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POLITICAL RISKS IN THE INTERNATIONAL OIL INDUSTRY

by
Howard L. Lax

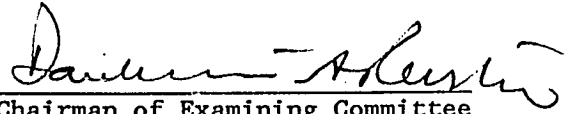
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Abstract

STATES AND COMPANIES:

POLITICAL RISKS IN THE INTERNATIONAL OIL INDUSTRY

by

Howard L. Lax

Advisor: Professor Dankwart A. Rustow

The study of political risk is a direct response to specific problems confronting transnational corporations (TNCs). As such, most works focus on developing predictive methodologies to forecast the incidence of political risk events and pay scant attention to the underlying cause or theory.

This dissertation attempts to begin laying the theoretical groundwork for understanding political risks by relating the analysis of political risk to a broader theory of interaction between host states and TNCs. Using the international oil industry as the content area, a conceptual model for the explanation of political risks is developed.

The premise of this dissertation is that the structure of the host/TNC relationship gives rise to an inherent conflict of interests and issue hierarchies between the two actors. These structurally determined differences are the root cause of political risks.

This conflict is mediated primarily by the bargaining and market relationship between state and firm. The bargaining relationship defines the range of opportunities available to the actors in dealing with each other and their ability to exploit those opportunities. The

bargaining relationship is seen as initially favoring the TNC and steadily shifting in favor of the host state.

Two other mediating variables are domestic demands and supports and the style and ideology of leadership. These define the necessity and willingness of the state to impose changes on its investment relationship with TNCs.

The articulation and implementation of host state interests in policies constitute specific political risk events. Political risk events confronting transnational oil companies (TNOCs) are embodied in host state changes in their oil policies. Policy changes, the immediate cause of political risk events, are explained in terms of the structural relationship and conflicting interests, with the timing and strategy of changes a function of the mediating variables.

Despite the inherent conflict of interests, the mediating variables constrain the actors and necessitate that they interact on a practical level in terms of a mixture of conflict, cooperation and collaboration. The long-term conflict of interests, however, is no less intense.

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I. INTRODUCTION

Risk taking is a basic economic function undertaken by businesses. Traditionally viewed only in economic terms, however, there is a growing sense of awareness that transnational corporations (TNCs) are confronted with political risks, that is, the probability that a project or contract will be affected by changes in the political environment. The TNC is not concerned with political changes per se, but with the impact such changes might have on operations. As political events can determine the success or failure of an investment abroad, TNCs must make every effort to analyze political risks as part of the decision making and ongoing management process.

To date, virtually all works in the emerging field of political risk analysis have focused on addressing a specific business problem in a specific context. As such, most of the energy has been expended on the development of predictive methodologies to forecast political risk events. Little attention has been paid to the development of any basic theory for the understanding and analysis of political risks.

The purpose of this dissertation is to begin laying the theoretical groundwork for understanding political risk by relating the analysis of political risk to a broader theory of interaction between host states and TNCs. Only after such an understanding is developed can there be a logical progression in the development of predictive methodologies. Using the international oil industry as the content area, a conceptual model for the analysis of political risks is developed. The hypotheses and model are presented in detail in the concluding section of the Introduction.

The premise of this dissertation is that the structure of the host/TNC relationship gives rise to an inherent conflict of interests and issue hierarchies between the two actors. These structurally determined differences are the root cause of political risks.

This conflict is mediated primarily by the bargaining and market relationship between state and firm. The bargaining relationship defines the range of opportunities available to the actors in dealing with each other and their ability to exploit these opportunities. The bargaining relationship is seen as initially favoring the TNC and steadily shifting in favor of the host state.

Two other mediating variables are domestic demands and supports and the style and ideology of leadership. These define the necessity and willingness of the state to impose changes on its investment relationship with TNCs.

The articulation and implementation of host state interests in policies constitute specific political risk events. Political risk events confronting transnational oil companies (TNOCs) are embodied in host state changes in their oil policies. Policy changes, the immediate cause of political risk events, are explained in terms of the structural relationship and conflicting interests, with the timing and strategy of changes a function of the mediating variables.

Despite the inherent conflict of interests, the mediating variables constrain the actors and necessitate that they interact on a practical level in terms of a mixture of conflict, cooperation and collaboration. The long-term conflict of interests, however, is no less intense.

Political and economic conditions necessitate that the TNC and host state government participate in a variable-sum game relationship in which their successes and failures are intertwined. Despite any wishes to the contrary, neither player can attain its goals without at least the reluctant, perhaps even forced, cooperation of the other.

The opening section of the Introduction reviews the premises and conclusions of the traditional approach to international economics and politics and how the fields increasingly are recognized as integrated. This integration, in turn, has theoretical ramifications for how states and other actors relate to each other. In no area of international affairs is the relationship between politics and economics more significant than in the international oil industry.

I.1 Politics, Economics, Transnational Corporations, and Foreign Investment

The evolution of the dominant Western intellectual tradition in the social sciences, liberalism, over the past two centuries has been predicated to a large degree upon the separation of politics and economics. From the eighteenth-century tenets of Adam Smith's laissez-faire capitalism, to John Stuart Mill's nineteenth-century principles of classical liberalism, to the post-World War Two faith in the ideal of a liberal international economic order, politics and economics have been treated as vaguely related but discrete realms of societal activity. By positing "a natural economic order with laws of its own, independent of politics and functioning to the greatest profit of all concerned when political authority interfered least in its automatic operation," Smith and his intellectual progeny drove a lasting theoretical wedge between politics and economics.¹

This theoretical distinction held prescriptive value as well: political considerations should not be permitted to interfere with the "natural" processes of the market. "Laissez-faire...should be the general rule: every departure from it, unless required by some great good, a certain evil."² Internationally, economic nationalism was held accountable for the world-wide depression of the 1930s and was considered a major source of the frictions which culminated in the Second World War. The post-war international monetary and trade order, as conceptualized in the Bretton Woods Agreement and such institutions as the International Monetary Fund (IMF) and the General Agreement on Trade and Tariffs (GATT), was designed to provide a "neutral" network of structures for economic intercourse with a

minimal degree of political interferences. Smith saw the same "harmony of interests" he hypothesized as underlying microeconomic motives and activity at work in the world market as well. The pursuit of global economic efficiency, as dictated by the dispassionate laws of economics, would be the automatic result of each state adhering to the laws of comparative advantage. This liberal economic vision, in which international economic cooperation was considered the norm and conflict the result of "irrational state policies," was assumed to be the key to orderly world development, as well as peace.³

The model of the liberal international economic order was an extrapolation from economic theory and the workings of the most successful domestic capitalist systems, Great Britain and the United States. The implicit political decisions and power which lay at the foundation of these domestic systems, as well as their relatively homogeneous values, resources, traditions, peoples, and institutions, were ignored. The anarchic arena of international relations⁴ was seen as the domain of politics and subsumed under a transcendent global economic harmony in which the world market was to be the regulator of international exchange, the tuning mechanism that would keep the economic goals and policies of states in "harmony."

In effect, however, the structure of the international market after World War Two reflected the structure of international political power at the time: power was highly concentrated in a few states, these states shared key common interests, and the U.S. was recognized and willing to act as the leader of the system.⁵ The model of a liberal international economic order, in reality, was placed upon the world--excluding those states which were sufficiently strong and

determined to resist--by a small group of the most powerful states acting in concert and was not the result of a universally applicable economic blueprint reflecting immutable laws.

There always have been some voices raised in opposition to the model of an essentially peaceful international economic system, devoid of political interferences, promising wealth and prosperity for all. The mercantilist tradition, which preceded the innovations of Adam Smith, saw the state acting as a unified political and economic unit. Later, Karl Marx and the numerous branches of his followers were highly critical of the free-market model. Political forces, it was argued, be they in the form of states or the ruling classes, could not be ignored. Increasingly, throughout the 1950s and 1960s (before the official demise of the Bretton Woods system and the onset of the global economic crises of the 1960s and the early 1970s) revisionist historians,⁶ structuralists,⁷ and other "radical" scholars,⁸ emphasizing such themes as dependency and imperialism and stridently rejecting the image and implications of the segregation of economics and politics domestically and internationally, became more vocal in pointing out the shortcomings of the liberal model.

Complementing the dichotomy between economics and politics described and advocated by the liberal view was the state-centric model of international politics. The "billiard ball" model⁹ of an international system composed of hard-shell, territorially bound, undifferentiated units called states was the dominant paradigm for the analysis of world affairs. The central concept in international politics was power;¹⁰ the central unit, the state, was treated as the defining variable or actor of the international system.¹¹

International politics, in short, came to be defined in terms of states and power,¹² with an overt focus on issues of security or "high politics." Despite the breadth implied in the field of international relations, "as a field of study its focus is on the processes by which states adjust their national interests to those of other states."¹³

The existence of nonstate actors is not denied by the state-centric paradigm. "The importance of nonstate actors and the extent of transnational activities are obvious," but a system must be defined in terms of its primary units; and "states are the units whose interactions form the structure of international political systems."¹⁴ Other "relationships or phenomena," are of no concern to students of international politics, "except where [these relationships or phenomena] impinge upon official government objectives or where they are employed by governments as instruments of inducement to achieve military or political objectives."¹⁵ (emphasis in original)

In recent years, the attack upon the separation of economics and politics and the exclusive focus on the state as the unit of international politics has intensified and, in effect, become almost mainstream. By treating economics as nonpolitical "neoclassical theory destroys [the] relationship [of economics] with the real world."¹⁶ The traditional liberal appeal to international competition is not silent, but it is being modified by a growing cognizance of the interrelationship between politics and economics. The interaction between politics and economics is seen as reciprocal,¹⁷ as "politics and economics are interwoven strands in the fabric of world order."¹⁸ Even texts on international business

consider it difficult, if not impossible, to separate the political system from the economic system,¹⁹ and leading scholars of economics conclude that "much of politics is economics, and most of economics is also politics."²⁰ Some scholars question whether there ever was a valid claim to a disjunction between economics and politics ("The sad truth is that there never was--nor is there likely to be--a world of free trade."),²¹ while others focus on events of the 1970s and early 1980s as having "undermined the separation of economics from the study of international politics."²² In either case, the classical liberal/laissez-faire model of a nonpolitical international economic regime has lost much of its application to the study and practice of international politics.

The renewed emphasis on political economy, the intellectual parent to both modern political science²³ and economics, has been undertaken, in many instances, by the same scholars who are challenging the universality of the state-centric paradigm. The exclusive focus on states in the study of international politics is, at least in part, the result of circular reasoning, as international politics, as mentioned earlier, often has been defined in terms of the behavior of states.²⁴ The primary challenge to the traditional model of international politics is the transnational approach.²⁵ The "transnational subparadigm"²⁶ rejects the international politics qua interstate politics approach; rather, it is concerned with a multiplicity of actors and issues, with "the movement of tangible or intangible items across state boundaries when at least one actor is not an agent of a government or an intergovernmental organization."²⁷ The role of the state as the most important actor

is still accepted.²⁸ The state, however, albeit the premier actor, is but one actor in the international system.

The transnational perspective also has led the assault on the conceptualization of international relations almost exclusively in terms of questions of power, force, and security.²⁹ States are not simply like units motivated by a unilateral drive for power and security.³⁰ States pursue multiple goals, and the social welfare function is recognized as increasingly important to the stability and longevity of governments³¹ and as one of the (if not the) primary concerns of the state. Not only are economic concerns perhaps the central issue of domestic politics within developed and developing states alike, but economic matters also have a strong claim as the primary issue in international affairs.

In contrast to the hard-shell units of the state-centric model, modern economic relations indicate the "porousness of political frontiers."³² Interdependence, despite the pitfalls of multiple definitions and accompanying conclusions,³³ is treated as an accepted fact of the international system.³⁴ The proliferation of transnational relations, the growing complexity of international issues, the ongoing revolution in technology, and the increasing concern with economic issues have induced a relaxing of the classical state-centric paradigm and a recognition of the importance of actors, relationships, and processes, heretofore excluded from the study of international politics, to the understanding of the international system.

