains to be put in the Chapter 26 of the Tax Code (Part 2) in a way that does not undermine the PSA law. Part 1 of the new Russian Tax Code, creating a basic general legal framework for taxation, was enacted in July 1998. The need to put PSA tax regime is highlighted by article 18 of the Tax Code, which requires that special tax regimes be set forth in the Code. This legislation is of vital concern to investors in PSAs because, among other things, it will determine the level of the profit tax, which is levied on PSA partners along with non-PSA oil producers.

In addition, there are about 6 draft laws covering yet more amendments to the basic PSA Law. One of the most significant amendments seeks to remove taxation from a PSA project altogether and allow direct distribution of production between the

government and the investor. According to the draft law's authors, after this single tax is paid, or rather after a share of production or its equivalent is handed over to the state, the investor becomes the owner of the rest of oil and no longer has to deal with tax agencies.[298] The proposed innovation is aimed at simplifying substantially the realization of PSAs since if adopted, investors would get a chance to ignore executive agencies' inactivity that blocks work under PSAs. It is also useful for the state because it fixes the state's take in production and encourages the investor to reduce production costs and increase profits that are not taxed. This one, unless drafted carefully however, could result in no or minimal foreign investment for Russia's PSA projects because the introduction of a 'single tax' would mean that foreign investors could be subject to double taxation in their home countries.

Other suggested draft laws would seek to impose limits on the length of time for PSA project negotiations, to mandate the purchase of Russian goods and services even if economically uncompetitive, to introduce a "third key" principle in which three instead of two levels of government would be required in PSA negotiation and to mandate approval by the Duma of all contracts concluded for PSA projects.[299] Thus, not only the shortcomings of existing laws stall foreign investment, but also the prospect of tinkering with the favorable provisions of the basic PSA law depicts a negative picture for the future of PSA developments.

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[298] *"PSAs= Progress Stalled Again,"* Oil and Capital VII-VIII (2000): 5-7. This 'direct sharing' of production is developed after the Peruvian PSA model. Unlike the Indonesian model, direct sharing calls for completely exempting the investor from any cash payments of taxes or duties.

[299] Andrei Mescherin, *"Duma prepares Amendments to complete work on PSA legislation,"* Russia/Central European Executive Guide (August 15, 2000): 10-13.

In 2003 Russia has a PSA Law that took 9 years to prepare, but as yet it does not have an effective PSA regime. In the seven years since the 1996 PSA Law, 28 fields have been put on the list of PSA projects whereas none, other than the grand fathered three projects, has been in effect. The total of investment in PSAs since 1993 comes to only $1.5 billion.[300] This is not even close to what is actually required to develop the industry. This is quite disappointing given that in Azerbaijan, for instance, 21 PSAs have been signed and in operation during the same period. Only PSAs can yield enough resources to give Russia a strong impetus in the investment sphere.

Why is the Russian system of PSA developing so slowly, showing constant failures to attract the much-needed investment into the oil sector? Why is the investment policy of the Russian state so uncompetitive as compared with other countries? What explains the lack of state capacity in creating a PSA regime and leading the development of natural resources in Russia? Why does so much controversy surround the PSA law? Now in the next part of the chapter, I turn to the answers of these questions.

III. Sources of Instability in the Investment Environment

One of the sources of instability in Russia's investment environment is seen in the deep-seated cultural opposition of Russians to the idea of foreign investment.

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[300] Irik Amirov, *"Simplify PSA Law substantially- or investors will go,"* Oil and Capital III (2000): 12-14.

Russia's history, not just in the Soviet period but going back centuries, has been one of isolation from the West and distrust of the outside world. This is often couched in terms of Russian national interests. The common fear is that Russia should not allow itself to be 'colonized' by Western investors and that it should not give away its natural resources to foreigners. This cultural hostility is best expressed in attitudes towards PSA. Many argue that adopting an investment regime that is used by third world countries is embarrassing for Russia. This pride is considered as one of the obstacles to a PSA regime in Russia.[301] This suspicion of foreign investment is perhaps stronger in Russia when compared with other oil producing states because the Russians have discovered most of their oil and gas reserves themselves without foreign assistance, and hence are more reluctant to give them away. Russian oilmen can remember having built a successful, growing industry of their own and resent being patronized by Western counterparts who belittle their achievements.[302]

Suspicion of Western involvement has not, however, been widespread as cultural arguments posit. Rather it depended on the type of investment project being considered and the extent of the control stakeholders have over that investment. When the Western side makes finance and technology available to the Russian party without seeking to obtain an equity stake in the project, it is normally welcomed with open arms. However, the idea of Western participation in the form of a joint venture or production sharing agreement arouses far greater suspicion. Such direct

[301] Author's interviews with Richard Freeman (Texaco) Moscow, August 22,2000; Jamal Quadir (Conoco) Moscow, August 25, 2000.
[302] Watson, 451.

participation has tended to be permitted only when there were significant, usually non-financial barriers to the independent development of resources by a Russian entity.[303] Moreover, the nationalists and communists used this cultural and ideological rhetoric against foreign investment in order not to lose control over the resources that provide them with political and financial leverage.[304] What is more interesting is that the PSAs that these groups so strongly oppose have been also promoted and used by Russian oil companies. This is a clear sign that opposition to PSA was less due to cultural hostility than political interests. In fact, in late 1998, when the responsibility to prepare the PSA amendments was transferred from the Natural Resources Committee (which was headed by a Yabloko deputy) to the Committee on Industry, Construction and Transportation, which would be headed by someone close to communists, PSA became a communist 'issue.'[305]

Another obstacle to a stable investment environment is seen in the geographic size of Russia and the resulting lack of coordination between its center and regions. The argument is that the central government can not afford to alienate or ignore regional actors. They have to be somewhat included in the decision making process, which makes consensus building fairly difficult. Therefore, as opposed to a small country, a large country like Russia produces many gatekeepers, which makes

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[303] The Sakhalin projects, for instance, need sophisticated offshore technology that the Russian do not have and they cover fields in a region, which is not an integral part of the country's energy complex. Similarly, the Timan Pechora project requires major investment in transport infrastructure and that is why it was less contentious to use foreign investment in this region.

[304] Author's interview with Glenn Waller (Petroleum Advisory Forum-PAF-) Moscow, May 10, 2001 and Vladimir Averchev (former Duma member) Moscow, April 19, 2001.

[305] Ibid.

politicization of investment issues more likely. Others argue that the size of the economy makes Russia less dependent on foreign investment. It, in a way, provides some level of self-sufficiency and thus less need to integrate into the global economy. This is especially important in a strategic sector like the oil industry. Oil is not only the main source of government revenues for Russia, but it is also the main foreign policy instrument towards the near abroad and the West. Hence, geostrategically, it is more difficult for Russia to share the operation and control of this 'commanding height' with foreigners and become vulnerable to outside interference.

Clearly, Russia's culture, size and geostrategic concerns have produced constraints on the creation of a stable investment environment. Yet, the more important question is how determinative the weight of these factors has been as opposed to the impact of political regime in Russia in the last decade. Unlike what these explanations assume, there was no consensus over investment policies, especially in the oil sector. While some groups used cultural, ideological and geostrategic reasons to oppose foreign investment, others were in favor of partnerships with foreign companies and supported the creation of an attractive and stable investment environment for them. As a result, these investment policies became very politicized and the Russian state faced fierce political struggles over them. Therefore, in order to understand the reasons why it has been so difficult to create a stable investment environment in Russia, we need to understand the interests of different actors and the institutions that shape these interests. The political regime enhances or constrains the capacity of different interest groups to influence policy

outcome. Now I turn to a discussion of the characteristics of the Russian political regime and the extent of institutionalized competition over oil policies.

IV. Political Regime and Instability

During the 1993-2000 period, Russia has been a hybrid political regime. It had many components of democracy such as regular elections and free competition. However, it also failed to approximate an authentic democracy.[306] This is why many scholars have labeled it 'low-caliber democracy,"(Fish, 2001) "bureaucratic quasi-authoritarianism," (Shevtsova 2001) "electoral democracy," "unconsolidated democracy" etc.[307] In this dissertation, I characterize Russia's political regime during the 1990s as 'hybrid' due to the limited extent of institutionalized political competition. While there were important veto players to challenge the policies of the government, there were also weak institutions to aggregate interests into policy coalitions and resolve conflicts among veto players through negotiation and compromises. Hence, pluralism within the state was left unchecked. It led to jurisdictional power struggles among state actors, resulting in both policy deadlock, chaos and instability. First I discuss the veto players in the political regime.

Despite the conventional wisdom, which assigns unprecedented powers to the president, in Russia the parliament has been an important veto player in the last

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[306] Steven Fish, *"Conclusion: Democracy and Russian Politics,"* in Barany and Moser, eds., Russian Politics (2001), 215. See also Archie Brown, *"Evaluating Russia's Democracy,"* in Archie Brown, ed., Contemporary Russian Politics, 564.

[307] According to Steven Solnick in *"Russia's Transition: Is Democracy Delayed Democracy Denied?"* Social Research 6:3 (Fall 1999): 789-824, Russia is not a democracy but a system with a durable division of power among a fairly stable group of elite actors.

decade. Many scholars argue for instance that while the constitution created a strong presidency, in reality Yeltsin was a weak president and the struggle between the legislative and executive branches had a significant impact on the policy environment.[308] Despite his constitutional powers, Yeltsin did not always rule without regard for the parliament. He in fact made several compromises on key issues. After the tumultuous relations between the legislative and executive branches during1991-93, both sides refrained from confronting each other too directly and tried to avoid another constitutional crisis. However, while the 1993 Constitution elevated the presidency above parliament, it also reserved sufficient powers for the legislature to complicate presidential rule. Even though the president had the power to legislate by decree, such decrees had to be subordinate to statute law in the Russian hierarchy of legislation. Being the principal lawmaker, the State Duma rejected or delayed draft laws presented by the government. Especially because the State Duma was practically constrained in its ability to remove the government (in fear of its own dissolution,) it has been less willing to share responsibility for the government's actions and policies.