In no sphere of international life is the inextricable link between politics and economics and the inadequacy of the state-centric

model more apparent than in the operations of transnational corporations (TNCs). Whether called transnational/multinational/global/international companies/corporations firms/enterprises, the essence of the phenomenon is the same: a "cross-border or transnational business organization or aggregate of organizations that is characterized mainly by the dispersal of its managerial centers among several nations for purposes of overcoming the barriers of the political frontiers of states."³⁵

The spectacular growth of TNCs in the post-World War Two era traditionally is measured in terms of direct foreign investment (DFI), the sine qua non of the transnational firm. In contrast to portfolio investments and other types of international capital movements, direct investment is "accompanied by varying degrees of control, plus technology and management."³⁶ Usually undertaken through branches or subsidiaries, foreign direct investment traditionally has entailed the ownership and control of producing assets in one state by a group or firm residing or based in another state.

Increasingly, however, the focus on an undifferentiated concept of DFI and the importance of ownership are coming under question. While TNCs traditionally operated abroad through wholly-owned and then partially-owned enterprises, the ownership of foreign producing assets no longer is a definitional trait of the transnational corporation.³⁷ The essence of the TNC is operations in more than one state.³⁸ Ownership is a moot point; operating "through affiliates that are subject to some degree of central control"³⁹ is the key. Rather than simply seeing direct foreign investment as the ownership of producing assets abroad, DFI has been reconceptualized as an

integrated package of activities undertaken by foreign companies.⁴⁰ The TNC is not merely, nor necessarily, the owner of a given project; rather it is an operator, importing and exporting raw materials and semifinished products, sending capital, making equity investments, as well as undertaking activities under licensing agreements, management contracts, service contracts, and marketing arrangements.⁴¹

Ostensibly, the movement of capital and productive inputs is solely an economic phenomenon. "Both economic analysis and empirical studies trace the underlying motive for investing abroad to profit expectations."⁴² This sounds distinctly similar to the micro-economic motives Adam Smith attributed to entrepreneurs. Foreign investment is a function of market forces; it is the result of "imperfections" in world markets.⁴³

Treating the activities of TNCs as solely an economic issue, however, is to harken back to the classical intellectual dichotomy between economics and politics and to ignore the reality of the impact of corporate undertakings. It requires, moreover, an implicit, almost religious, faith in the sanctity of "pure" market forces which, if left to their own workings, will mysteriously (through the "invisible hand") produce a Panglossian best of all possible worlds. The classical liberal appeal (which, in the never-ending changes of the complexion of the political spectrum, is now more closely associated with political conservatives than with liberals) to competition as the unbiased regulator of economic activity ignores the political nature of economic systems and corporate activities.

Even within the domestic framework, with its given and legitimate institutional and legal structure, politics and economics form a

seamless web and corporations are political actors. The U.S., the modern paragon of capitalism, has an economy which is thoroughly infused with the exercise of corporate power unregulated by mythical competition⁴⁴ and beyond the reach of the government.⁴⁵ The corporation, moreover, is an authority system making binding decisions, at its own discretion, which affect broad areas of public policy and the lives of the people;⁴⁶ this gives corporations a form of social control.⁴⁷ Business is, in effect, a political activity, as "it depends on and sustains a distribution of authority, power and rewards" and, "like governments, it allocates a wide range of resources in ways that significantly affect peoples' lives."⁴⁸ The economic model, blinded by the illusion of an attainable ideal market, ignores the political preconditions and considerations that go hand-in-hand with the economic system. Any departure from perfect competition insures that political forces will be introduced⁴⁹ and that individual firms will affect the broader social environment.⁵⁰

Internationally, the political ramifications of corporate operations are far more salient, obvious, and explosive than in the domestic setting. At the international level, there is no common cultural, legal or institutional heritage sanctioning any one particular economic approach. There is no government or legitimately constituted authority to represent the diverse interests of states, groups, and individuals. The home state of the TNC, particularly in the natural resources sector, typically is stronger, both economically and politically, than the host state in which the firm is investing or operating. TNCs, moreover, are symbolic and tangible evidence of an international economic order imposed upon the world by a small number

of advanced capitalist states.⁵¹ With most TNCs based in the developed world, they are the most visible reminder of the gulf which separates North and South⁵² and the colonial legacy.

By their nature, transnational corporations are less subject to the control of a host state than are the national firms of a state. Even though the TNC may not have overt political motivations, it has substantial political consequences.⁵³ TNCs, while operating across state boundaries and not within the jurisdiction of any one state, have a significant impact upon domestic public policy concerns in terms of such issues as employment, regional development, the distribution of wealth, trade, consumption, and the balance of payments. "The importance of transnational corporations as actors within host countries necessarily implies some impact on the political systems and institutions of these countries. The impact may be direct and deliberate or it may be a side-effect of activities and decisions that are primarily economic."⁵⁴ In either event, the decisions of foreign corporations affect vital areas of national concern. Even an apologist for TNCs admits that these companies affect people and states "in a manner that necessarily challenges the prerogatives and responsibilities of political authority."⁵⁵

While the Third World may be more vulnerable to the influences of TNCs than the developed countries are, particularly with respect to the crucial areas of development and modernization policies, the nature of being a host state necessarily implies some degree of political influence on the part of foreign-based firms. The classical economic approach of pointing to the rule of profitability is insufficient justification for the claim to being nonpolitical, "for

in obeying that rule the multinationals are also affecting the growth rates, the employment, the balance of payment problems, [and other issues of concern to] nation-states."⁵⁶ If the essence of sovereignty is national control of decision making⁵⁷ and policy implementation, then the TNC cannot but be recognized as imposing a limitation upon the sovereignty of the state.

The foreign investment relationship, moreover, is not an ephemeral phenomenon; rather, it "create(s) economic and political relationships of a lasting and significant character."⁵⁸ TNCs stimulate certain patterns of trade or processes of economic growth and development that have long-term consequences.⁵⁹ In general, TNCs further integrate states into the world market and generate international economic linkages and interdependencies, with the accompanying costs and benefits, between states. In dependency theory terms, the TNC is a vehicle of transnationalism between center and periphery maintaining the traditional relationship of exploitation by means of the functional spread of institutions and exportable technostucture.⁶⁰

But one need not take a cynical view of corporate intentions or fall back on past legacies of sinister corporate conduct to conclude that multinationals--by affecting a society's capacity to control the rate, direction and beneficiaries of change--are a significant force in a country's political development. Whether intentionally or not, the multinational corporation is a distinct political actor in the domestic politics of any state within which it operates.⁶¹

Transnational corporations, in effect, make a wide range of decisions that affect host societies and, at times, are all but binding upon host governments.

While corporate managers are quick to condemn government policies which are not in their companies' interests as unwarranted political

intervention, they are reluctant to admit the political impact of corporate activities. They ignore the point, moreover, that the host government's decision not to play an active role in the economy and the regulation of TNCs is the equivalent of an abdication of governmental responsibility in favor of permitting foreign firms greater latitude in determining the country's economic future. Rather than being neutral, a "hands-off" policy by the host government is tantamount to leaving policy in the hands of the TNCs, as "if governments declare the enterprises free to operate across national boundaries without constraints they are, in effect, accepting the distribution of benefits as decided by the [corporate] managers."⁶²

No market is apolitical. The market reflects and reinforces the distribution of authority and the values of a system and is a primary means by which binding decisions are made. Domestically, the market operates with the express sanction of the state. By introducing transnational forces in the form of large, powerful TNCs, the marketplace becomes even more politicized. The host government must function as the political counterweight to TNCs, which otherwise are "too dominant a force in the market."⁶³ The net effect is a relationship between host and firm that is inherently political:

To free themselves from constraints imposed by multinational corporations, nations seek remedial strategies or compensatory national policies. The effect is to politicize the economic marketplace. The market is less and less economic and more and more political...At some point the network of international exchanges is so mediated by political considerations that real-politik replaces comparative advantage.⁶⁴

I.2 Oil: Politics and Economics

Petroleum is a mineral resource which, as a commodity, has both economic and political value. Oil is a key fuel in industrial production, as well as a vital input in the manufacture of a wide range of products. The economic dimension, however, does not capture the full importance of petroleum. The oil industry is so international in scope, petroleum is so essential to the life-style and economics of both crude oil importing and exporting states, oil is so dominant in world trade, that petroleum cannot be considered as simply an economic input. "Oil is the preeminent strategic commodity,"⁶⁵ "the most important commodity in the world economy."⁶⁶

By the early 1980s the petroleum 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.⁶⁷ The 1982 trade in oil was valued at approximately \$450 billion, about twenty times the value of trade in any other commodity.⁶⁸ Oil accounted for 44% of world primary energy consumption in 1980, and more than 50% of the crude oil lifted enters international trade.⁶⁹

The pattern of consumption and trade is highly regional and closely linked to the historical evolution of the oil industry and the distinction between developed and developing nations. The U.S. depended on oil for 43% of its primary energy consumption in 1980, while Western Europe and Japan relied on petroleum for 53% and 84%, respectively.⁷⁰ Combined, these countries were the recipients of more than 75% of gross global crude oil imports.⁷¹ Conversely, the Middle Eastern and North African countries accounted for 72% of gross

world exports of crude oil in 1980, with Latin America and West Africa combined contributing another 16%.⁷²

Net petroleum imports represented 39% of U.S. oil consumption in 1980 and 17% of total U.S. primary energy usage; net imports accounted for 83% of European and 100% of Japanese oil consumption, and 44% and 84%, respectively, of their total primary energy demands.⁷³ Oil is no less important to the leading exporters. Overall, the Organization of Petroleum Exporting Countries (OPEC) relied on oil sales abroad for more than 94% of their total 1980 exports: with the exceptions of Indonesia and Ecuador, every OPEC member counted on the petroleum trade for more than 90% of its total exports, while oil accounted for more than 99% of exports by Saudi Arabia, Libya, and Iraq.⁷⁴

Similarly, oil contributed almost 50% of the 1980 total GNP of the 13 OPEC members, with the GNP of Iraq, Kuwait, Libya, Qatar, Saudi Arabia, and the United Arab Emirates at least two-thirds dependent on oil sales.⁷⁵ As essential as oil is for the consumer nations, it is even more so for producer countries. "For nations with enormous oil deposits, such as Venezuela, parts of the Middle East and North Africa, oil is the economic life"⁷⁶ of the country and its control and regulation is a primary political concern. (emphasis in original)

The conclusion is inescapable that

of all the commodities moving in international trade, oil is undoubtedly the supremely political one. Because most oil moves internationally, because the trade is of enormous monetary value, because huge profits are to be made, because it is a vital necessity to most oil-importing countries, because it is of crucial importance to the economies of the oil-exporting countries and the balance of payments of the developed countries--for all these reasons, the ordinary day-to-day flows of international oil trade are the resultants of enormous and conflicting political pressures among the companies, governments, and international organizations.⁷⁷

The petroleum industry also has given rise to transnational oil corporations (TNOCs), some of the largest industrial firms in the world, as well as being the medium through which a small number of less developed countries executed the largest international transfer of wealth in history.⁷⁸ The international struggle over oil has included three sets of actors: the host or producer states, the TNOCs, and the home states. Our focus will be on the host and firm, the two players most directly and consistently involved in the struggle for control over the oil industry and with the most at stake on the outcome. Home states have a more nebulous--albeit important--set of roles, ranging from passive to active actor, usually, but not exclusively, in favor of the corporations, to mediator, to bystander. To a large extent, therefore, the evolution of the oil industry can be read in terms of the relative positions of the two leading players, the TNOCs and the host states.

It is only since the 1970s that the struggle over oil has become an overt aspect of the international system. As recently as 1969, international oil struggles were largely below the surface, making news only in extreme situations.⁷⁹ Since that time, oil issues have risen in frequency of occurrence and prominence, often holding center stage and influencing state behavior. For the TNOCs and most oil exporting countries, however, petroleum issues always have been the central concern, the axis around which all other issues rotate. The "below the surface" oil struggles, therefore, though perhaps not of great importance to the international system or home states, represent a substantial part of the history of the relationship between TNOCs and host states.

I.3 Political Risks

Risk is a common business term referring to the potential "chance of injury, damage, or loss compared with some previous standard."⁸⁰ Interest rates change, markets expand/contract, additional competitors enter the marketplace: businesses evaluate the likelihood of these, as well as other occurrences which might affect operations, before making an investment. The undertaking of risk is a common business activity; in fact, taking of risks may be considered the primary role of entrepreneurs. Oil companies, and the natural resources industries in general, are familiar with traditional business risks, as well as the additional geological risks they confront: exploration is a costly gamble, drilling yields many more dry holes than productive wells, small pools are more plentiful than large fields, and extraction costs are highly sensitive to physical conditions at the point of production. The assessment of alternatives and chances of success, given a large number of variables, is fundamental to rational investment decisions.

The outcome of a project is never known for certain in advance. If it were, there would be no risks involved. Risks, however, are measurable. "Uncertainty, on the other hand, is a feeling of doubt and unreliability."⁸¹ The distinction between risk and uncertainty may seem trivial, but "there is a crucial conceptual difference: both terms refer to future likelihoods, but risk implies the ability to calculate probabilities, whereas uncertainty does not."⁸² (emphasis in original) Uncertainty is inherently subjective. Risk implies sufficient information about the "objective probabilities of all possible outcomes."⁸³

Risks inhere in possible future developments.

Risk is a dynamic concept that revolves around the probability of changes. Current conditions are not risks: rather, risk stems from changes in those conditions. The rules governing an investment are a current parameter at the time an investment decision is made. Risks are future occurrences that may change the rules.⁸⁴ (emphasis in original)

As such, risks are not necessarily negative. Although risks usually are thought of in terms of potential losses and adverse consequences, which also is the point of view of this study, the category of "risks" also includes the probability of fortuitous changes that are beneficial to the investor.⁸⁵

In addition to "normal" business risks, the foreign operations of TNCs always have been influenced by political conditions and events abroad. The foreign investment relationship, as discussed earlier, is inherently political. All foreign investment decisions, as such, "implicitly assume a given degree of political risk."⁸⁶ Not taking political variables into consideration is tantamount to assuming political changes, if any, will not interfere with corporate operations.

Over the past two decades there has been a growing awareness that political variables must be addressed in the foreign investment decision process. The increasing internationalization of corporate operations, the growing emphasis on international economic issues, the rising assertiveness of scores of states that attained independence in the 1950s and 1960s, the increased incidence of nationalizations and expropriations,⁸⁷ and the near universal tendency to impose restrictions on foreign corporations have forced TNCs to recognize political risks in making investment decisions. In 1981, more than 60% of U.S. firms operating abroad reported having suffered

"politically inflicted damage" in the preceding five years.⁸⁸

Foreign conditions and the actions of foreign governments have become central determinants of the success of foreign investment projects.⁸⁹ Political events and developments, in short, no longer are simply a parameter worth consideration in investment decisions, but are variables which demand to be factored into the decision process.⁹⁰

If politics has become important to the success of operations abroad in general, it is a key determinant in the petroleum industry. Because oil is so significant politically, the oil industry is particularly sensitive to political changes. The "extractive industries are often the first to be hit by political events,"⁹¹ and petroleum invariably heads the list of industries targeted for political changes. One survey of forced divestments in developing countries during the 1960-1976 period reported that the oil industry was subject to such losses in 54 of the 76 countries surveyed, far more than the number of losses reported in other industrial sectors.⁹² Stability in investment terms always has been particularly important to natural resource projects because of the need for large, fixed investments relying on economies of scale, with long lead times before projects come on-line, and pay-back periods which can run for five years to a decade or longer. The vulnerability of natural resource projects,⁹³ the international political focus on oil, and the evolution of the host-company relationship "necessitate going beyond conventional technical and economic analyses of oil ventures to include an evaluation of the political climate in which these ventures may operate."⁹⁴

Political risk refers to that category of risks which are political in nature. Political risk is the probability that the goals of a project or contractual agreement will be affected by changes in the political environment.⁹⁵ Investment relationships, whether governed by general legislation or ad hoc negotiated agreements, entail a set of "rules of the game" which provide mutually defined conditions of behavior, interaction, and responsibilities on the part of the host government and TNC and a basis for expectations about the future.⁹⁶ The conditions or rules which prevail at the time a firm is contemplating a decision are knowable. Laws limiting foreign ownership or providing for investment criteria reviews may be irksome to a TNC, but they constitute current parameters of the investment climate; as such, they are not political risks. Political risks stem from changes in the political conditions that are relevant to an investment or project. An investment climate can be poor not only because of unacceptable risks, but also because of unfavorable policy:⁹⁷ host government policy and the obligations placed upon TNCs may be too onerous regardless of potential future political risks. The temporal difference between current and probable future conditions is the line dividing political "givens" from political risks.

The distinction between political risks and "normal" economic risks does not always seem clear. At root, the difference has to do with the "stimuli of potential change: does change come from political acts and decisions on the part of government and other political actors or have market conditions changed without such influence?"⁹⁸ TNCs are not concerned with political events per se; rather, their concern is with "all potentially significant managerial

contingencies that result from political events or processes."⁹⁹ Political events are the cause, the managerial contingencies are the effect. Foreign firms' interests in political matters extend only to those policies, issues, or conditions that affect them.¹⁰⁰

Political risk analysis is not new. Increasingly, however, firms are moving from implicit to explicit evaluation of political risks. Rational investment decisions based on anticipated rates of return, discounted cash flows, and alternative investment opportunities are impossible if political risks are not adequately addressed. As political risks have a substantial bearing on corporate profitability from and control of a project, failure to assess political risks and include such assessments in decision making precludes the maximizing of rationality in the corporate decision making process.¹⁰¹

Ignoring the dimension of political risk increases the likelihood that companies will make poor investment decisions: profitable opportunities may be missed and costly, unrewarding projects may be entered into. Failure to address political risks specifically, moreover, is "tantamount to assuming an ideal political environment in which political developments will not affect the investment regime of a project."¹⁰² While transnational firms may prefer an investment regime which is apolitical, they have no choice but to deal with the reality of the political nature of the foreign investment relationship. Political myopia rapidly would render a TNC unfit to survive, particularly in the politically dynamic oil industry. The firm which fails to adapt to the changing political environment is destined for extinction.¹⁰³

Managing conflicts with its environment is essential to a TNC's survival.¹⁰⁴ The "external relations" function, a significant measure of which entails efforts at managing political risks, is both time consuming and important to ongoing corporate activities. The general managers of U.S. corporate subsidiaries in Western Europe report spending between 5% and 20% of their time on government relations, while managers in Latin America and the developing Asian countries spend as much as 45% to 50% of their time on this function.¹⁰⁵

Conflict management, by definition, comes into play only after an investment or agreement has been made. If the political risks present too cloudy a future for a potential project, the firm may prefer a strategy of conflict avoidance. The reluctance of the TNCs to engage in exploration in a number of instances can be traced, at least in part, to the unacceptably high risk that the terms of such agreements will be unilaterally changed by the host government.¹⁰⁶ Hence, there is a tendency to explore in politically "safe" countries.

In response to changed economic conditions and political demands, TNCs have become increasingly flexible. Compelled by the exigencies of their situation, TNCs have been among the most innovative transnational firms, employing a diversified portfolio of investment approaches abroad. Despite its adaptability, the corporation, like all large organizations, institutions, and states, is a planning machine with a horizon that extends beyond short-term profits. The TNCs have learned that

profits can be made under a wide set of political, economic, social and cultural conditions. But the key to profits is planning the proper strategy given prevailing conditions, and the key to proper strategy formulation is projecting conditions with a sufficient degree of accuracy.¹⁰⁷ (emphasis in original)

Corporations can operate under a less-than-ideal investment regime if the continuity of such a regime is predictable; "but it is not possible to do the kind of efficient planning that is the *raison d'être* of the global corporation when the rules are subject to precipitous change."¹⁰⁸

The importance of political risk to TNCs brings us full circle to the corporate need to make the most rational decisions possible about potential future developments in a politically fluid setting. At the time a company undertakes an investment, the prevailing investment regime, one can assume, is at least acceptable, if not better.

By definition, the future [investment regime] is inherently less certain. It is the future, however, that holds both the promise of profitability and the risk of changes that might reduce corporate returns or otherwise interfere with corporate interests. As decisions made today will be proved wise or foolish by consequences in the future, successful corporate decisions depend on an accurate projection of tomorrow.¹⁰⁹

I.4 Hypotheses and Model

Modeling multidimensional variables and the relationships between those variables invariably requires simplification. The variables must be reduced to "ideal" types (ideal in the sense of archetypes, not the best or perfect) that permit a closer inspection of relationships without the problem of outside "noise" caused by exceptions to the rule or other external factors. These idealized or simplified types should be conceptualized as offering the best and most logically consistent explanation of the behavior of the variables under study.

For purposes of this analysis, the state and the TNC are assumed to be totally selfish entities whose primary motivations totally dominate their behavior. The state is a territorial entity with the

purpose of gaining power and exercising that power to serve its own interests. The TNC is a non-territorial actor devoted to its own profit-making potential with no regard for states. These are simplifications to which there are countless examples of exceptions. But these idealized types explain the core motivation of the state and the TNC and form the basis for how these two actors interact.

Extrapolating from this conceptualization of the state and the TNC, the relationship between host state and transnational (oil) firm gives rise to inherent conflicts of interests. There is an inherent structural conflict of interests between these two actors, and this conflict is the ultimate source of political risks for TNOCs.

From the TNC's perspective, the host state should be deferential to the wishes of the firm and afford the company the opportunity of complete control over all decisions and operations and unrestrained earnings; the state should be wholly committed to the principles of free trade and free movement of economic inputs and limit its public policy initiatives to those issues which do not interfere with corporate operations; the government should ensure domestic peace and provide the best attainable conditions for business operations. The host, by contrast, sees the TNOc as an efficient machine that should be used for developing an indigenous oil industry which serves the interests of the state; the TNOc should have no interests independent of the concerns of the host state and should undertake investments and provide services on as close to a cost-free basis as possible; the TNOc should phase itself out to the point that its role is reduced to the bare minimum of being a supplier of services in return for a modest fee. Carried to its logical conclusion, the TNOc view of an

ideal environment would be a stateless world government devoted to economic efficiency, while the host looks toward national corporations that totally displace the foreign firms. Given each actor's preferred version of the other, both would be reduced to a skeleton, subservient structure bearing scant resemblance to their former selves.

There are variations on the themes, but the essential relationship between host and firm is a fundamental difference in the nature of the two units.

In the most simple economic terms, state governments are trying to maximize economic and political returns netted by the country and minimize the costs incurred by the operations of foreign companies. Conversely, TNCs are interested in maximizing their earnings from [and control over] foreign operations and minimizing the additional cost burdens placed upon them by foreign governments.¹¹⁰

In mathematical terms, the host and TNOG are pursuing mutually exclusive "limits": given different interests, it is not possible for both actors to maximize their interests (benefits) while minimizing their costs (interference with their interests). Both players cannot simultaneously reap all of the profits and have total control: at its extremes, the relationship is a zero sum game.

This one-on-one perspective of the market is another simplification. We have omitted consumers, whose demand for oil is a key factor in the marketplace, and the home state of the firm. These players have been excluded not because they are irrelevant, but because they are not important to understanding the fundamental cause of the problem under study: political risk. There may, moreover, be multiple companies and/or states involved simultaneously. Regardless of the number of players on each side and whether these players are

organized or not, we have assumed the perspective of a two-person game in which the host state(s) confront the TNC(s).