During most of Yeltsin's presidency, the ideological battle between reformists and anti-reformists has further fueled the battle over institutional jurisdiction. Opposition parties solidified control over the State Duma in 1995 and the Communist party emerged as the center of an opposition that controlled a working legislative majority. As such, obtaining the Duma's agreement in particular policy issues became

[308] Robert Moser, *"Executive-Legislative relations in Russia, 1991-1999,"* in Barany and Moser, eds., Russian Politics (Cambridge University Press, 2001), 64-102.

very difficult for the government and the president. The strategy of the conservative parliamentary majority has been to restrict the executive branch's freedom of maneuver without assuming governing responsibility. The Duma, which could not influence the government decisions on many important cases, showed hostile attitude while discussing laws.[309]

In addition to the strength of the lower house of the parliament to challenge the government, the regional administrations also exerted significant amounts of veto power over the executive branch during Yeltsin's presidency. The disintegration of the Soviet Union had resulted in the devolution of considerable political and economic power to 89 regional administrations both in terms of law making and implementation of laws. In terms of law making, the upper house of the parliament, the Federation Council, played a crucial role. Made up of regional executives and the leaders of regional legislatures, this legislative body was designed by Yeltsin as an instrument of legislative control but has in fact developed into a more autonomous lawmaking body that have embodied the interests of regional elites.[310] Moreover, in 1996, Yeltsin relinquished his appointment power over regional executives and allowed them to be directly elected. This gave the upper house a greater degree of autonomy. Although it remained less confrontational than the lower house of the parliament, it nevertheless defied Yeltsin on several occasions.[311] It also challenged

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[309] Author's interview with Alexander Kursky (Advisor to the government) Moscow, April 27, 2001.
[310] Moser, 86.
[311] Kathryn Stoner Weiss, *"The Russian Central State in Crisis,"* in Barany and Moser, eds., Russian Politics (Cambridge University, 2001), 127.

the State Duma and prevented the development of federal legislation and regulation. It has been responsible with the scrutiny and approval of bills prepared and passed by the Duma. As a rule, bills going through the Russian Parliament had to pass through a total of three readings in the Duma, then a fourth by the Federation Council and finally be signed by the president before they actually become a law. In this capacity, the Federation Council has become a significant veto player. For example, during the Duma's second term, the upper house vetoed 23% of all laws passed by the Duma.[312]

The regional administrations have also been assigned significant regulatory and administrative powers to oversee the implementation of laws. Yeltsin's famous statement "take as much independence as you can swallow" to the regional elites in 1990 had been quite instrumental in creating this autonomy. This 'parade of sovereignties' was intentionally engineered by Yeltsin in the wake of the breakup of the Soviet Union and the violent showdown between the president and the Supreme Soviet of October 1993. Even though with the 1993 Constitution he later aspired to limit the powers of the regions and centralize state authority[313], his concessions to the regions during the 'parade of bilateral treaties' not only reduced the authority of the federal center but also eroded the legal equality the Constitution proclaimed for different levels of center-periphery relations. Regional elites won budget privileges, powers of appointment, exemption from various federal requirements, and a tacit

[312] Paul Chaisty, *"Legislative Politics in Russia,"* in Archie Brown, ed., Contemporary Russian Politics (Oxford University Press, 2001), 118.
[313] Yeltsin incorporated two articles (71 and 72) in the Constitution enumerating exclusive federal and shared federal and regional areas of jurisdiction, but did not include an article exclusively reserving certain powers for the regions.

understanding that federal officials would look away from violations of the Federal Constitution and federal policies.[314] Between 1994 and 1998, forty-six of the eighty-nine subjects of the Federation signed bilateral treaties with the federal executive. In addition to these treaties, many republics and regions adopted their own constitutions and charters. This 'war of laws' produced thousands of laws and constitutional clauses that contradicted the federal constitution and federal law.[315] The federal government's default on many jurisdictional responsibilities left the regions with empty policy space and free reign.

Pluralism within the state is in fact a characteristic of democratic regimes. Separation of powers is crucial for a state to function effectively. And so are the mechanisms of checks and balances. Horizontal accountability among state institutions prevents the tyranny and domination of one over the others. What makes Russia a hybrid regime, however, is the combination of this pluralism in the state with weak institutions of conflict resolution. The indicators that I use for this variable are the strength of political parties, interest group organizations and bureaucracy, which not only provide institutional channels for societal actors to check the powers of the state, but also provide mechanisms of negotiation and comprise among veto players.

Parties are needed to aggregate social interests, construct majority coalitions and serve as a bridge between the branches of government as well as between

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[314] Jeff Kahn, *"What is the new Russian Federalism,"* Contemporary Russian Politics (Oxford University Press, 2001): 374-384.
[315] Ibid. Kahn also reports that in 1996, nineteen out of twenty-one republican constitutions violated the federal constitution.

national and local politicians. Parties also constrain and discipline their members in the parliament, but because they aggregate constituent interests, they also provide parliamentary deputies with resources allowing them to act collectively. Without strong political parties, politics becomes very personalistic. Politicians prefer dictating and ruling directly to governing through impersonal, established rules and agencies and view institutions as obstacles than as necessities.

Russia has had a weakly institutionalized party system. During the 1990s, political parties in Russia could not facilitate compromise and cooperation between the legislative and executive branches. The absence of disciplined party blocks endowed parliamentary politics with a fractious fluidity. The erratic fluctuation in the number and size of political groupings complicated the identification of party alliances capable of forming winning majorities. Parties were often divided internally, usually dominated by a single strong personality.[316] Moreover, parties had weak control over policy coordination and legislative strategy across committees. As a result, deputies enjoyed a high level of personal control over legislative activity in Duma committees, which resulted in a legislative process that furthered particularistic interests. Finally, parties failed to link the state actors to their constituencies. With no vertical accountability, these state actors engaged in jurisdictional power struggles over the institutions of the state, furthering the constitutional conflict between the two branches of government.

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[316] Richard Sakwa, *"Parties and Organized Interests,"* in Stephen White, Alex Pravda, and Zvi Gitelman, eds., Developments in Russian Politics (Durham: Duke University Press, 2001), 89.

The absence of well-developed political parties was not only an obstacle to stable executive –legislative relations but also undermined center-periphery relations. In Russia there were not many national political parties that could perform unifying functions. Most of the political parties that had candidates running in the elections to the State Duma had little institutional presence outside of Moscow. The communist party of Zyuganov was to a certain extent an exception but even it was unable to provide a great deal of assistance to local candidates. Many of the communist governors pursued their own agendas as opposed to the party's interests. Moreover, most regional assemblies were populated by elected deputies with no party affiliations.[317]

By the same token, weak interest group organizations in Russia could not check abuses of office by members of the parliament and government. For instance, the new trade unions were subject to the factionalism and splits typical of the pseudo-parties. Including trade unions, most of the larger social organizations tended to be top-heavy bureaucratic organizations with weak links to the mass of their membership. Interest groups played a much less salient role in post-Soviet political life than they did during the perestroika period. Individuals and groups had no organized sphere in which they could articulate and reconcile their interests on the bases of established laws.[318]

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[317] Kathryn Stoner-Weiss, 124.

[318] Marcia A. Weigle, Russia's Liberal Project: State-Society Relations in the Transition from Communism (Pennsylvania State University Press, 2000), 335.

Instead of a pluralism of interest groups, Russia's political life was dominated by key groups, such as finance and raw materials lobbies. Others like the agrarians, the manufacturers, and the military-industrial complex had very little and sporadic influence.[319] Due to financial and organizational constraints, they found it difficult to mobilize their constituencies. The energy lobby and their banker allies, on the other hand, could pressure the state on various policies, using their media outlets and informal personal contacts with government bureaucrats, parliamentary deputies and regional elites. This oligopolistic influence on the state crippled the institutionalization of different interest groups. It made the lobbying process highly opaque and unbalanced. Rather than providing checks on the executive and mediating among state veto players, it hastened the spread of corruption at all levels of the state.

Finally, the weakness of the Russian bureaucracy has been a destabilizing force in Russian politics. Especially since the breakup of the Soviet Union, the economic difficulties facing bureaucrats have given them incentives to pursue their self-interests more than the interests of the state. The influence of powerful economic groups over the bureaucracy has been enormous, leading to significant levels of corruption. Different government ministries and agencies have been fighting one another to gain as much power and financial benefits as possible. In the law making arena, this lack of coherence and hierarchy in the government produced a plethora of

[319] Vladimir Chervyakov and Vladimir Berezovskii, "Corporate Groups of Industrialists and Managers in the Production Sphere," and "Sectoral Production Capital: Military Industrial Complex and Fuel Complex," in Klaus Segbergs and Stephan De Spiegeleire, eds., Post-Soviet Puzzles, Vol.3, ch. 13 and 14 (Baden: Nomos, 1996).

different government proposals and drafts reflecting different and oftentimes-clashing interests of various bureaucratic agencies. In the implementation of the laws, once again this infighting caused confusion and delay of investment projects.

Additionally, the split nature of the executive branch contributed to the weakness of the bureaucracy. In Russia the president and the government constitute the two major components of the state that carry out executive functions. The 1993 Constitution established them as two different branches of power. The President, independent of the government, has at his disposal the presidential administration. On the other hand, the government works independently, with only intermittent direction, or intervention from the president. This split structure weakened the mechanisms of coherence and responsibility sharing within the bureaucracy. The presence of presidential and governmental teams above the ministries confused lines of authority and encouraged ministries to play the head of state and head of government against each other. All too often, the result was confusion and self-destructive competition.[320] Once enacted, laws faced neglect or distortion at the hands of bureaucratic officials responsible for implementing the law. Laws remained without effect until they had been concretized through the issuance of enabling acts by the government and relevant ministries. Because the formation of the government was in the hands of the president, and the parliament practically could not use its vote of no confidence to control the actions of the government, the ministers did not feel accountable to the

[320] Eugene Huskey, *"Democracy and Institutional Design,"* in Archie Brown, ed., Contemporary Russian Politics (Oxford University Press, 2001), 45.

parliament and frequently obstructed the implementation of the laws. According to many, this incompetent, unprofessional, corrupt bureaucracy was the main reason why it has been so difficult to create a stable policy environment in Russia.

Given this institutional mix and the enormous stakes involved in controlling oil resources, the PSA issue immediately became, what many observers called, a 'political football' in Russia. The hybrid regime that assigned significant veto powers to various state actors in the absence of conflict resolution mechanisms made it difficult for proponents of PSAs to exclude or co-opt opposition groups. In the next part of this chapter, I discuss in detail this political competition over oil policy.

V. Political Competition Over Oil Policy

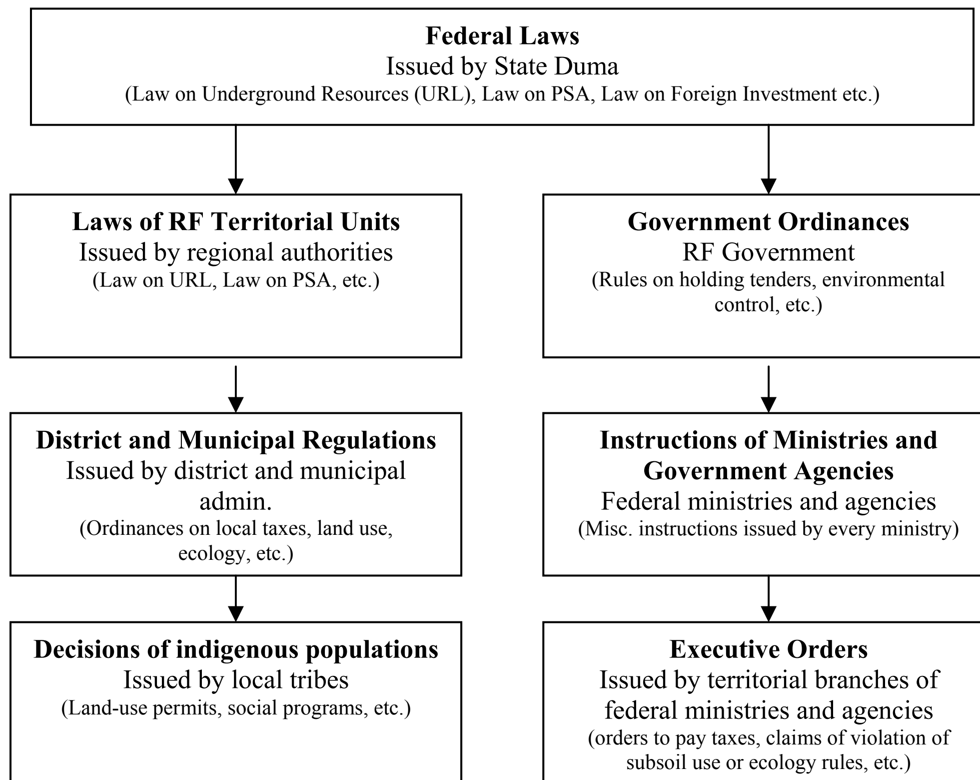
Passage of the PSA legislation, which potential foreign investors describe as a key problem in attracting large-scale investment in the fuel and energy sector, has been a source of domestic political debate for almost a decade. Promoting and controlling PSA have become politically attractive. At the federal level, the executive and legislative branches have been locked in a battle for political authority and the government itself had to fight, often in vain, to assert its control over semi-independent administrative agencies. Moreover, the federal government and the regions were clashing over resource ownership. The pluralism within the state in the absence of strong parties, interest groups and a cohesive bureaucracy that serve integrative and conciliatory functions led to jurisdictional struggles over oil policy. Unchecked fragmentation in the state hindered the development of coherent

legislative and regulatory framework as well as the implementation of these rules and regulations for the oil industry. In the last decade the Russian state produced conflicting legislation and regulatory measures at different levels of government (see Figure 5.2). The conflicts also made it difficult for foreign investors to know who has the authority to strike a deal in Russia.

i. Between the executive and legislative branches

First of all, the initial draft law on PSAs encountered significant opposition in the upper house 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 production sharing contracts with investors. This was unacceptable to Duma members because of their traditional mistrust of the government. They assumed that if government officials had the right to sign agreements with foreign investors, they would be bought off and the state would be left with nothing. Thus the reluctance of officials in the legislature to relinquish the regulatory power, which they enjoyed, was certainly one factor delaying legal reform.

Figure 5.2: The hierarchy of Russian laws on oil



Especially the leftist factions in the State Duma had problems with the clauses on the contractual nature of the relation between the investors and the government, international arbitration and the royalty system of payments.[321] Initially, the left wing factions blatantly ignored the bill on the grounds that all PSA legislation amounted to "privatization of natural resources." It was with great difficulty that it proved possible, in 1997, to get the first seven deposits eligible for development on PSA

[321] Opposition in the Duma came especially from Sergei Glaziev, leader of the Democratic Party of Russia faction and the chairman of the Duma Committee for Economic Policy. Another key critic has been Gennady Zyuganov, the Communist leader. Neither of these men has actually ever directly and unequivocally challenged the need for investment in the energy sector and for PSAs. They were really objecting to the terms of these contracts.

terms through the State Duma and to clear the first reading of the Bill on Amendments towards the final endorsement. The leftist factions in the Duma agreed to vote for the extremely badly needed Amendments (upon its third reading) only after the Federation Council, the higher parliamentary chamber, approved changes and additions to the PSA law on December 1998 and the president assured his signature.

The division of power and differences in opinion between the two branches was also apparent during the discussions on the *Law On the List of Fields Eligible or Development on PSA Terms*. The government in response to demands from regions promised to develop a long list of oil fields under PSA terms. These promises hindered government's ability to cut down the list when communist deputies in the State Duma flatly declared that they would never vote for a PSA list exceeding twenty fields and refused to participate in a session on the 20th of March to adopt the draft Law.[322] For almost a year, neither the legislative branch nor the executive could do anything to advance PSAs.[323] Following months of exhaustive wrangling, the Duma finally approved in principle a draft law on the list of fields eligible under PSA terms (see Figure 5.3.)

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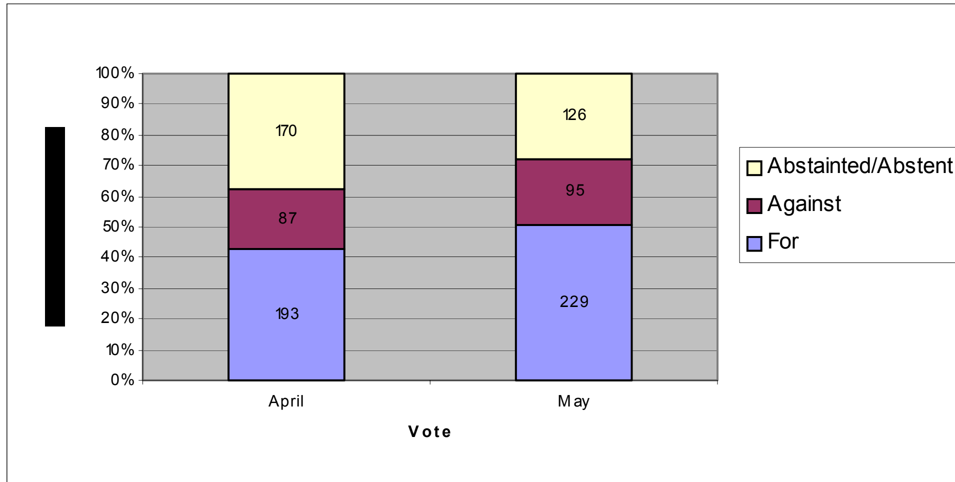
[322] Even though dissatisfaction with the draft may have been one reason behind the boycott, many argue that it was also very much political. Both Liberal Democrats and Communists were insulted that Yeltsin restructured his Cabinet without first consulting them. Second, Yeltsin would have liked to cite progress on PSA legislation during a summit with US president Bill Clinton and the leftist factions wanted to avoid any actions that could be interpreted as pro-government or as economically detrimental to regions and workers. *"Lurching Forward: Despite Encountering New Setbacks, PSA List Law is Poised to Clear Major Hurdle,"* Russian Petroleum Investor (April 1997): 18-22.

[323] *"Something for Everyone: Duma Edges Closer to a Viable Version of PSA List Law, but Foreign Investors Remain Wary,"* Russian Petroleum Investor (March 1997): 19-23.

Figure 5.3: State Duma Vote on PSA List Law



Source: Russian Petroleum Investor, June/July 1997.

The passage of the amendments to the 1995 Law on PSA has been also woefully drawn out because of similar conflicts between the government and the leftist majority in the State Duma. By this time, though, the Duma did not want to make either a positive or a negative decision on PSA issues. A vote in favor would have drawn criticisms from radicals within their ranks but voting against the PSA laws would have sparked a falling out with the regions and Russian companies.

Some progress on the PSA regime was finally achieved as a result of major concessions to the parliament. In exchange for its acceptance of some of the government proposals on PSAs, the parliament acquired significant veto powers over the PSA process. However, its increasing involvement in oil policy making created unprecedented obstacles for foreign investors. According to the Article 19 of the

Federal Law on Production Sharing Agreements, for instance, when proposing a draft federal budget law the government had to submit annually to the State Duma a report on the result of work under production sharing agreements. Moreover, the approval of the parliament was needed for each PSA field to be initially put on the list of fields to be explored. What this meant was that companies had to present to Duma some kind of feasibility studies before they could even negotiate and prepare the contracts with their partners. Not only was this approval seen as costly and risky for the investors, but it also meant that they needed to negotiate with the Duma first and then with the government. Such a legislative approval is not a very common procedure around the world. In 42 oil-producing countries that use PSAs, legislative bodies are not involved in the approval of oil contracts.[324] In Russia, on the other hand, agreements had to be approved by special laws. That meant that amendments to a commercial contract would be treated like any other federal law. The approval of the Russian parliament was also required for specific PSA deals negotiated after a field has been included in the PSA zone. As such, Russian practice dictated that amending a contract would require more than a year.[325] This veto power of the legislative branch over the creation of the PSA law and approval of each PSA has been a major obstacle for foreign investment in Russia in the last decade.

[324] PSAs are approved by the government in Algeria, or they require an authorized minister's approval as in China or the president's sanction in Indonesia. On the contrary, in Venezuela a single joint sitting of the Congress's two chambers is required to approve an agreement. The procedure is similar in Tunisia. In Denmark, rights to acreages on the continental shelf (but not the agreements themselves) are approved by the parliament's special committee. In Azerbaijan, as discussed in chapter 4, the parliament approves agreements but the country does not have a special PSA law. However, in these countries the parliamentary approval is very different than it is in Russia.