In most instances, the host/firm relationship is not at one of the theoretical extremes in which the interests of one player are maximized at the expense and exclusion of the interests of the other. Political and economic realities mediate the theoretically antagonistic relationship, forcing host and firm to deal with each other on multiple planes ranging from conflict to cooperation. Necessity takes precedence over theory, bringing host and firm together in a complex relationship of conflictual and shared interests. The broader the issue and the more actors involved, the more the host/company relationship includes mixed motives and interests in which they have a shared stake. Conversely, strictly bilateral issues that affect only the host and TNOC are more likely to be closer to our theoretical extremes in which the relationship is closer to a zero-sum conflict situation.

The resolution of price and quantity issues, for example, involves other interested parties--consumers, home governments, other states and companies--besides the TNOC and the host state. While both host and firm each want to be the decision maker, they share a more tangible interest in maximizing overall industry revenues than bickering over who makes the decision. Controlling supply (quantity) and raising price usually is in the interest of both host state and firm. Rapidly rising prices, like those seen in the 1972-1974 period, benefit both host state and TNC in terms of greatly increased revenues. These gains, shared on a variable-sum basis, come at the expense of other parties to the mutual advantage of host and firm.

When this multilateral issue in which host state and TNOC can cooperate at the expense of other actors is reduced to the bilateral question of how to divide the spoils, on the other hand, the relationship is more conflictual. Each is interested in its own gains and wants the whole pie for itself, regardless of the size of the pie. The preference of each is to capture all revenues for itself, regardless of whether those revenues are rising or falling.

Host state and firm do not share in any enduring "harmony of interests." The natural conflict of interests between these actors, on the other hand, is mediated in practice by external conditions necessitating a degree of cooperation. In many respects, this cooperation is a transient arrangement of mutual need and convenience, rather than a reflection of long-term interests. Even if long-term interests point in different directions, the short-term needs of both players may converge. The resulting cooperation is a conditional reflection of political and economic conditions: the continued inability of host states to control fully their domestic oil industry, as well as the international oil industry, and their continued need for the TNOCs, on the one hand, and the TNOCs' need to operate in an international system composed primarily of sovereign states, on the other.

The conflict of interests between host and firm is reinforced by the different political natures of the state and TNOC. As a sovereign entity, the host state naturally resents and is frustrated by its reliance on legally inferior TNOCs. Neither the political nor legal equal of states, TNOCs are able to exert a good deal of influence over the fate of the oil producing countries. On the other hand, TNOCs,

for all their influence, have no independent political base and, in the final analysis, are subject to the jurisdictional authority of both home and host states.

The nature of the actors and the structure of the host-firm relationship give rise to two contradictory sets of postulated interests and issue hierarchies. On the part of the host states, these interests and issue hierarchies prevail regardless of differences between politics and socio-economic institutions. These interests and hierarchies, moreover, are both descriptive and prescriptive: in addition to being logical, they are consistent over time. The continuity of host interests with respect to oil policy constitute the host state's national interest.¹¹¹ The interests and issue hierarchies of the two actors are ranked as follows:¹¹²

Host Government

1. Solidify power base and control
2. Increase economic returns (satisfice)
3. Further domestic policy goals
4. Exercise control over natural resources
5. Further foreign policy goals.

TNOC

1. Increase economic returns (satisfice)
2. Insure transfer of supply and funds
3. Retain control over operations
4. Retain ownership

As a prerequisite for executing the authority of the state, the governing regime must be institutionalized. It is only after a regime is secure in power that it can pursue economic returns. Once the state has begun to increase its share of the pie, it can turn toward using its oil industry and oil revenues to promote domestic policy goals. At this point, the breach between the wealth of the government and ruling elites and a broader social welfare function has been crossed. The channeling of the domestic petroleum industry to serve policy goals is a prelude to the exercise of full domestic control

over a nation's oil wealth and the attainment of permanent sovereignty over natural resources. As a last concern, host states employ their oil for foreign policy ends.

TNOC interests and hierarchies are different. The TNOC's central goals are profits and making money. A related interest is the ability to transfer abroad profits in hard currency and transfer (or export) supply (to earn additional profits and facilitate operations outside the host country). The third preference of TNOCs is the retention of control over operations. This fosters profit making and the rational utilization of the various exploration, production, refining, transportation, and distribution capabilities of the firm. In short, control is closely related to the company's market position vis-à-vis the host state. The last priority is ownership, which the TNOCs have proven willing to cede to protect their other interests.

Political risks are a result of the conflicting interests inherent in the structure of the foreign investment relationship in oil. As the host increasingly pursues its interests, the TNOC's interests are subject to a continual erosion. The immediate causes of political risks are policy changes implemented by host governments trying to attain goals and cope with problems. The structural relationship is mediated or constrained by three variables. These variables determine the timing of policy changes aimed at the oil industry and the strategies employed.

The most important mediating variable is the relative market power--the ability to influence and exercise control over the market--and bargaining position of host and firm. The policy interests of host states were constrained for decades by market conditions that

were not propitious to the exercise of control by the hosts. With the producing countries dependent on the major international oil firms¹¹³ for virtually all aspects of exploration, production, transportation, and marketing, chronic problems of oversupply, minimal host political and economic capabilities, and a highly oligopolistic market structure, host states had to press their demands on TNOCs slowly and tenuously. The continued growth in consumption and reliance on imported oil in the West, the increased activity by independent oil companies, the emergence of indigenous personnel skilled in the oil industry, and the political solidarity of OPEC weakened the market position of the TNOCs and created the fundamental preconditions essential to the policy changes host governments initiated in the 1970s.

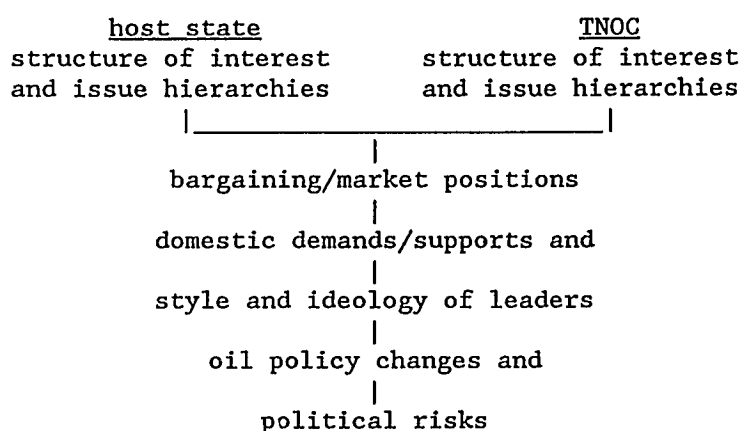
The bargaining position of host and firm has, over time, led to a natural shift in power in favor of the host and away from the TNOCs. The improved bargaining position of producer states has created situations of opportunity to impose changes upon the firms and has complemented and reinforced the hosts' intentions to move along the issue hierarchy. Conversely, the TNOCs are left to a strategy of retreat, fighting a rear guard action against the increasing assertiveness and capabilities of host states. Operationally, this translates into an erosion of the TNOCs' market position and growing vulnerability to political risks.

Given the conflicts implicit in the host-firm relationship and the perception of opportunities created by the respective bargaining power of the two actors, the occurrence of political risks is further mediated by domestic demands and supports and the style and ideology

of leadership. These determine the political necessity and/or willingness of decision makers to impose changes on the TNOCs. Pressures from elites, opposition groups, or a generally disaffected populace might motivate leaders to take actions against foreign oil companies. Decision makers, similarly, have preferences with respect to TNOCs that also will be important to policy.

There are incidents of political risk which are not covered by this structural model. Involvement in a foreign war leading to physical destruction or interruptions of operations and anomic domestic political violence cannot be explained by the structural argument. Domestic instability also seems to lie outside of the explanatory range of the structural model. As often as not, however, domestic instability (which is not a primary source of political risk and may even be considered more an accompanying symptom than cause of risk; see Chapter II) is related to a regime's failure to pursue adequately the national interest we outlined earlier or to deal effectively with the TNOCs. In these instances, the instability is structurally related. Mass discontent with the Shah of Iran in the 1970s, for example, was at least partially rooted in his regime's failure to channel the nation's oil wealth towards popularly accepted domestic policy goals and to rein-in the TNOCs. His government seemed to have "gotten stuck" on the preliminary interests of aggrandizing state power and increasing the economic returns flowing to the state and elites; had the Shah paid adequate attention to popular domestic goals and used the oil industry to promote those goals, the history of his regime might not have ended as abruptly as it did in 1979.

The conflict of interests is inherent in the TNOC-host relationship. Depending upon political and economic conditions, as policy evolves, these differences lead to political risks for the firms. The domestic capabilities of the host and power vis-à-vis the TNOCs, the perceptions and styles of host leaders, and domestic demands and supports mediate the timing and form of "political risk events,"¹¹⁴ specific outcomes in a host country that will have an impact upon the success of TNOC operations. Schematically, the model can be depicted as follows:



In summary, the central hypotheses of this study are:

1. Host states have a (shared) set of interests and issue hierarchies (national interest) with respect to their oil industries; TNOCs have an opposing set of interests.
2. Structurally rooted conflicts between the nature and interests of host and TNOC produce tensions and are the ultimate cause of political risks.
3. Despite differences and conflicting interests between host and state, the practical relationship between the actors is a complex mixture of cooperation, conflict, and compromise.
4. Specific political risk events are embodied in policy decisions.

5. The bargaining/market relationship shifts over time in favor of the host state; this creates the opportunity for increased host demands and renders TNOCs further vulnerable to political risks.
6. The bargaining relationship, host leadership style and ideology, and political demands and supports in the host country mediate the structural determinants of political risks.

Notes to Chapter 1

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⁶⁷Albert L. Danielsen, The Evolution of OPEC (New York: Harcourt Brace, 1982), p.1.

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⁶⁹Data compiled from BP Statistical Review of the World Oil Industry (London: The British Petroleum Company, 1981), pp.6,8,16.

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⁷¹BP Statistical Review, p.10.

⁷²BP Statistical Review, p.10.

⁷³BP Statistical Review, pp.8 and 10.

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⁷⁵OPEC, pp.xvi and xvii.

⁷⁶Michael Tanzer, The Political Economy of International Oil and the Underdeveloped Countries (Boston: Beacon, 1969), p.11.

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⁸⁷ Although often used as synonyms, expropriation is the seizure or modification of the property rights of a company or group of companies, while nationalization is the same act aimed at a particular industry or sector of the economy. See Dan Haendel, Robert G. Meadows, and Gerald T. West, eds., The Measurement of Political Risk and Foreign Investment Strategy, Proc. of the Conference on the Measure of Political Risk and Foreign Investment (Philadelphia, Foreign Policy Research Institute, 1975), p.12.

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II. THE STUDY OF POLITICAL RISK

The field of political risk deals with a practical business concern. For this reason, there has been a tendency for works on this subject to be applied in nature, offering some sort of methodology for measuring or assessing risks. While an applied focus meets the short-term needs of corporate decision makers better than theoretical works, the field suffers from a lack of theoretical development. As a result the methodologies developed typically are not based on any understanding of the relationships between the underlying variables. Rather than develop yet another predictive methodology, this dissertation proposes to contribute to the development of the foundation of the field of political risk by examining political risk in the context of a broader theory of the relationship between host states and TNCs.

The opening section of Chapter Two reviews the development of political risk as a field of study, some of the problems inherent to the topic, and the need to develop a theory of political risk. Most of the Chapter is dedicated to reviewing the approaches and contributions made by earlier works in the field. This is done to lend a sense of historical perspective to the study of political risk and to show how and where this dissertation draws on earlier works. In keeping with the goals of developing an explanatory model, the literature is critiqued in terms of the premises and assumptions of the works, implicit or explicit, and their contribution to theory building, not in terms of the predictive value of the different approaches.

The final section of this Chapter focuses on one of the biases that plague the study of political risk: the tendency to see

political risk as a result of instability. The tendency to concentrate on instability is apparent from the text and Exhibit II.1, in which the definition and approach of each author is classified as "instability" or "policy" oriented.