[325] Mikhail Subbotin*, "The dangers of writing too much into the law,"* Oil & Capital II (2000): 14-15.

ii. Between the Center and the Subjects of the Federation

The stalemate over the PSA regime has been further exacerbated by the challenge that the subjects of the Federation posed for the central government both in terms of making and implementation of laws. Within the legislative branch, the tendency of the Federation Council to challenge the legislative authority of the lower house has significantly contributed to the PSA legislative impasse. The members of the Federation Council on many occasions have utilized their constitutional powers to veto the PSA legislation in fear that it would limit the prerogatives of regional governments and impose on them financial obligations.

First challenge came during the adoption of the draft law on PSA in 1995. Even though Federation Council favored the concept of PSA legislation, it opposed the simplified tax plan contained in the draft.[326] This provision according to the regional and local government leaders, limited their ability to collect taxes from PSA projects on their territories.[327] Because the law undermined the lengthy tradition of unlimited state control over Russia's natural resources, it faced opposition from several factions within the Federation 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, deputies from those regions

[326] The opposition group in the Council was headed by Krasnodar's newly elected governor, Nikolai Kondratenko, who with RF Audit Office Chairman and former Council member Yuri Boldyrev was instrumental in persuading the Council to reject the PSA law in 1995.
[327] *"On the Right Track: PSA Legislation Edges Forward,"* Russian Petroleum Investor (April 1995): 18-20.

fiercely lambasted the current version of the draft law, demanding that the legislation guarantee that domestic enterprises receive as much as 70% of the orders for equipment required for use under PSAs.[328] Finally, representatives from agricultural regions had minimal interest in energy-related projects, and saw little benefit from foreign investment in such projects.[329]

Another controversy between the two chambers of the legislative branch was fueled during the discussion of the List Law. Regional representatives in the Federation Council directly accused Duma deputies of disrupting major investment projects whose implementation could markedly improve these regions economy. Certain regions engaged in 'revenge politics' and tried to kill the law because their fields were removed from the list.[330] Although not successful at the end, these regions were at least able to prolong the legislation process and hamper the PSA projects in the regions approved by the list law. After much debate, the Federation Council approved the list law at the end. Those regions that supported PSAs were able to achieve the majority in the Council to reject the ultra nationalist amendments proposed by the Duma in 1997, on the grounds that they would adversely affect the core law approved in 1995.

In addition to the representation of regional interests in the Federation Council, the Article 72 of the Russian constitution invests the regional governments

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[328] *"Change of Venue: After finally clearing the Duma, PSA legislation meets opposition in parliament's upper chamber,"* Russian Petroleum Investor (September 1995): 17.
[329] *"Stalemate: Leftists' New Clout in the Council of Federation Could Endanger Investor-Friendly Legislation,"* Russian Petroleum Investor (February 1997): 13-15.
[330] *"Glimpse of the Future: Council of the Federation Chairman Predicts the Future of Foreign Investment in Russia,"* Russian Petroleum Investor (October 1997): 12-14.

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 both with the regional governments and the Ministry of Fuel and Energy, the regional governments have been pivotal in the signing and implementation of these contracts. While some, like the Sakhalin and Tatarstan administrations, have been strong advocates of PSA contracts, others like the Nenets Autonomous Okrug, have been opposing PSAs and obstructing the attempts by foreign investors to initiate oil development projects.[331] In other regions, the regional legislative bodies passed laws on PSA that contradicted or circumvented the federal legislation without openly violating it.[332]

Moreover, the contest at the sub regional level also contributed to the difficulties facing the investors. Autonomous districts (okrugs) in some oblasts were claiming the same rights as oblasts and ethnic republics based on the 'ambiguous'

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[331] The government of Tatarstan was one of the key proponents of the 1995 Law on PSA during its turbulent passage through the federal parliament. Since adoption of this law, Tatarstan president Shaimiev has continually pushed the federal government to pass the necessary amendments and enabling legislation. In 1997, it even adopted its own Law on Oil and Gas. Similarly, in Sakhalin, three post-Soviet governors exerted a positive influence on the progress of PSAs. Not only did they support the federal government's efforts to create a PSA regime, but they also implemented one of the two PSA projects in Russia today. As a result, after Moscow, the Sakhalin island became the second largest FDI recipient in Russia. As some analysts have argued, Sakhalin became the chief laboratory for Russian PSAs. On the other hand, the governor of Nenets okrug, Vladimir Butov, in April 1997 excluded several fields of primary interest to Western investors from the list of fields that it was proposing for development under PSA terms. He claimed to oppose PSAs because they fail to specify time periods for initiation of geological exploration and production. He argued that Western companies' preference for PSA terms was a pretext to reap super profits at the expense of Russia in general and Nenets okrug in particular.

[332] An example of this was seen in Khanty-Mansiysk Autonomous District. In 1996, the district Duma passed a law on PSA that restricted the foreign oil company operations. *"More Power to Them: Khanty-Mansiysk's regional PSA Legislation Could Restrict Investor Rights,"* Russian Petroleum Investor (August 1996): 16. Another example is Tatarstan. In July 1997, Tatarstan legislature enacted its own Law on Oil and Gas.

provisions in the 1993 Constitution. An important example of this institutional feud was seen in the Tyumen oblast. The two okrugs Khanty-Mansiisk and Yamal-Nenets were locked in an increasingly fierce dispute with the Tyumen oblast for control over oil and gas projects and revenues. As a result of these disagreements, in February 1999, the Russian State Duma decided to exclude three Khanty-Mansiisk oil fields from the proposed Uvat PSA project.[333]

Finally, even though the constitution grants them no rights over underground resources, some municipal governments have also used independent taxation powers (granted to them in a presidential decree) to exact additional revenues from foreign investors. Even though investors managed at times to win exemptions from such taxation, overall municipal authorities used their control over utilities and influence with the local population to extort payments from foreign investors.

The significance of the regional dimension is heightened by the fact that Russia's energy resources are heavily concentrated in a handful of Russia's 89 provinces.[334] For instance, Tyumen alone accounts for more than two thirds of Russian oil output. This regional concentration has created a tug of war between the have and have-not regions. The regions which are not self sufficient in energy and have experienced frequent energy shortages, as in the Far East, have lobbied against some of the terms of the investment relationship with foreign companies. For

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[333] John Webb, *"Election season in West Siberia: A signpost for foreign investment,"* CERA Decision Brief (September 1999.)

[334] According to Rutland, this is partly a result of geography, and partly a result of deliberate decisions in the 1960s to focus development efforts on the West Siberian oblast of Tyumen.

instance, they opposed sale of oil abroad and the raising of energy prices and promoted domestic content requirements that can help moribund local industry. Those with substantial oil resources, on the other hand, have been more open to foreign investment. Generally speaking, they have been inclined to give foreign investors a break on domestic content requirements, tax burdens etc. However, as discussed earlier, the attitudes of the subjects of the Federation towards PSAs have not been uniform. Some opposed PSAs fearing that the local governments would have little control over them and be left out.[335] Others on principal welcomed PSAs but delayed the implementation process as a result of red tape and too much regulation.

iii. Interest Groups and Political Parties

Despite the strength of veto players in challenging the PSA legislation and implementation, the societal interest groups had little institutional means to mobilize their interests into voting as a bloc and to exert influence on state policies regarding PSAs. Different groups that could have benefited from PSA projects could not constrain the jurisdictional power struggles among state veto players. Considering the impact of PSAs on many interest groups, the lack of this societal pressure has further contributed to policy deadlock and instability. PSAs are 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

[335] Germana Canzi, *"One Step Forward, Two Steps Back,"* Project Finance 193 (May 1999): 26-27.

fields.[336] Moreover, the domestic content requirements in PSAs can in the long run serve to improve local industries and subsequently bring significant amount of welfare to the regions. Despite these benefits of PSAs, interest groups such as worker unions and certain industrial groups could not pressure the state actors to make the investment environment more attractive for foreign investors.

Moreover, political parties could not resolve the conflicts among various veto players by disciplining their members and reaching compromises among them. They could not aggregate interests into majority coalitions in the parliament. Oftentimes they voted as a block for or against PSA legislation but their positions depended more on the institutional balance of power than the interests of the constituents they represented. Business groups have contributed to political parties and parliamentary factions, but no clear pro-business party organization has emerged.[337]As a result, Russian political parties could not provide the representative and integrative functions that are expected of strong parties. Lack of such institutional constraints left ample room for state actors to get into jurisdictional struggles with one another.

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. The best example of this was the *Our Home is Russia* party, led by Chernomyrdin. This party was in fact called "Our Home

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[336] 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 oil production there. In the event that a field closes, Russian authorities face the prospect of mass unemployment and will be compelled to evacuate hundreds of residents.
[337] Rutland, 13.

is Gazprom" for it was seen as representing the interests of the energy lobby and the financial corporations associated with them.[338] When Chernomyrdin became the prime minister in December 1992, his government was often called 'the Government of the Energy Complex" implying that the industrial background and sympathy of the prime minister gave the oil and gas network unlimited opportunities for interest representation. Chernomyrdin was the founder and head of Gazprom and during his government positions he obtained important privileges for the oil industry and Gazprom in particular and promoted their interests. For instance, in terms of the PSA legislation, it is argued that his natural inclination was to go slow to protect domestic oil companies. "He would always find an excuse to leave Moscow whenever there was a discussion of the PSA legislation in the parliament."[339]

The Ministry of Fuel and Energy also articulated the interests of the oil industry. The careers of ministers like Vladimir Lopukhin, Yuri Shafranik were closely tied to oil industry, and so they often became active supporters of oil interests in the government. Russian oil companies had direct access to the government. They strongly affected the appointment of some members of the cabinet. Many government officials at the middle levels were paid by oil companies to promote company interests.[340] Finally, these oil companies made sure that those leaders that were

[338] Ibid. Overall, though, there were about 5 deputies connected directly to the oil industry.
[339] Author's interview with Glenn Waller (Petroleum Advisory Forum) Moscow, August 28, 2000.
[340] Author's interview with Alexander Misulin (Head of the Department of Foreign Economic Relations in the Ministry of Energy) Moscow, May 17, 2001.

supportive of their interests were elected as governors. This way they ensured that their interests would be represented in the Federation Council.[341]

Even though the oil lobby had some success in eliciting support for its political interests, it lacked the organizational and ideological unity to act as a strong interest group. The Russian oil companies did not have a uniform influence on policies regarding foreign investments. The most important form of lobbying has been the informal personal contacts between oil directors and government bureaucrats and deputies in the parliament. The lobbying process was highly opaque, fragmented and disorganized. Although organized groups have been created, such as the Union of Oil Industrialists and Entrepreneurs, the Union of Oil Exporters, the House of Oil etc., their influence generally has been weak and sporadic. Since the biggest 100 companies produce 40-50% of GDP but employ less than 3% of the labor force, building a broad based party of oil business interests has been fairly difficult.[342] Moreover, most other parties and parliamentary factions have been critical of the interests of the oil and gas industry. Yabloko party in the liberal wing of the Duma, for example, supported measures to increase taxes on the Russian oil and gas complex. Similarly, the support for the oil industry in the government was only

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[341] For instance, these governors included Yevgeny Krasnoyarov of Sakhalin, Yuri Komaravsky from the Nenetsk Autonomous Region, Pavel Balakshin from the Arkhangelsk region, Alexander Filipenko of Khanty Mansiyk etc.

[342] The support for this party came mostly from regional governors. Despite their lack of strong representative organizations at the national level, industrialists have been quite successful at coordinating their activities at the regional level. In most regions of Russia, the industrial party in the form of an informal network of local economic elites and their political-bureaucratic allies effectively runs local politics.

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.[343] The Ministry also had its own agenda, that of maintaining its supervisory functions. It was not always considered the conduit for the oil and gas companies. Even with Chernomyrdin, the influence went both ways. While in some cases Chernormyrdin was promoting the oil industry's interests, at other times he used pressure on the oil and gas complex to register its support for certain government policies in return.

Finally, Russian oil companies' attitudes towards PSAs were mixed. In the first years after the breakdown of the Soviet Union, many companies were wary of going into partnerships with foreign companies on an individual basis.[344] Prior to partial privatization, the position of the heads of large oil production associations- the oil generals- were very insecure, and so partnership with a foreign company bringing with it greater publicity and increased fiscal demands from central and local governments, was more of a hindrance rather than a help.[345] Overall, these companies had no tradition or mentality of partnerships- even with other domestic companies.[346]

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[343] Lane, 5.

[344] With the collapse of the Soviet ministries in 1990/91 and the shift of control from the USSR to the republics and the regions, a spontaneous process of privatization began. Enterprises and organs of local administration together began to form independent companies. The management of the companies and the leaders of the local administrations took over assets in the oil industry. They sought to maximize short-term profit and neglected investment. For more information on the Russian oil industry organization, see David Lane, ed., The Political Economy of Russian Oil, (Rowman &Littlefield Publishers: 1999.)

[345] On the part of the foreign companies, it was also difficult to do business with local companies. It was difficult to understand who controlled a particular company, what relations were between the company's component parts and between it and other enterprises. Overall this lack of transparency deterred many foreign investors.

[346] Author's interviews with Mikhail Subbotin (Advisor to the government) Moscow, April 19, 2001 and with Valeriy Ovcharenko (Conoco) Moscow, April 16, 2001. Mr. Ovcharenko further argued that

Moreover, these managers wanted to buy oil companies as cheaply as possible and so they did not want multi-billion dollar PSAs on the books, driving the prices up.[347] They had short-term concerns and priorities; planning for the long-term performance of the industry was not on their agenda. As the Russian banks gained more control of the oil industry, the short-term profit motive of the industry by sacrificing long-term investments got even stronger. With access to bank capital, domestic companies did not see any need to attract foreign investors.[348]

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 the competition for export capacity. More importantly, these companies have been more interested in empire building or exporting their capital offshore than in investing to renew their assets or restructure their operations.[349] In the beginning, then, most Russian companies were very reluctant about PSAs.[350] They were not necessarily always against it but they were not for it either. They in fact lived quite well under the existing system. They knew how to

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this lack of trust for partnerships was a legacy of the command economy in which companies were always competing for funds and equipment but not for selling their product and making a profit out of it. If the end goal was profit, these companies would have engaged in a win-win situation by forming partnerships.

[347] *"Russian Oil: Not a Gusher,"* Economist (October 14, 1995): 78,79.

[348] The experience of YUKOS and Menatep with regard to Priobskoye project was a good indicator of this trend. The Priobskoye field was supposed to be developed by the Russian oil company, YUKOS and Amoco (US). However, when Menatep bank acquired control of YUKOS, the Russian partner's negotiating stance changed dramatically. Instead of proceeding with the comprehensive development of the field and waiting eight to ten years to recoup its investment, Menatep insisted on developing the field block by block to get quicker returns.

[349] Thane Gustafson, Capitalism Russian-Style (Cambridge: Cambridge University Press, 1999), 226.

[350] Author's interview with Alexander Strugov (Director of Center for PSAs in the Ministry of Natural Resources) Moscow, April 18, 2001.

maneuver, how to influence, and whom to influence.[351] They enjoyed being the 'insiders.'

However, over time, the former corporate unity of the oil elite from the Soviet Union 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.[352] This change in the management structure, according to some, has made some companies more open to foreign investment.[353] As the operations grew and the geographic span widened, some companies became less locally based and more nationwide with their headquarters located in Moscow. These companies made significant progress in lobbying for the full-scale introduction of PSAs in 1998-2000. However their support was conditional. They were in favor of PSAs when the price of oil dropped, the costs were high, and there was no alternative financing available. At times when they could finance the projects themselves or through lending, they did not lobby for PSAs.[354] Other companies that were located in a particular region and acted as a monopoly, on the other hand, resisted the

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[351] Author's interview with Anders Morland (BP) Moscow, April 3, 2001.
[352] For more information on the configuration of the oil elite and their values and attitudes, see David Lane, *"The Russian Oil Elite: Background and Outlook"* in Lane, ed., The Political Economy of Russian Oil (1999.)
[353] For instance, the Russian company, TNK, is more open than most Russian oil companies to partnership with the West. The company's president, Simon Kukes, is a former Amoco executive with 16 years of business experience in the US. This orientation was reinforced in July 1998 when Len Blavatnik, the head of a New York based shareholder in TNK was elected to TNK's board of directors.
[354] Author's interview with Alexander Levshov (Statoil) Moscow, March 14, 2001 and Dmitri Zhdanovich (Surgutneftegaz) Moscow, April 9, 2001. According to Mr. Zhdanovich, Russian oil companies found PSAs useful only for old oil fields because developing new ones were costly and the PSAs did not give a chance to cover the costs.

liberalization of the investment environment.[355] They either pressured the regional administrations to build barriers for foreign investors or they simply stayed passive regarding the PSA process.

iv. The Bureaucracy

In some accounts, the real opponent to PSAs has been the infamous Russian bureaucracy. There has been a covert infighting to control PSAs within the government since 1993 because PSAs directly affect budgetary revenue on which all parts of the government depend.[356] The whole subject has become a 'talking shop' with proposal after proposal being drafted and then argued in talks between the ministries of fuel and energy, finance, economy, taxes, and natural resources without developing a common, constructive approach. Ministers and top civil servants have been reshuffled more than the meetings have been, which has made it difficult to consolidate any position.[357] This zigzagging of power at times brought policy deadlock and passivity within the federal government.[358]

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[355] *"Business: A dangerous bear-dance,"* Economist (August.29, 1998): 57-58.

[356] According to Andrey Krivorotov (Oil and Gas Eurasia) during his interview with the author in Moscow on April 10, 2001, this infighting among Russian bureaucracies was encouraged by Yeltsin on purpose. In order for them not to fight him, he provoked them to fight one another.

[357] *"Putin tells ministers to end PSA impasse,"* Oil & Capital V (2000): 8-9. Part of this reason was certainly the legal vacuum that provided no clear guidelines as to how government agencies should act.

[358] Author's interview with Anatoly Averkin (PriceWaterHouseCoopers/Advisor to Duma) Moscow, April 13, 2001.

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 Customs Committee, for instance, viewed PSAs as receipts of income flowing into the federal budget and imposed heavy tax burdens without taking into consideration the long-term effects of these taxes for foreign investment. They also feared the fixed terms of the PSAs, which would potentially reduce their control of oil revenues.[359] Struggling to maintain their control over the licensing process, geological associations, represented by the State Committee on Underground Resources, Roskomnedra, were equally against the PSA contracts, which proposed the bypassing of the licensing system entirely.[360] On the other hand, those parts of the government that were responsible for long-term economic development – the Ministry of Fuel and Energy, the Committee for Foreign Investments and the Ministry of Economics- tended to be against heavy taxation and thus for PSAs.[361] Even though there were ideological differences in terms of priorities among different bureaucracies, the competition among them to have as much power and money through oil deals is an important explanation of why enactment and implementation of PSA 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

[359] *"Everything's Negotiable: Finance Ministry's Opposition Could Slow Approval of PSA Tax Changes,"* Russian Petroleum Investor (May 1996): 30.
[360] *"Trench Warfare: PSAs could jeopardize Roskomnedra's control over subsoil use,"* Russian Petroleum Investor (February 1995): 20-21.
[361] Watson, 449.