Instability, the argument is made, is not the primary cause of political risks. While the ultimate cause of political risks can be traced back to the structural relationship between host and firm, the proximate source of such risks are the policy decisions made by states. Political risk events are embodied in policy decisions. Political risks, moreover, are not limited to developing states. While developing states may present certain problems and risks for TNCs, political risks also are present in developed states.

II.1 Toward a Theory of Political Risk

Political risk analysis entails the application of political, sociological, and economic concepts to one of the practical problems facing corporations that operate abroad: the likelihood that political developments will have an adverse impact upon the operations and profitability of a project. Given the political importance of TNCs and international economics, particularly in the case of the oil industry, the study of political risk is more than an exercise in optimal corporate management; rather, it is an inquiry into the relationship between two international political actors that is of more than passing relevance to other political actors, as well as the international system. Moreover, political risk is a significant area of study not only to students of TNCs and international political economy, but to host government decision makers that are interested in attracting foreign investment as well.¹

While exposure to political risk is not new, it is only since the 1970s that TNCs and scholars of international investment have recognized the need to study political risk and incorporate evaluations of political risk in decision making. Although early works in the field were available,² and corporate decision makers, especially in the extractive sector, were well aware that their investments were subject to political changes, prior to the early 1970s little attention was paid to the concept of political risk. While the "OPEC Revolution" of 1973-74 stirred additional interest in the field, it was the traumas of the back-to-back revolutions in Iran and Nicaragua that stimulated the flood of interest in political risk. This interest was practical, commercial, and academic: TNCs tried to develop in-house political risk assessment capabilities to help direct future investment decisions, consulting groups and independent "experts" sought to sell their services as political risk analysts to transnational firms, and scholars of international business and politics began to treat political risk as a legitimate field of inquiry.

In the past dozen years, numerous approaches, methodologies, hypotheses, and models have been generated to predict political risks.³ To some extent, this diversity reflects the relative youth of the field; as the field matures, the diversity should narrow to center on those works that withstand the empirical test of time. On the other hand, the diffusion of techniques is indicative of the complexity and special problems encountered in the study of political risk. The most obvious problem confronted in trying to predict political risk is similar to that faced by "futurologists,"⁴ and crystal ball gazers: one is trying to read the future. The farther

into the future one projects, the more difficult it is to have confidence in the accuracy of the projection. To be useful in the oil industry, however, a risk forecast must address a time-span of at least five years and perhaps as long as ten years or more. Ideally, a risk forecast would cover the exploration and development and entire productive life of a field, which may run 25 years.

Even if future political conditions could be known with 100% accuracy, that still leaves half the problem unsolved. The corporation is concerned with the effect, the specific managerial contingencies that will arise because of political conditions and changes. Knowing tomorrow (and the day after) is the first step; the second step is to determine how tomorrow will affect operations and profits. As, in the final analysis, projects are undertaken by TNOCs because of the profits expected, the economic value of a project involves determining, as best as possible, how profitability will be affected by political risks. The problems inherent in predicting outcomes and relating those outcomes to revenue streams may prove insurmountable and may explain (and perpetuate) the diffuse nature of the field.

Despite the behavioralist or scientific drive, the study of political events never will reveal as neat and orderly a process as that found in natural phenomena; the paths of the planets are far more regular and predictable (as far into the future as one might ever want to know) than those of states and the international system. It is only by means of an understanding of planetary movements that the position and orbits of the planets can be forecast. In the absence of any knowledge of the heavens and physics, predicting the future move-

ments and locations of the planets is an impossible task, as there are an infinite number of possibilities and no reason to select any particular choice over the others. Careful observation and a crude understanding of physical principles, however, as shown by earlier civilizations and pre-Renaissance scientists, provide a basis, however imperfect, for educated projections.

One must be skeptical of claims at revealing immutable laws in the social sciences that will permit the certain forecast of political developments and the accompanying risks. There are too many non-quantifiable variables, not the least of which are the actions, undertaken by people, who, unlike the planets, have a great deal of autonomy in their behavior. We do have some grounds, however, for well-reasoned predictions in the field of political science. Although the accuracy of political risk evaluations will never approach the exactness of our predictions of planetary movements, the better our understanding of political phenomena, the better those evaluations will be.

There is a general sense, however, that "the study of political risk is in a state of disarray...There is no consensus as to what constitutes a 'political-risk,' let alone an accepted methodology for anticipating and assessing overseas developments."⁵ The field "has got stuck," unable to overcome the "Ayatollah Phobia"⁶ and preoccupation with momentous political upheavals. The fundamental problem is the failure to build assessment methodologies upon solid conceptual and theoretical frameworks. There remains no general theory of political risk, and there is little effort to link political risk analysis with related inquiries into the state and transnational

corporation. As such, most of the work in the field of political risk lacks foundation, resembling the astronomer who tries to plot the path of heavenly bodies by relying solely on observations of one or two planets.

The goal of this study is not to construct another methodology for predicting political risks. Rather, the effort will be aimed at taking the field back a few steps and relating the study of political risk to a broader theory of interaction between host states and TNCs. The focus is not on the predictive tool of "how to" forecast political risks, but on the nature and structure of political risks themselves. The effort is not to develop an applied methodology into which data can be "plugged," but to develop a broader theory and model of political risk. This is a prerequisite to which has been paid too little attention in the rush to devise applied measuring techniques. This study will aim, at least in part, to help bridge the chasm between the practical orientation of political risk analysis and the study of the underlying political and economic variables and interactions. The review of the literature in political risk (see Section II.2), therefore, will not address the merits and shortcomings of the predictive methodologies per se, but will concentrate on the premises and assumptions, implicit or explicit, in the works.

In contrast to the emerging non-theoretical literature on political risk, there is a well-developed academic body of empirical and theoretical works on TNCs and their role in the international system. In the most general sense, works in this area can be divided into apologists for⁷ and critics of⁸ TNCs. Neither group pays much attention to political risks: the latter tends to see political

risks as a Western, corporate fabrication to justify an exploitative relationship, while the former treats political risks as the product of nationalistic and/or ignorant decision makers and peoples, usually of the Third World, interfering with the logic of economics and the operations of TNCs. The structural relationship between firm and host state is either ignored or treated in the context of a general assessment (usually negative) of the world capitalist economy in which the TNC is merely a manifestation, rather than an autonomous actor.⁹

Those who assess host-firm interactions in terms of the bargaining model¹⁰ come closest to treating the TNC as an autonomous political actor and analyzing the structure of the relationship. The bargaining situation, however, is not sufficient by itself as a model of TNC-host state interaction or of political risk. Bargaining is a dynamic mediating variable, not the independent variable which drives the host-company relationship and is the root cause of political risks. Similarly, the bargaining situation does not translate directly into outcomes, as it is further mediated by other variables.¹¹

II.1.1.1 The Literature on Political Risk

The earliest works on political risk were more concerned with identifying the subject as a relevant field of inquiry and showing the shortcomings of the way TNCs were considering political variables than with presenting models of political risk. In one of the earliest pieces to address the subject, Aharoni criticized the tendency on the part of corporate decision makers, particularly in the U.S., to view government involvement in the market place as "interference" and ipso facto, wrong.¹² This perspective was indicative of a general predisposition to extrapolate U.S. standards and culture abroad;

anything which violated the political expectations found in the U.S. was considered a political risk. The result, Aharoni pointed out, was the description of political risks in broad, sweeping terms, with "unqualified deduction(s) from some general indicator to a specific investment."¹³

Root, in what perhaps was the first survey of corporate political risk analysis techniques, found that few TNCs regularly evaluated political risks or monitored political developments abroad.¹⁴ Based upon a study completed in 1966, Root reported that "no executive offered any evidence of a systematic evaluation of political risks, their identification, their likely incidence, and their specific consequences for company operations."¹⁵ A subsequent study by Stobaugh found that the most common corporate approaches to political risk were superficial and simplistic.¹⁶ He suggested, however, that more sophisticated methodologies were available and becoming more popular. While Stobaugh was encouraging more rigorous means of measurement, such as probability analysis and range of estimates, he never mentioned how the quantitative data would be derived and ventured no insights about the relationship between political events and TNCs.

Table II.¹⁷ summarizes the definition of political risk and approaches to the field used in more than one dozen works on political risk. Each author has been generally classified as being in the "instability" school or "policy" school in their approach. The instability school, as the term indicates, includes those works that, either explicitly or implicitly, explain political risk in terms of instability (however defined--or undefined). The policy school, on

Table II.1: Classification of Earlier Works on Political Risk

<u>Author</u>	<u>Definition of Political Risk</u>	<u>Approach</u>
Stobaugh (1969)	General conditions affecting investment conditions (instability)	General and quantitative; overview of methodologies
Business International (1979)	Ambiguous; concern with things that affect businesses (instability)	Checklist; country rating scale
Robock (1971)	Difficult to anticipate discontinuities in business environment caused by political change and which might affect profits or other goals of the firm (instability)	Conceptual; dichotomize micro vs. macro risks; framework relating sources of risk to groups generating risks to "political risk effects" or outcomes
Boddewyn & Cracco (1972)	Whether government will adopt more or less nationalistic policies (policy)	Conceptual; analysis of role of government in economy and how TNCs should play the game
Green (1974)	Adverse changes stemming from radical political changes (instability)	Conceptual; relates risk of radical political change to instability of type of government
Rummel & Heenan (1978)	Ambiguous; concern with political change (instability)	General and quantitative measurement of variables affecting domestic instability, foreign conflict, political extremism, and economic climate and probability of outcomes
Johnson (A.D. Little) (1980)	Politics and economics are inseparable in causing business, financial, and catastrophic risks and events (instability and policy)	Conceptual and quantitative; model: a state's level and evenness of development, mediated by power capabilities and aid received, determine the occurrence of risk events; cost/benefit relationship
Haendel, West, and Meadow (1975)	Risk of occurrence of political events that change prospects of profitability of a given investment (instability)	Quantitative; components approach using indicators to construct indices (stability, nationalism, etc.)

<u>Author</u>	<u>Definition of Political Risk</u>	<u>Approach</u>
Truitt (1974)	Propensity to expropriate (policy)	Conceptual and quantitative; building and testing of hypotheses regarding expro- piation in terms of host and investor variables
Jodice (1980)	Propensity to nationalize and expropriate (policy)	Conceptual and quantitative; generation and testing of hypotheses regarding state characteristics and expro- piation with historical data
Bunn and Mustafaoglu (1978)	Political risk event as any outcome in host coun- try that would have a negative impact on the success of a venture (policy and instability)	Quantitative; formula for predicting likelihood of ten political risk events based on combining expert's opinions on the probability of related factors
ASPRO/SPAIR- Shell Oil (Gebelein, Pearson, and Silbergh) (1978)	Probability of not main- taining oil contract dur- ing a period of 10 years in the face of changing economic and political circumstances (policy)	Quantitative; method for combining expert's opinion the likelihood of occur- rence of components of political risk
Brewer (1981)	Listing of specific risks that tend to emerge from political processes (policy)	Conceptual; relates various models of politics to under- standing different types of political risks
Frost and Sullivan (WPRF) (Coplin & O'Leary)(1982)	Probability of various types of restrictions or losses (policy)	Quantitative; based on gen- eral model of pluralistic political processes; expert generated data
Channon and Jallard (1978)	Political intervention (policy)	Conceptual; intervention by government reflects policy choices
Kobrin (1980)	Forced divestment (policy)	Quantitative and conceptual; analysis of forced divest- ment through historical data
Lax (1983)	Likelihood that political — changes will prompt a change in the investment climate regulating a pro- ject or contractual agreement (policy)	Conceptual; political risk events as result of host government policies to attain state goals

the other hand, includes those works that see political risks expressed through policies implemented by the state.

Stobaugh found that approximately 20% of the firms he surveyed used a rating scale to evaluate political risks.¹⁸ Rating scales entail the assignment of values to a standardized list of variables; the scores are added; the higher (or lower, depending on the designated point values of each scale) the total score, the greater (or lesser) the political risks.