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.[362]

The pluralism within the executive branch and a lack of coordination among federal agencies have been very destructive for the implementation of investment projects. For instance, the Sakhalin II project, which was one of the three grand fathered PSAs that was able to start oil extraction, faced many bureaucratic hurdles, at times subverting and delaying its operations. Companies had to obtain more than 600 approvals from different agencies only to start the first phase of their Sakhalin project. They estimated that the number of approvals would be 3000 for the second phase.[363] Moreover, federal customs officials in Sakhalin were ignoring both the Federal Law on PSA and Prime Minister's direct orders to stop collecting value-added and import taxes on equipment and material imported by Sakhalin projects. By refusing to carry out Russia's obligations, as defined in the Sakhalin PSAs, the State Customs Committee was trying to meet its short-term fiscal quotas. This willfulness of bureaucrats who were accustomed to making decisions on matters concerning their departments based less on laws than on personal whim was a significant hindrance to foreign investors.[364]

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[362] ibid., 440.
[363] Author's interview with Ivan Chernyakhovskiy (Sakhalin Energy) Moscow, April 9, 2001.
[364] *"Caught in the Crossfire: Conflicting Agendas Threaten to Stall Russia's Only Active PSAs,"* Russian Petroleum Investor (February 1997): 46-49.

v. Crises and Personalities

Even though the institutional structure was the same, interests within and outside of the state changed course over time due to several reasons. First of all the August 1998 economic crisis[365] and resulting evaporation of much Western investment in Russia have clearly forced Russian politicians and businessmen to rethink their traditional opposition to PSAs in the interest of attracting new sources of Western funding for energy projects. The withdrawal of several Western oil companies raised the alarm that despite the talk, there has been little investment into the oil sector. Low oil prices highlighted the danger of a sectoral collapse in the absence of significant levels of new capital investment. Multinational oil companies, under PSAs were recognized as one of the few reasonable sources of financing in the near term for the oil industry. This change in interests was a crucial factor in the limited progress that there was regarding the PSA regime in 1999. Criticism of PSAs from communist and nationalist deputies became less vocal than before. Similarly, the regional governments that were imposing harsh conditions on PSA projects became more accommodating to foreign investors' interests and increasingly supported the PSA regime. Finally, the Russian oil companies' initial benefits from the ruble devaluation were offset by the decline in the domestic price of crude, from

[365] The August crisis had two distinctive phases. The first phase was triggered by international developments related to the Asian financial meltdown-the fall in world crude prices and the 'flight to quality' of Western investment capital. The second phase began on August 17 with the Russian government's de facto devaluation of the ruble and default on its short term debt, and the accompanying collapse of Russia's commercial banking system and key elements of its trade networks.

$67 per ton to $24 per ton in September.[366] The companies also faced reduced availability of foreign credits owing to a general collapse of investor confidence in Russia. Thus, they started seeing PSAs as something to be supportive of since it was the only way to develop their fields. Some analysts argue that if Russian oil companies had not thrown their full weight behind it, the PSA legislation would not have made much progress during legislative discussions in 1999. While initially PSAs were the exclusive goal of foreign investors in Russian oil, especially after the 1998 economic crisis and drop in oil prices, they have also become the goal of Russian companies. Indeed, many of the fields that the State Duma has made available for development under PSA terms were exclusively licensed to Russian companies. PSAs secured these companies' operations against unfavorable low oil prices. Russian companies such as TNK, Lukoil, Surgutneftegaz, Tatneft and Yukos became the biggest beneficiaries and supporters of PSA legislation.[367] Overall, then the harsh realities of the financial crisis of 1998 motivated all groups involved to improve the legal environment for western oil company participation. This helped to eliminate many of the earlier problems associated with the creation of a PSA regime.

Personalities also played an important role, no doubt. Significant progress on PSA legislation was not made until Prime Minister Primakov worked directly with the Duma to get the legislation passed. As the former head of foreign intelligence service and as somebody deeply respected by the communists, he was a moderating

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[366] Vadim Eskin and John Webb, *"Russian Oil Companies in the New Time of Troubles,"* CERA Private Report (January 1999): 11.
[367] *"Oil Sector Report,"* Troika Dialog (May 2001): 94.

force. In November 1998, Primakov sent new drafts of enabling legislation and amendments to the 1995 PSA law to the Duma, along with his personal instructions.[368] Moreover, he settled a critical dispute between the Ministry of Fuel and Energy and the Ministry of Natural Resources, which ensured that PSA will take precedence over both the Subsoil Law and Ministry of Natural Resources' licensing power for exploration and production. He earned the trust of investors by staking his reputation on PSA passage.[369] His commitment to continued foreign investment was certainly an important factor that pushed this process further. Conversely, reluctance of Chernomyrdin[370] and inexperience of the Minister of Energy, Gavrin, both contributed to the delay in the PSA process.[371] Some even argue that the fact that Yeltsin was never a 'true champion' of PSA, as Aliev was in Azerbaijan for instance, was also influential in the outcome.[372]

While these contingent factors, such as crises and personalities, are important, they cannot by themselves explain the change in the opposition to the PSA regime in Russia. Essentially, the institutional structure and power relations within the state

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[368] Pat Davis Szymczak, *"Oil Slump Eclipses PSA Triumph,"* AMCham Newsletter (March-April 1999.)

[369] *White Paper: Energy Sector Investment in the Russian Federation*, prepared by the Energy Committee of the American Chamber of Commerce in Russia and the Petroleum Advisory Forum (September 1999.)

[370] It is argued, for instance, that on July 20 and 21 1995, precisely when the Federation Council was to decide the fate of the Law on PSA, Chernormyrdin chose to hold a colloquy in Tyumen that included the administration heads of Siberian regions, the leadership of local oil companies, and pivotal pro-PSA legislators. Thus many of the lawmakers supporting the PSA law were forced to miss the reading in the Federation Council. Taking advantage of the absence of many of the bill's supporters, opponents were able to reject the bill.

[371] Valery Ovcharenko, interview with author.

[372] Ibid.

determine the constraints faced by supporters and opponents of PSA and the mechanisms at their disposal to overcome conflicts of interests. Interests certainly change over time due to crises or to initiatives of certain individuals, but they do so within an institutional setting that affects the outcome of these changes. In this chapter, I outlined this distribution of institutional power in Russia's hybrid political regime to demonstrate the difficulties that foreign investors encountered in the oil sector over the last decade.

VI. Political Effects of Foreign Capital

Russia today is at a crossroads. Its significant oil resources cannot be developed by domestic oil companies alone. It is true that when oil prices go high, Russian companies have healthier cash flows that can also be used for investment. Considering the frequent changes in oil prices, however, counting on the cash flows of domestic companies is not very realistic. Moreover, 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 Soviet fields without much foreign involvement. However, Russia's next generation of oil deposits are generally located offshore or in hard-to-reach remote areas without preexisting infrastructure. Most of these deposits require large investments, typically several billion dollars and so it would be difficult for any company to finance these projects on its own. It might be possible to get that sort of money from large international financial institutions but

their attitude towards Russia is similar to that of international oil companies. Cooperation with major foreign companies not only brings access to international technology, management experience, but also access to international markets. Finally, Russian state cannot afford to wait until the domestic companies accrue the money needed to undertake the investments themselves. Some investments in particular those in well rehabilitation need to be undertaken immediately. Decline of oil output from fields in which investments have not been made may create energy shortages that would have disastrous effects on the economy. Therefore, as the competition for international investment capital gets severe, Russia cannot afford to watch this opportunity go by.

As foreign investors have repeatedly emphasized, in order to benefit from foreign capital flows, Russia needs to make its investment environment more stable and attractive. As this dissertation demonstrates, stability in investment environment can more easily be achieved in either authoritarian regimes or consolidated democracies than in hybrid regimes. Consequently, Russia is faced with two options. It can either become more authoritarian by excluding opposition groups from the decision making process or more democratic by mediating among them and co-opting them into acceptable policy outcomes. Unfortunately, the latest developments in Russia since Putin came to power make the former trajectory more likely. Having realized the immediate importance of a PSA regime, Putin has been taking authoritarian measures to deprive certain groups of their rights to oppose and challenge the PSA process.

When Putin came to power, he pledged personal control of the PSA process and that Russian PSA legislation would be brought in line with world standards by the end of that year. In his address to the PSA-2000 Conference in Sakhalin, Putin maintained that PSAs were Russia's strategic priority and delaying them would be against the country's interests. Warning against turning PSAs into a "political football", he envisioned several institutional changes. First of all, he asserted that instead of a cumbersome bureaucracy, the Ministry of Economic Development and Trade would take charge of PSAs.[373] Under this ministry, a new State Investment Agency that would act as a consulting and support center was created. Second, Putin suggested that the state oil company, Rosneft, would realize the income from the state's share of production. Rosneft's getting the right to sign agreements on state's behalf would be similar to the role played by Norway's Statoil or Azerbaijan's SOCAR.[374] Hence this new approach to PSAs is based on strengthening the state's regulation and control functions so that PSAs yield results without any further delays. This administrative reform to provide a single window approach under which an investor deals with one government authorized agency on all issues promises to be one of the solutions to the investment conundrum in Russia.

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[373] Natalya Olenich, *"Gref's Share: His ministry will be in charge of PSAs,"* Vremya Novostei (February 7, 2001). Even though the government made its preliminary decision in August, the Ministry had to wait for an approval for nearly six months. Some even argue that the statute would have failed to be signed were it not for a direct order from the president.

[374] Creation of a state oil company responsible from PSA projects is seen as an important strategy to overcome the bureaucratic barriers that investors have been facing. This procedure would save the investor a lot of time and trouble in terms of reducing the number of gatekeepers. However, Rosneft's proposed role in PSAs is opposed by other domestic companies that fear the privileges that might be given to Rosneft.

As well as streamlining the government bureaucracy, Putin has also challenged 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. According to some, this would not be difficult given the new balance of power between the executive and the State Duma. In the new Duma, communists do not enjoy the deciding vote anymore. Four pro-Kremlin factions, Unity, Fatherland-All Russia and Russia's Regions and People's Deputy-two small centrist factions- have more than the 226 needed for a majority in the 450-member Duma.[375] As a result, the polarization between the executive and legislative branches have seemed to wane, making it easier for Kremlin to forge alliances between left and right and push for reforms. It seems that the Law on PSAs has ceased to be a focal point of political battles on the parliament floor. There seems to be a new pragmatism in the legislature.[376]As Alexander Kursky, advisor to the Duma, argues, "bills drafted by the government, including lists of PSA-eligible projects, encounter next to no resistance in the Duma and quickly pass the parliamentary hurdles."[377] Furthermore, the new law on political parties by setting strict requirements on party formation and state financing of parties, is another attempt by Putin to curtail political competition and assert extensive state control over opposition in the parliament.[378]

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[375] *"Four Duma Factions Forge Pro-Putin Union,"* The Moscow Times (March 26,2001.)
[376] Mescherin, 10.
[377] Alexander Kursky, interview with author.
[378] M. Steven Fish, *"Putin's Path,"* Journal of Democracy, 12:4 (October 2001): 71-78.

In addition to changing the relations between the executive and legislative branches, Putin is also consolidating more power in the state by excluding regions from policymaking. In May 2000, he announced a sweeping reorganization that replaced the presidential representatives in most of Russia's regions with seven presidential representatives in seven new administrative districts that are outside the governors' sphere of authority. This decree was also designed to ensure greater presidential control over the thousands of other federal employees who are scattered across Russia and who have been subject to control by regional authorities. The decree removed all such federal employees from the direct jurisdiction of the governors.[379] In an even more direct challenge to the governors' authority, Putin also introduced legislation that would remove governors from the Federation Council and empower him to dismiss governors and disband regional legislatures on legal grounds.[380] Finally, Putin's tax reform aimed to centralize collection and distribution of tax revenues left to governors. The 2001 tax law takes about 60% for the federal budget as opposed to the previous 52%.[381] As such, Putin succeeded in significantly rolling back powers seized by the regions during the 1990s. The creation of a new layer of lawmakers-not elected, but appointed- is likely to lead to unrepresentative

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[379] John Webb, *"Russia's Governors Could Make or Break Industry Reform,"* CERA Decision Brief (July 2000): 3.
[380] Ibid.,1.
[381] *"Federation Council Passes Tax Overhaul,"* The Moscow Times (July 27, 2000.)

legislative action.[382] As most analysts agree, this move is a clear breach of the principle of the division of executive and legislative powers.[383]

Putin has further centralized his authority by building a police state. He has been using primarily the police organs of the Federal Security Service- the main KGB successor agency, known as the FSB- and the army to seize all key power positions, eliminate dissent and attack both internal and external 'enemies.' New laws and decrees have given the FSB control over electronic and email transmissions in Russia and reinvigorated the FSB's agent network in society and its ability to recruit informers in the army. The FSB conducted raids on businesses and media outlets deemed critical of Putin and his regime. [384] This "law of dictatorship" instead of the dictatorship of the law that Putin has promised when he came to power, seems to be moving Russia away from democracy.

Finally, under Putin, the traditional oligarchs are finding it harder to obtain favors from the government for their companies. In the summer of 2000, Putin met with them to announce that the government would not favor any company over the others and that it would distance itself from these vested interests and aim to provide equal conditions for business, domestic or foreign.[385] As much as this sounds like a

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[382] Yulia Latynina, *"New Investments in Federation Council,"* The Moscow Times (August 2, 2000.)
[383] Vladimir Zharikhin, (head of electoral technologies at the Moscow Foundation of Presidential Programs think tank) *"Putin's plan is formula for good and evil,"* The Russia Journal (May 29-June 4, 2000.)
[384] Stephen Blank and Theodore Karasik, *"Policing Privatization-or Police State?"* The Moscow Times (July 26,2000.)
[385] *"The End of the Beginning: After Sacking his Energy Minister, Putin Signals Start of Real Work on Production Sharing,"* Russian Petroleum Investor (March 2001): 5-8.

move towards the rule of law, many commentators in fact have asserted that the oligarchic structure would be allowed to continue in Russia. Replacing one set of oligarchs with another that is loyal to this administration provides more evidence for Putin's attempts in concentrating more power in the state.

As Putin centralizes political power in Russia, foreign investors are beginning to utilize the opportunity offered by this country's huge natural resource potential. Anglo-Dutch Shell and Germany's Wintershall almost simultaneously announced spectacular increases of their involvement in Russian oil projects, off Sakhalin and in the Barents Sea.[386] Other companies are speeding up their projects and getting ready to invest more.[387] The recent 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 for them.[388] A strong and stable centralized power is acclaimed by foreign companies as the most important condition under which they can invest in Russia.[389]

Even though Putin's consolidation of state power seems to be working, it will take a long time before a long-term stable investment climate is guaranteed for investors. Putin's authoritarian style may not be enough to overhaul the Russian system over night. After all, in contemporary Russia Putin cannot institute a sultanistic regime like Azerbaijan. Despite the changing balance of power between

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[386] *"The Put-In Effect: Major Foreign Investors Signal Confidence in Putin's Policies, Hike Investments,"* Russian Petroleum Investor (August 2000): 9-12.
[387] Author's interview with Yuri Mikhailovih Ten (Duma Deputy) Moscow, May 23, 2001.
[388] *"BP Completes Big Oil Deal with Russians,"* The New York Times (Feb. 12, 2003.)
[389] Author's interview with Peter Henshaw (BP), Moscow, April 11, 2001.

the legislature and executive branches and the depoliticization of the PSA issue to a certain extent, it seems very unlikely that Duma is going to give up its control over the oil policy altogether. The latest Duma proposals that tinker with the favorable provisions of the PSA law are evidence to this 'foot dragging.'[390] It is plausible to say that the parliament is still committed to maintaining Russia's Byzantine PSA system, which is a chief pillar of parliament's influence over Russian economic life.[391]

The same is true also for the bureaucracy. There is still hidden opposition that is reflected in the delays concerning PSA issues.[392] For example, even though the government made its preliminary decision to transfer the PSA responsibility to the Ministry of Trade and Economic Development in August 2000, the Ministry had to wait for an approval for nearly six months. And there are still many normative acts that need to be passed in order to ensure the compliance of government bureaucracies to the PSA legislation. Therefore, despite some positive signs, it looks like it will take a long time before investors can fully commit themselves to Russia.

VII. Conclusion

For twelve years since it first emerged as an idea in 1991, PSA legislation has become an indicator of Russia's investment climate, an acid test as to whether the investment crisis has been overcome, how radical the reforms in the economy are and

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[390] These proposals were discussed earlier on page 182-183.
[391] John Webb, *"Russia's Novice Legislators Turn to Energy Bills: What's in Store for Investors?"* CERA Decision Brief (March 2000): 6.
[392] Vitaly Ovcharenko, interview with auithor.

whether there is hope for permanent economic growth. It has been one of the most contentious pieces of legislation to pass through the Russian parliament since the collapse of the Soviet Union. Investment conditions in Russia have made PSA legislation and regulations a necessary precondition for the huge amounts of FDI that have been identified and in some cases contingently committed. The law was meant to unleash billions of dollars of investment in oil projects and help Russia reverse a dramatic decrease in production. However, despite genuine attempts by certain groups in the state and society and regular insistence of foreign investors, the PSA regime has not yet taken effect in Russia.

In this chapter, I argued and demonstrated that this failure to create a stable investment environment for foreign investors was a result of the limited institutionalized competition that Russia's hybrid political regime produced. While within the state, different regions, and two houses of the parliament had institutional veto powers to challenge oil policies, weak institutionalization of political parties, interest groups, and bureaucracy made it impossible to keep the conflicts among veto players in check, and resolve them through compromises. As a result of weak mediating institutions, proponents and opponents of PSAs engaged in jurisdictional struggles to gain as much political control and economic benefits as they could from oil development projects. This unchecked fragmentation of state power often produced deadlock in legislation as well as confusion and ambiguity over the implementation of PSAs.

The study of the investment environment in the Russian oil industry illustrates the difficulties facing hybrid political regimes in a globalized economy. The PSA story demonstrates the fragmented and divided configuration of political and economic elites who have contributed to the development of chaotic capitalism in Russia.[393] In the twenty-first century, new challenges are facing Russian elites as they try to integrate their economy into global networks of capital and production. Whether or not they will be able to create an environment in which capitalism can flourish will essentially depend on the political choices that they will make. The eventual trajectory that Russia will take remains to be seen.

[393] Lane, 9.

CHAPTER 6

CONCLUSION: TWO FACES OF GLOBALIZATION

Even though some question its novelty and extent, globalization- defined as the enormous acceleration of transactions among national economies in the past two or three decades- poses major challenges to nation states. In order to benefit from international flows of capital, states need to make certain adjustments in their investment regimes. Not every state with attractive economic endowments, such as significant natural resources, cheap labor, large domestic markets or supporting industries, can successfully attract foreign capital. While these factors are important, foreign investors also look for various legal, fiscal and administrative guarantees that can secure their property and contract rights throughout the life of their projects. Considering the fierce competition for foreign investment around the world, the host governments that need outside financing and expertise cannot overlook these demands from international investors. In order to provide stability, predictability and consistency in their investment environments, governments need to overcome domestic opposition to the terms offered for investors by either excluding or winning over the consent or acquiescence of non-beneficiaries. As such, domestic politics plays an important role in providing the conditions under which foreign capital is attracted.

In this dissertation, I focus on foreign direct investment in the oil sector of three major oil-producing countries, Norway, Azerbaijan, and Russia. Given the capital-intensive nature of exploration and development, and the long lead times in commencing production, generating income and recovering costs, the stability of the investment environment has always been of vital importance to multinational oil corporations. Host governments can provide for that stability by formulating laws that clearly set the investment terms regarding taxation, production ceilings, license requirements, operational safety regulations and dispute resolution mechanisms. Governments are also expected to create a regulatory and administrative framework in which investment laws are implemented and safeguarded by executive bodies and investors have clear channels of interest representation. An attractive investment regime does not only consist of investment promotion policies, such as tax cuts, ease of entry and exit, and deregulation. As the Norwegian case illustrates, high taxes and strict licensing terms do not necessarily drive investors away. A clear, enforceable framework protecting property and contract rights provides the stability that is attractive for foreign investors.

This dissertation explores the causes behind the variation in levels of foreign investment and the political effects of foreign capital in these three countries. I make two main arguments. First, regime type plays an important role in determining the extent to which foreign investment can be attracted and the form that investment takes. The Azerbaijan and Norwegian cases demonstrate that globalization favors two polar opposites: authoritarian regimes and established democracies. Through co-

optation or exclusion of opposition groups, both of these regimes are able to create policy environments that significantly reduce investment risks for foreign investors.

The observation that both of these regimes can successfully attract foreign investment brings to attention the analytical importance of thinking about regimes along a continuum rather than as dichotomous variables. Stuck between the two, hybrid regimes that have both authoritarian and democratic elements are fast becoming the norm rather than the exception in many third wave democracies. As the Russian case demonstrates hybrid regimes face many difficulties in attracting foreign investments. Limited institutionalized competition leads to arbitrary and unpredictable policy changes that threaten the profitability and security of investment projects. In hybrid regimes, like Russia, high degrees of political risk keep investment levels down. The property and contract rights that a democracy provides cannot be secure if the democracy itself is not.[394] This dissertation contributes to a burgeoning literature on hybrid regimes by showing how such regimes respond to globalization.