The rating scale approach is attractive because of its simplicity: theoretically if one could list all of the potential variables which might indicate political risks, devise an objective means of quantifying these variables,¹⁹ and develop a logical function by which to combine the data, an overall measurement of political risk would be produced. The scales, however, lack theoretical justifications for the selection of variables or how variables are interrelated. There are countless variables which may be relevant to issues of foreign investment and political risk, and these variables can be grouped in various ways. Evaluating political risk is a "multidimensional task involving several hundred political, economic and sociocultural factors."²⁰ Scales give no sense of the underlying political processes, other than an impressionistic sense that the chosen variables somehow are important to political risks.

This remains true of the current leading commercially available rating published by Business International (BI). The Business International Country Ratings (see Table II.2) are a "scoreboard" of four sub-indices (political, legal and social; economic; financial; and energy vulnerability) of 34 factors. "Departure from the perfect

Table II.2: Business International

Country Ratings: Factors Rated and

Maximum Scores

Political-Legal-Social Factors	Score
1) Political stability	
a. Long-term stability guaranteed	15
b. Strong government but vulnerable institutions	10
c. Elected government prone to ideological swings	8
d. Active internal factions	5
e. Strong probability of overthrow (external and internal)	2
2) Probability of Nationalization	
a. No threat	15
b. State participation in selected firms	12
c. Full takeover of specific firms	9
d. Nationalization of key sectors	6
e. Large-scale nationalization	3
3) Restrictions on Capital Movements	
a. No restrictions on any transfers	15
b. Minimum controls	12
c. Limits on certain inflows and/or outflows	9
d. Strict restrictions on remittances and repatriation	6
e. No transfers permitted	3
4) Desire for Foreign Investment	
a. No restrictions on any type of foreign investment	10
b. Favorable climate with incentives	8
c. Selective investment policy	6
d. Lukewarm climate for foreign capital	4
e. Hostile foreign investment capital	2
5) Limits on Foreign Ownership	
a. No ceiling on foreign equity percentage	10
b. Desire but no requirement for local equity	8
c. Local majority required in many of key industries	6
d. Strict joint venture requirements	4
e. Only foreign minority position tolerated	2
6) Limits on Expansion of Foreign-Owned Firms	
a. No government restrictions on expansion	8
b. Obstacles to expansion, e.g. antitrust, environment	5
c. Limits on specific industrial sectors	3
7) Government Intervention in Business	
a. Free enterprise system	8
b. Limited government controls, e.g. price controls	6
c. Strong but selective government intervention	4
d. Tightly controlled economy	2

Table II.2, Cont.

8) Likelihood of Internal Disorder and Vandalism	
a. No threat of disorder	8
b. Isolated cases of unrest	6
c. Strong possibility of vandalism, kidnappings	4
d. Probability of social revolution or civil war	2
9) Delays in Getting Approval	
a. No red tape	6
b. Occasional delays	4
c. Exasperating red tape	2
10) Cultural Interaction	
a. Easy to grasp cultural and business concepts	5
b. Difficult to establish confident rapport	3
c. Impossible to assimilate country's culture	1
Commercial Factors	
1) Present Market Size as Indicated by GNP	
a. Above \$500 billion	12
b. \$100-500 billion	9
c. \$50-100 billion	6
d. \$10-50 billion	3
e. Less than \$10 billion	1
2) Annual Average Real GNP Growth - Last Five Years	
a. High growth (above 8%)	6
b. Good (5-8%)	4
c. Moderate (3-5%)	2
d. Low (less than 3%)	1
3) Annual Average Real GNP Growth - Next Five Years	
a. High growth (above 8%)	8
b. Good (5-8%)	6
c. Moderate (3-5%)	4
d. Low (less than 3%)	2
4) Present Market Sophistication as Indicated by Income Per Capita	
a. Above \$6,000	12
b. \$4,000 - \$6,000	9
c. \$2,000 - \$4,000	6
d. \$1,000 - \$2,000	3
e. Less than \$1,000	1
5) Restrictions on Foreign Trade - Next Five Years	
a. No restrictions	12
b. Minor restrictions	9
c. Substantial restrictions	6
d. Stiff restrictions	3

Table II.2, Cont.

6) Availability of Local Capital - Next Five Years	
a. Abundant and inexpensive	12
b. Subsidized (i.e. low cost) but restricted	9
c. Available but costly	6
d. Difficult to get	3
7) Availability of Labor - Next Five Years	
a. Plentiful skilled and unskilled	12
b. Shortage of skilled labor	9
c. Tight and costly	6
d. Very tight	3
8) Stability of Labor - Next Five Years	
a. Very stable	12
b. Active unions but reliable labor	9
c. Frequent labor unrest	6
d. Continual politically motivated strikes	3
9) Corporate Tax Level - Next Five Years	
a. Low (income tax less than 35%)	8
b. Fair (income tax 35% to 50%)	4
c. High (income tax at least 50%)	2
10) Quality of Infrastructure - Next Five Years	
a. Good services readily available	6
b. Adequate but specific shortcomings	4
c. Inadequate infrastructure	2
Monetary - Financial Factors	
1) Annual Inflation - Last Three Years	
a. Low (less than 4%)	8
b. Moderate (4-8%)	6
c. High (8-15%)	4
d. Rapid (over 15%)	2
2) Annual Inflation - Next Three Years	
a. Low (less than 4%)	16
b. Moderate (4-8%)	10
c. High (8-15%)	5
d. Rapid (over 15%)	2
3) Number of Devaluations - Past 10 Years	
a. No devaluation	5
b. One to two devaluations	4
c. Weak with predictable manipulations	3
d. Three devaluations	2
e. Continual devaluations	1

Table II.2, cont.

4) Percentage of Devaluation - Past 10 Years	
a. Zero	5
b. Up to 5%	4
c. 5 - 10%	3
d. 10 - 20%	2
e. Over 20%	1
5) Currency Forecast - Next Three Years	
a. Consistently strong currency	16
b. Occasional weakening	12
c. Weak with predictable manipulations	8
d. Continual depreciation expected	4
6) Overall Balance of Payments - Next Three Years	
a. Strong with consistent surpluses	12
b. One to two deficits expected	6
c. Continuous deficit position	2
7) External Debt Position - Next Three Years	
a. Repayment manageable	8
b. Some repayment difficulties	5
c. Severe measures needed to avoid default	2
8) Reserves/Imports Ratio - Past 12 Months	
a. Highly favorable (three months or over)	6
b. Satisfactory (two to three months)	4
c. Unsatisfactory (less than two months)	2
9) Reserves/Imports Ratio - Next 12 Months	
a. Highly favorable (three months or over)	8
b. Satisfactory (two to three months)	5
c. Unsatisfactory (less than two months)	2
10) Convertibility in Foreign Currencies - Next Three Years	
a. Freely convertible	16
b. Minor restrictions	12
c. Strict controls on specific transfers	8
d. Prior approval for all transfers	4
Energy Vulnerability	
1) Dependence on Imported Oil for Energy Needs - Next Five Years	
a. Self-sufficient or net exporter	14
b. Low (1-25% dependent on oil imports)	10
c. Moderate (26-50%)	6
d. High (over 50%)	2
2) Import Oil Bill as a Percent of Total Exports - Last Three Years	
a. Minimal (0-5%)	12
b. Moderate (6-20%)	8
c. Large (21-35%)	4
d. Over 35%	1

Table II.2, cont.

3) Development of Alternate Energy Sources - Last Three Years	
a. Oil self-sufficient - no need to develop alternatives	6
b. Meaningful progress	4
c. Little or no development of alternate energy programs	1
4) Growth in Use of Alternate Energy Sources as a Percent of Total Consumption - Next 10 Years	
a. Oil self-sufficient - no need to develop alternatives	8
b. High (over 10% of energy consumption)	6
c. Moderate (5-10%)	3
d. Small (0-5%)	1

SOURCE: Reprinted from the Business International research report:
 "STRATEGIC PLANNING FOR INTERNATIONAL CORPORATIONS: Organizations,
 Systems, Issues and Trends" (December 1979), pages 89-93, Business
 International Corporation (New York).

score (340, although the factors are not weighted equally) reveals the degree of risk and lessened opportunity--political, economic, and financial--that foreign investors face in a specific country."²¹ Although the BI ratings are more formal than the scales described by Stobaugh and carry the weight of a respected business interest institution, they suffer from the same fundamental theoretical and conceptual deficiencies common to scales of political risk. Simply summing all the potentially relevant variables is a procedure unsound in logic, theory, and concept. The result is a list with some descriptive value, not a model with analytical applications.

Perhaps the first major conceptual contributions made to the study of political risk (in contrast to earlier works on how companies were looking at such risks) appeared in a 1971 article by Robock. Robock offered a clear definition of political risk, stating that political risks exist "(1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate, and (3) when they result from political change" and have the potential to affect significantly the profits or other goals of a firm.²² Gradual, progressive and continuous changes, in which trends are evident and expected, on the other hand, Robock said, do not constitute political risks.²³ This distinction between "normal" and discontinuous, unexpected changes as the criterion of political risk seems dubious in its open invitation to subjectivity and shortsightedness. "Continuous" changes over the course of a year or more may yield an investment climate radically different from that when an initial investment was made. The claim, moreover, that the predictability of adverse political changes means there are no political risks is syllogistic:

the net effect may be no different, and perhaps worse, than a sudden future change. Robock's definition leads to the logical conclusion that a better understanding of political phenomena and increased ability to forecast accurately political changes somehow would mean reduced political risk; this is conceptually confusing (the ability to predict an event means the event is no longer an event?), particularly in light of the definition of risk as a measurable probability.

Of more enduring value was Robock's dichotomy between macro and micro political risks.²⁴ Macro risks, which are less frequent but more dramatic, are directed against all foreign firms. Micro political risks are more common and affect selected fields of business or companies with certain characteristics. Vulnerability to micro risks, therefore, varies from sector to sector and perhaps even from firm to firm.

Robock also presented a conceptual framework identifying the sources of political risk, the groups through which such risks can be generated, and the "political risk effects" or changes that might ensue for TNCs.²⁵ The framework, however, implies bilateral linkages connecting individual sources of risk with separate transmission groups and risk effects. There is no indication of interrelationships between variables, nor recognition that a multiplicity of sources and groups can contribute to risk effects. His framework, moreover, seems to belie the stated concentration on sudden, unanticipated reversals, as several of the effects cited, such as operational restrictions, discriminatory taxes, and losses of transfer freedoms, might just as easily be phased-in as a "normal" part of the "evolutionary path" of the investment regime and not entail a radical change prompted by

political discontinuities. These weaknesses aside, Robock's article is generally recognized as "the first effort to analytically link independent and dependent variables of political risk" and serving "as an impetus for further development of the discipline."²⁶

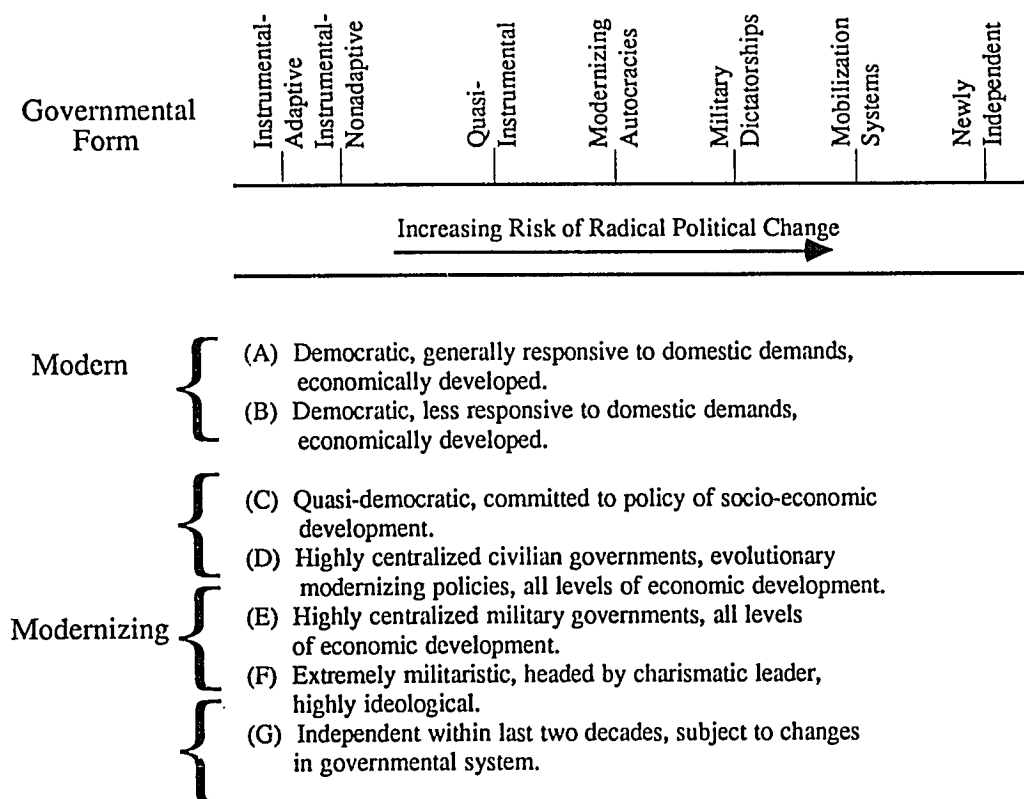
Boddewyn and Cracco suggest that the host government is the key determining the investment regime and, therefore, potential government intervention is the primary cause of political risks. Determining politico-economic developments depends on assessing whether the host government will move toward more or less nationalistic policies."²⁷ Nationalism is not treated pejoratively, but rather as an inherent propensity to promote and control national development.²⁸ The central theme they present is that the opportunities created by government intervention often are as, if not more, relevant than the risks. TNCs can anticipate, they claim, and prepare for the risks and prosper from playing the "political game."