An initial analysis of the statistics offered by United Nations World Investment Report support my argument based on these three case studies. The top host economies that have the highest FDI Performance consist mostly of either established democracies or authoritarian regimes (see Figure 6.1). Even though further research needs to be done to clearly confirm and generalize the relationship between regime type and foreign investment performance, the three cases analyzed in this dissertation provide valuable insights into the causal dynamics of this

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[394] Mancur Olson, Power and Prosperity (Basic Books, 2000), 41.

relationship. Although there are many other factors shaping investment decisions, political factors figure more prominently in these decisions than it is generally given credit for.

In this dissertation I also call attention to the other ‘face of globalization’: the political effects of foreign capital. I argue that the flow of foreign capital as well as the need to attract it has significant effects on regime type. First, I challenge the Anglo-American ideological prescriptions, aptly labeled the “Washington Consensus,” which assume a direct relation between increased economic openness and democratic transition. According to this line of thinking, the neoliberal policies that increase trade and free mobility of capital bring economic prosperity to countries, and consequently sow the seeds of democracy. The Clintonesque policy of encouraging developing countries to join in global networks of trade and capital had at its base this assumption that globalization would not only bring a convergence in macroeconomic policies, but also a convergence toward democratic political systems.

The appearance of the former Soviet republics as new states with the collapse of the Soviet Union provided a venue for testing this neoliberal view of globalization’s political affects. Many in the West initially believed that opening up these formerly planned economies to global market forces would undermine authoritarian regimes and speed democratic transitions. This would not only be the triumph of capitalism over communism, but also democracy over totalitarianism. Almost a decade later, however, the picture is not so encouraging for advocates of the neoliberal paradigm. As the Azerbaijani case clearly demonstrates, those former

Soviet republics that successfully attracted significant amounts of global capital, instead of becoming more democratic, legitimized their authoritarian regimes and strengthened their hold on power. The partnership between global capital and autocratic rulers in countries like Azerbaijan disconfirms neoliberal arguments about the positive political effects of foreign capital.

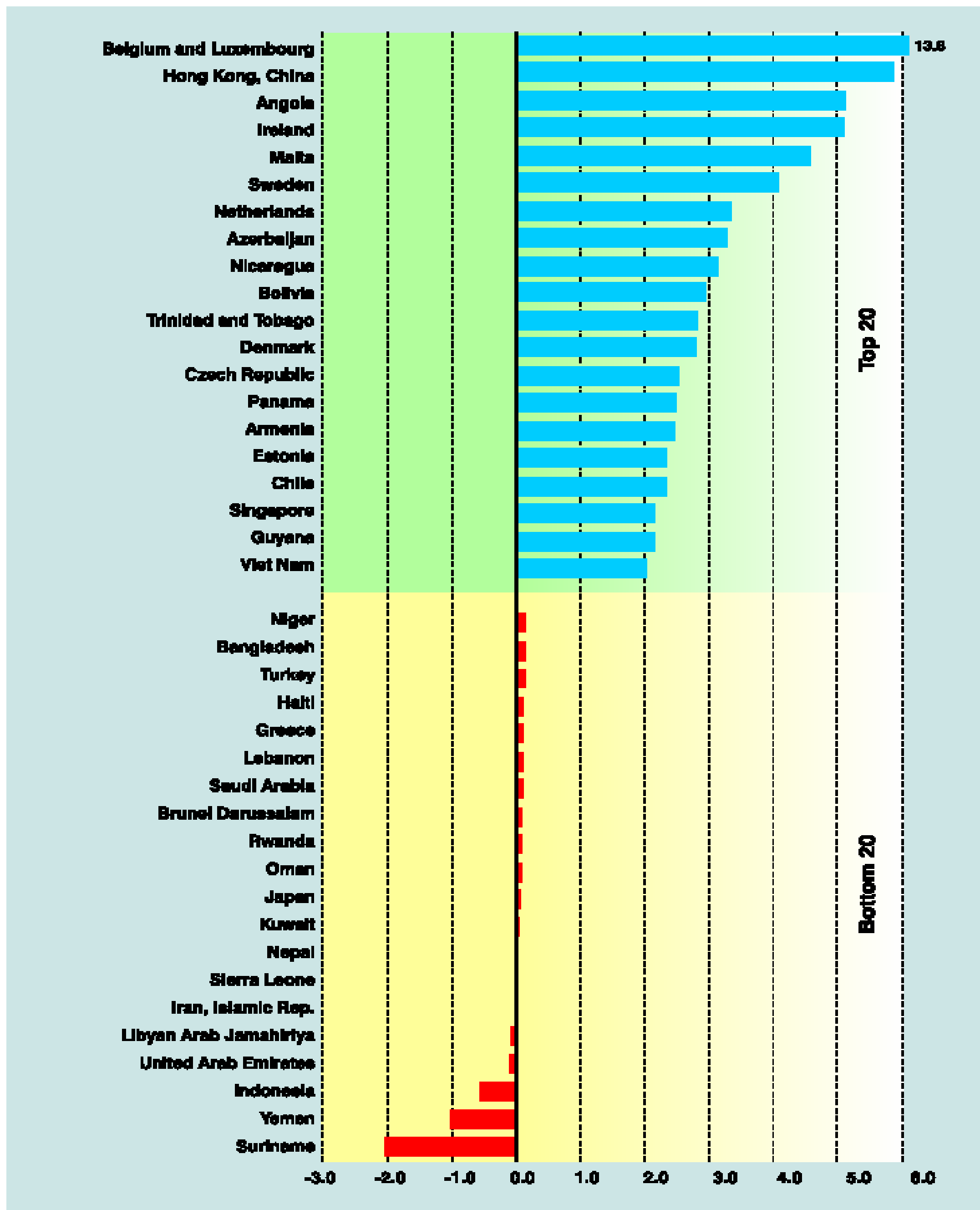
In this dissertation, I also challenge the dependency theories, more specifically the rentier state literature, that emphasizes the anti-democratic elements of foreign capital. The Norwegian case clearly demonstrates that economic success brought on by the inflow of foreign capital, increases the legitimacy of decision-makers and strengthens the foundations of a democratic state. Foreign capital in Norway has had a positive effect on further consolidation of the welfare democracy. Therefore, I emphasize that political regimes not only help determine whether there will be foreign investment in the first place, but they also mediate the effects of foreign capital once it is invested. In both authoritarian regimes and consolidated democracies, foreign investment has a 'reinforcing effect' on the political regime. The success of attracting significant amounts of foreign capital into the economy strengthens and consolidates the existing regime regardless of its nature. Foreign capital provides not only additional resources to state coffers, but it also gives legitimacy to the ruling elite.

Finally, I argue that foreign capital has 'polarizing effects' on hybrid regimes. In the face of globalizing pressures, i.e. the need to attract foreign investment, hybrid regime is inherently non-viable over the medium term. It must transit to either the

authoritarian and democratic type. However, the troubling aspect of globalization is that the urgency to attract foreign investment may leave the ruling elites with no options. Not being able to introduce the necessary institutional measures to create stability means less competitiveness in a world where international investment resources are scarce and states in need of investment are plenty. Especially when faced with serious economic crises, decision-makers in hybrid regimes are left with little flexibility and oftentimes are inclined to use exclusionary tactics to overcome opposition rather than include different interests in the decision-making process and engage in institution building. A move towards a more authoritarian regime may be the inevitable accompaniment to economic reforms. Those who are in power may rationalize their authoritarian measures as temporary solutions to overcome economic problems. They might use the rhetoric that authoritarianism is a necessary step to achieve economic development and democracy in the long run.

Recent evidence from Russia under Putin's presidency shows that this is exactly what is happening in Russia today. Putin is consolidating more power in the state and increasingly depriving certain groups their rights to oppose and challenge his policies. Putin's authoritarian moves mean more stability for investors who regard stability as the key requirement for long-term investments. The recent 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 for them.

Figure 6.1: Inward FDI Performance Index by Host Economy:
The Top 20 and the Bottom 20 (1998-2000)



Source: UNCTAD World Investment Report 2002

Even though the recent hike in oil prices and increase in oil production are benefiting domestic Russian oil companies and giving the impression that PSAs are not an urgent issue in Russia, Putin's personal endorsement of the PSA regime demonstrates the undisputable need for foreign investment in order to develop the new and technologically challenging oil fields.[395] The bulk of current production comes from fields in the middle to late stages of their production lives and domestic oil companies are able to exploit these old Soviet fields without much foreign involvement. However, Russia's next generation of oil deposits require substantial foreign investment to develop, as such deposits are generally located offshore or in hard-to-reach remote areas without preexisting infrastructure. Having realized the significance of PSAs for the future of oil production in Russia, Putin is taking authoritarian measures to exclude opposition groups from the PSA process. Even though by all means, there are many other factors shaping the trend towards authoritarianism in Russia, this paper draws attention to the pressures coming from foreign investors and the institutional measures the state needs to take in order to create a stable investment environment in the oil industry[396]. Given the strategic importance of oil for the Russian economy and politics, it is not surprising to see this association between oil investments and the political regime.

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[395] 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.

[396] For further discussion of the increasing authoritarian tendencies in Putin's Russia, see Journal of Democracy 12:4 (October 2001).

While this dissertation underscores troubling aspects of globalization, it still leaves room for optimism. As the experiences of these three countries demonstrate, there are apparent trade-offs for each regime type. 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 are confidently expected to last across generations are the securely democratic societies."[397] Therefore, even though globalization constrains policy options of elites in hybrid regimes, the response to global forces still depends on political decisions that take into consideration these trade-offs and the priorities of those who rule and in some cases even those who are ruled.

To conclude, the goal of this dissertation is not to engage in a normative debate over the benefits of authoritarian and democratic regimes. Simply put, this dissertation attempts to demonstrate the trends underlying investment decisions in the oil industry and to explore the causal relationship between regime type and the ability to create a stable investment environment. Future research on a larger selection of cases can further shed light on this relationship that this dissertation has introduced.

[397] Olson, 42.

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VITA

Okşan Bayülgen was born in Istanbul, Turkey on October 11, 1973, the daughter of Doğudan Bayülgen and Űmit Bayülgen. After completing her work at Űsküdar American High School, Istanbul, Turkey, in 1992, she entered the Department of Political Science and International Relations at Boğaziçi University, Istanbul. She received the degree of Bachelor of Science from this university in May 1996. In August 1996 she entered the Graduate School of the University of Texas at Austin.

Permanent Address: 251 West Center St., Manchester, CT 06040

This dissertation was typed by the author