The identification of the host government as the central actor shaping the investment climate is an important building block in the focus on policy as the carrier of political risk events, an assumption of this and a number of other recent studies." Boddewyn and Cracco, however, recommend for the TNC a politically activist role that seems out of touch with the less than cozy relationships that have emerged between TNCs and host governments. They elevate the foreign firm almost to the position of a constituent of the host government. The legitimate overt and political role of the TNC abroad, however, is sharply limited. In many instances, political activity on the part of the TNCs will, by definition, be construed as interference in the domestic affairs of the host state. The increased visibility of the

TNC which would accompany the activities suggested by the authors, moreover, frequently have been cited as contributing to political and nationalistic antipathies to foreign firms.²⁹ There is a general tone throughout the article that as long as nationalism remains "rational," TNCs can enjoy a mutually beneficial and cooperative relationship with the host; it is only the "irrational" for which firms must watch. Although perhaps not a complete circle, this argument leads toward circular reasoning, as changes which interfere with corporate operations will, almost by definition, appear irrational to the firm, while a favorable investment regime will ipso facto be treated as evidence of rationality.

Perhaps the most frequently cited cause of political risk is instability. (Section II.3 contains an expanded critique of approaches which center on instability.) That instability is unhealthy for a TNC is part of the traditional wisdom. Green was one of the first analysts to formalize the focus on instability as the cause of political risk. "Radical political change," "the ascendancy to power of a person or group holding a different political philosophy than the person or group that it replaced," introduces an "unknown" and represents a major risk to TNCs.³⁰ The "propensity for instability is reflected in [a nation's] form of government," he argued, enabling "an estimate of the probability of radical political change...by observation of this variable."³¹ Green has developed a seven-tier classification scheme of countries according to their degree of modernization and form of government. The more developed and modern a politico-economic system is, he concluded, the less likelihood there is of political risks (see Figure II.1).

Figure II.1: Green's Typology of Government Form and the Probability of Radical Political Change



Source: Reprinted from Robert T. Green, "Political Structure as a Predictor of Radical Political Change," Columbia Journal of World Business, 9 (Spring 1974). Copyright 1974 Columbia Journal of World Business.

The most significant contribution made by Green is his explicit use of works in the field of comparative politics and his effort to link risks with types of political systems. While typologies by nature are general, Green's classification may be relevant to certain political phenomena, but is far too simplistic to explain the complexity of political risks. One of his fundamental premises, moreover, that political instability "is generally the most significant form of political risk" and the cause of the "most dramatic, most common, most arbitrary actions"³² is erroneous. The "dramatic" nature of such occurrences, it would seem, mitigate against their being as common as Green contends. The risk of radical political changes is, in effect, one of the least likely political risks TNCs confront.

Green's model suffers from being too simplistic and, more importantly, not having a well conceptualized dependent variable. "Radical political change" is more a condition than a political risk, more a cause than an effect. The end point of Green's analysis is a political event which does not have clear meaning for any particular firm, rendering it useless in application. While political risks may or may not stem from a given political event, they are not the same as a political event.

The focus on instability is perhaps the most common theme running through the literature on political risk. Devising a measurement of instability is the centerpiece of the approaches to measuring political risk employed by Rummel and Heenan³³ and The Futures Group.³⁴ In neither instance is instability related directly to political risk in an empirically or theoretically sound manner. While these methodologies are more rigorous than Green's typology in

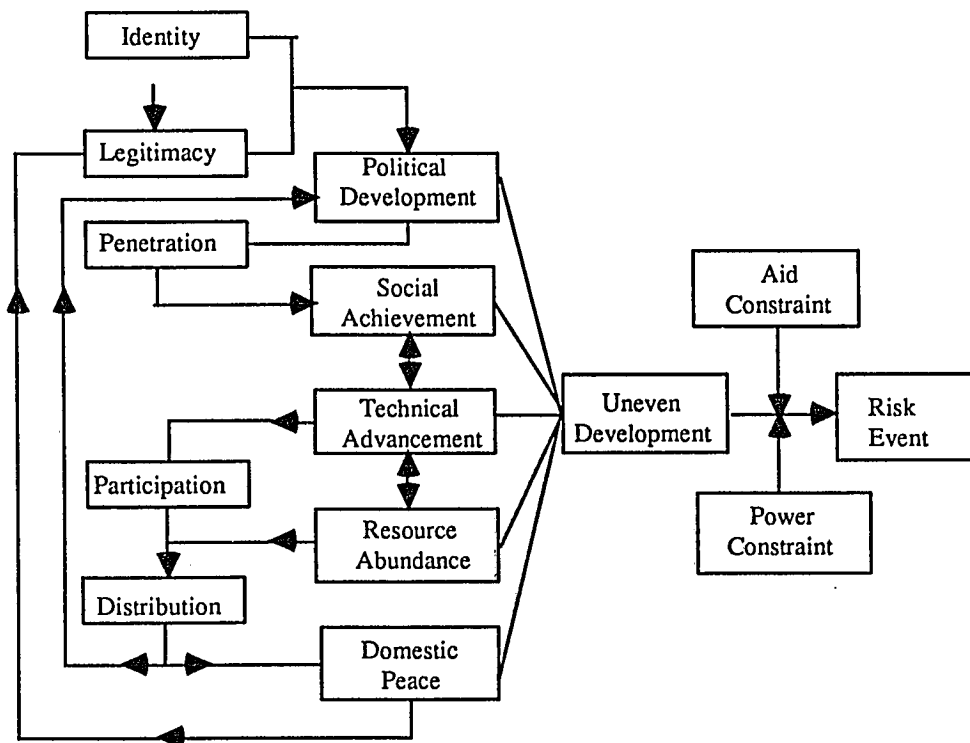
measuring instability, they share with Green the failure to focus explicitly on political risk as a discrete dependent variable.

Taking the instability argument one step further, Johnson has developed a model of political risk which looks at the degree of uneven development of states. Implicitly drawing upon the rich literature on development theory, particularly the five "crises" of identity, legitimacy, penetration, participation, and distribution³⁵ through which states must pass as they modernize, Johnson's model focuses on a five index measure of uneven development. Uneven development, however, is a "necessary but insufficient condition for high country risk":³⁶ the independent variable is mediated by an "aid constraint" and a "power constraint." The receipt of aid from the U.S. government, for example, is considered a moderating influence making recipient countries less likely to subject U.S. based firms to political risk. Similarly, Johnson argues, a host state must possess sufficient power if it is to be able to undertake actions which are adverse to the interests of TNCs and to withstand the subsequent pressures exerted by the foreign firms and their home governments. Johnson's model of political risk is portrayed in Figure II.2.

Impoverished, traditional societies and wealthy, mass consumption societies, he concludes, are least likely to be areas of political risk. Rather, it is the industrializing, rapidly changing states that Johnson identifies as the most risky group for foreign firms.

Johnson focuses exclusively on macro level indicators and expressly denies that risks are related to a specific firm or industry.³⁷ Given the data which indicate that certain industries are more likely to be vulnerable to political risks than firms in

Figure II.2: Johnson's Model of Political Risk



Source: Howard Johnson, Risk in Foreign Business Environments: A Framework for Thought and Management (Cambridge, MA: Arthur D. Little, 1980).

other sectors,³⁸ Johnson's purposeful ignoring of company characteristics seems unjustified. The argument that aid constrains recipient states, moreover, is subject to debate. Aid is as likely to prompt resentment and backlash on the part of host governments as it is to create docile regimes. Threats to withdraw aid over investment disputes between host governments and TNCs, as the U.S. learned in its futile efforts to "discipline" regimes that do not treat U.S. firms favorably, are almost certain to backfire. "Risk events," the dependent variable Johnson is trying to explain, moreover, are left undefined.

While Johnson's cost/benefit relationship indicated in his graphic depiction relating risks to stages of development is subject to question (see Figure II.3), it implicitly shares a premise with the arguments of this dissertation: political risks are a product of governments making rational decisions. Johnson, however, has abstracted government out of his model and misses the logical arguments which accompany any measurement of costs and benefits.

Another variant on the instability theme is presented by Haendel, West, and Meadow. They have developed a political system stability index (PSSI), based on empirical data, ranking Third World states. The PSSI is a measure of one of the various components that analysts may consider relevant to an assessment of political risk.³⁹ Haendel et al. argue for a components approach to political risk evaluation: the amorphous, unwieldy gross category of political risk needs to be disaggregated into specific measurable components. The components then can be "reaggregated in a form suitable to meet the particular needs of the political risk analyst."⁴⁰

Figure II.3: Johnson's Cost-Benefit Relationship Between Risk and Stages of Development

<u>Stages of Development</u>		<u>Intensity of Statecraft Problems</u>					
<u>Economic</u>	<u>Political</u>	<u>Cost-Benefit Relationship</u>	<u>Uneven Development</u>	<u>Power and Aid</u>	<u>Identity and Penetration</u>	<u>Legitimacy, Participation and Distribution</u>	<u>Probability of Risk Events</u>
Traditional	Politics of Unification	$C_{ne} < B_{ne}$	Low	Low	High	Low	Low
Preconditions		$C_{ne} \leq B_{ne}$					
Take-off	Politics of industrialization	$C_{ne} > B_{ne}$	High			High	High
Drive to maturity	Politics of industrialization	$C_{ne} < B_{ne}$					
	Politics of abundance	$C_{ne} \leq B_{ne}$					
Mass consumption		$C_{ne} < B_{ne}$	Low	High	Low	Low	Low

(Cost-benefit expressed in terms of actions with negative events for investors)

Source: Howard Johnson, Risk in Foreign Business Environments: A Framework for Thought and Management (Cambridge, MA: Arthur D. Little, 1980).

Haendel et al. offer a method by which a predictive model can be developed, paying only scant attention to the problem of understanding political risk. The focus on instability is justified in terms of the types of political risk insurance provided by OPIC (Overseas Private Investment Company) and the commercial rating scales popularized by Business International, Business Environment Rate Index, and others.⁴¹ There is neither a theoretical nor an empirical justification for the selection of the components which supposedly indicate political risks. Once again, the dependent variable is only vaguely related to the independent variables.

The authors expressly state that their model is not applicable to the "United States or developed states in general."⁴² This diminishes the utility of the PSSI as a tool in comparative risk analysis. More critical theoretically, Haendel et al. fail to justify the distinction between developed and developing states and why their model is appropriate to the latter but not the former. The model is not grounded in an analysis of the relationship between socio-political processes and political risks and falls back upon traditional biases which emphasize highly visible, impressionistic variables which typically are associated with less developed countries.

A number of analysts have presented and tested specific hypotheses with respect to political risk. One of the earliest examples of such a work is Truitt's study of expropriation. He advanced a series of hypotheses about a state's "propensity to expropriate," relating the probability of such actions to a series of host and investor variables.⁴³ Truitt's results were inconclusive, but his approach broke new ground in efforts to generate testable hypotheses about

political risk. As is typical of most subsequent empirical exercises in the field, Truitt's selection of a dependent variable is a mixed blessing. While expropriation is a far more specific, tangible result than an ethereal sense of an undifferentiated concept of political risk, it is the least likely, most dramatic political risk event to which a firm may fall prey. Measuring the likelihood that a company may lose all of its operating assets says little, if anything, about the possibility of that company being exposed to less sudden and partial losses.

Perhaps the dominant model employed in analyzing the host/firm relationship, although typically not in the context of political risk, is the bargaining framework. Vernon's "obsolescing bargain,"⁴⁴ in which the terms of an investment agreement are seen as undergoing a systematic shift over time in favor of the host state and against the interests of the TNCs, is the most frequently referenced example of the bargaining framework. The shifting terms of the "bargain" are a reflection of the inexorable changes in the respective needs and strengths of host and company: the former becomes increasingly less dependent on the latter, while the latter grows more vulnerable to the demands of the former.

The bargaining theme is prevalent throughout the literature on mineral economics and foreign investment. Leading works by Smith and Wells,⁴⁵ Mikesell,⁴⁶ and Moran⁴⁷ treat the bargaining model as the primary paradigm through which to analyze the relationship between host governments and transnational firms. The bargaining model, which is developed in detail in Chapter V, is an important part of the study

of political risk and is introduced by this dissertation as an intervening variable.

Reacting against the instability arguments and bargaining model, Jodice picks-up the tradition begun by Truitt and advances five specific hypotheses about expropriation. While the dependent variable is limited, it is clearly defined. The hypotheses are interrelated, yielding more insight than a single variable or string of unrelated hypotheses. Jodice's five hypotheses are:

1. There is "a curvilinear relationship between the modernity of the host country and the extent of expropriation of foreign direct investment in natural resource extraction."
2. "There is a positive and linear relationship between state capacity" (operationally defined as the ratio of central government revenues to GNP) "and the propensity to expropriate foreign investment in natural resource extraction."
3. "There is a positive and linear relationship between economic performance failure" (instability of export earnings) "and the extent of expropriation of FDI in natural resource extraction."
4. "There is a negative and linear relationship between government dependence on bilateral foreign aid from the U.S. and the extent of expropriation" (of American corporate assets).
5. "Controlling for the coercive disposition of the state, there is a linear and positive relationship between increases in the magnitude of political threat against governing elites and their propensity for expropriation."⁴⁸

Hypothesis one (1), which is similar to that presented by Howard Johnson, is not supported by the data. To the contrary, Jodice

concluded that there is a positive and linear relationship: "the propensity for nationalization increases with the economic development and administrative capacity of the host country."⁴⁹ Hypothesis number four (4) (which also is part of the Johnson model) is only weakly supported and may be more aptly described as a curvilinear relationship. Hypotheses two (2), three (3), and five (5) were the most strongly supported. While Jodice's hypotheses do not constitute a complete model of risk analysis, they do point toward salient questions and are derived from historical evidence. He explicitly treats expropriation, moreover, as a logical policy alternative for the state. Jodice's premises and data, however, have been subject to strong criticisms.⁵⁰

Given the political activity in which the oil industry has been engulfed over the past 15 years and the politically induced losses to which the TNOs have been subject, it is not surprising that some analysts have developed models of political risk in the specific context of the petroleum industry. Bunn & Mustafaoglu have structured an analytical framework relating a series of independent variables to a number of types of political risks (dependent variables). Ten "political risk events," outcomes which "would have a negative impact on the success of the venture," are determined by sets of "political risk factors," those "circumstances which influence the occurrence of a political risk event"⁵¹ (see Table II.3). They do not treat political risk events as discrete possible outcomes. Rather, they recognize the complexity of the political processes and the interrelationships between risk factors, citing the importance of cross impact probabilities between risk events.⁵² The incidence of certain

**Table II.3: Bunn and Mustafaoglu's Model
of Political Risk Events and Risk Factors**

Political Risk Event	Political Risk Factors
1. Civil disorder	1.1 Strength of economy 1.2 Aspiration levels 1.3 Continuity of leadership 1.4 Socioeconomic suppression 1.5 Political suppression 1.6 National coherence 1.7 Regime legitimacy 1.8 Government corruption 1.9 External support of resistance or liberation movements 1.10 Hostility toward home country 1.11 Visibility of foreigners
2. War	2.1 Ideological shift 2.2 Threat negation 2.3 Arms race 2.4 Negative sanctions
3. Sudden expropriation	3.1 Ideological change 3.2 Visibility of foreigners in economy 3.3 Colonial identification of firm 3.4 Demonstration effect 3.5 Marketing ability 3.6 Bureaucratic development 3.7 Availability of managerial and scientific technology 3.8 Relations with firm's parent country 3.9 Reciprocal dependence 3.10 Performance of economy
4. Creeping expropriation	4.1 Same as for number 3 above, but occurring over a longer period of time
5. Domestic price controls	5.1 Domestic inflation 5.2 Political support
6. Adverse tax changes	6.1 Ideological shift 6.2 Nonindustry tax revenues 6.3 Defense expenditures 6.4 Demonstration effect
7. Production restrictions	7.1 Large income effects 7.2 Investment absorption capacity 7.3 Conservation 7.4 Production regulation
8. Production export restrictions	8.1 Internal consumption 8.2 Participation in an embargo
9. Repatriation limitations	9.1 Balance of payments 9.2 Economic development
10. Devaluation risk	10.1 Balance of payments 10.2 Decline in reserve position 10.3 Internal inflation 10.4 Government policies that treat symptoms rather than causes 10.5 Economic-political policies 10.6 Economic ties

Source: Reprinted from D.W. Bunn and M.M. Mustafaoglu, "Forecasting Political Risk," Management Science, Volume 24, Number 15, November, 1978. Copyright 1978 The Institute of Management Services

events, in particular civil disorder and war, affect the likelihood of the occurrence of other political risk events.

By disaggregating political risk into more specific dependent variables, Bunn and Mustafaoglu are able to focus directly on the possibility of outcomes which carry meaningful, concrete results for TNOs. They recognize, moreover, the industry specific nature of political risks, a position they share with most analysts of political risk.⁵³ Bunn and Mustafaoglu do not, however, indicate how the risk factors they identify influence the probability of risk events. They leave that stage of the analysis to country experts, much the way that rating scales and many other methodologies rely on expert generated rather than empirical data. In effect, their framework is an analytical shell; listing potentially relevant variables, an exercise undertaken by many students of the field,⁵⁴ is useful and instructive, but only scratches the surface of the problem. Identifying the variables is an essential first step, but Bunn and Mustafaoglu fail to carry through to the logical, and substantive, conclusion of analyzing the relationships among the variables.

The ASPRO/SPAIR (Assessment of Probabilities/Subjective Probabilities Assigned to Investment Risks) methodology developed by Shell Oil also addresses political risk in the context of the oil industry. The premises and the dependent variables are explicit and focused:

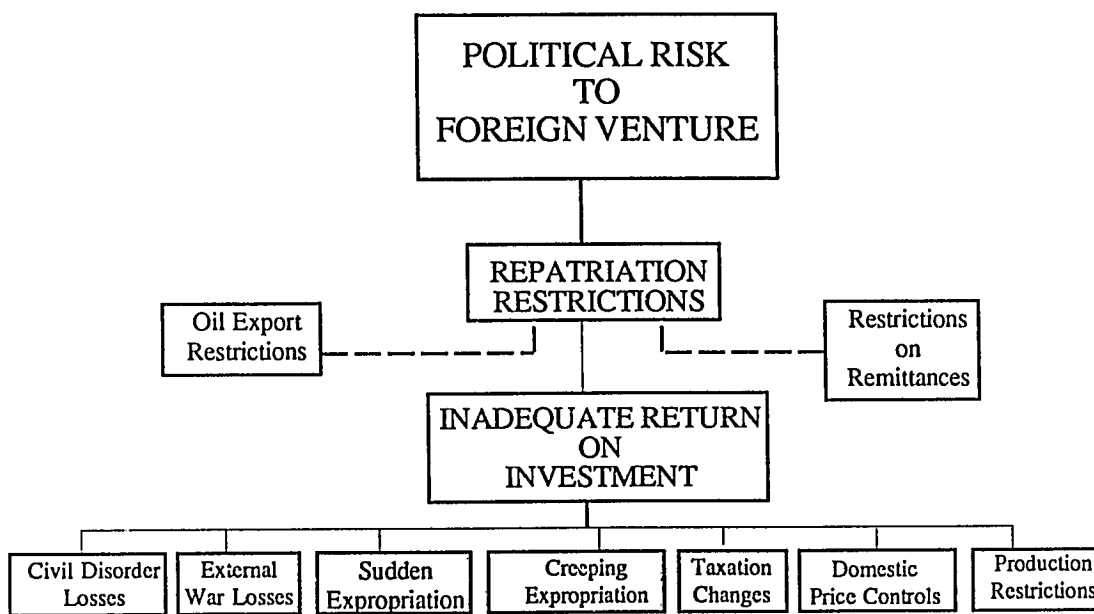
- o the oil firm has or is negotiating an agreement for the exploration and development of petroleum;
- o the contract is seen as fair by both firm and host;
- o the project will prove successful; and

o the amount of crude discovered will be sufficient to have a "significant economic impact" on the host for the next decade. Given these conditions, "political risk is defined as the probability of not maintaining the described contract during a 10-year time span in the face of changing economic and political circumstances."⁵⁵

ASPRO/SPAIR sees two general categories of political risks: unilateral government actions causing inadequate returns on investments in the host country and restrictions on the movement of oil or revenues out of the country.⁵⁶ These two classes of risks are divided into nine components (see Figure II.4). While the methodology of evaluating each component in light of alternative scenarios and the well defined parameters of the problem being investigated enables the tailoring of analyses to the particular conditions surrounding any given project, it does nothing to help us understand the nature of political risk. As is the case with Bunn and Mustafaoglu, ASPRO/SPAIR pays virtually no attention to the processes--be they political, economic, or social--which create political risks. The attention is paid to a methodological procedure of combining expert opinions about the probabilities of the occurrence of adverse changes, regardless of the dynamics and causes of those changes and events.

Reacting against the failure of most works in the field to look at the "political" in political risks, Brewer has recommended applying the models of political analysis to political risk.⁵⁷ These models, he suggests, point to potentially different sources of political risk. He has identified four models of political analysis relevant to the study of political risk:

Figure II.4: ASPRO/SPAIR Components of Political Risk



Source: Reprinted from C.A. Gebelein, C.F. Pearson, and M. Silbergh, "Assessing Political Risk of Oil Investment Ventures," Journal of Petroleum Technology, May 1978, pp.725-730. Copyright 1978, SPE-ATME.

- o the state-centric model of international politics, in which he assumes governments can best be seen as competing for power vis-a-vis each other;
- o the pluralist paradigm with the state responding to multiple conflicting interest groups;
- o the bureaucratic politics/organizational behavior model, seeing government actions as the product of organizational process and bureaucratic institutions; and
- o the transnational politics model, emphasizing the importance of non-governmental actors.

While it is refreshing to see an overt focus on political models for the understanding of political risk and Brewer's main point--that the various models point to different independent variables and processes--is well taken, the author states his point and drops it. Reminding us of an obvious conceptual puzzle, that what one sees is structured by how one looks, in a not-so-obvious context, Brewer makes no effort to clarify the relative advantages and disadvantages of the various models. He expands the scope of the problem, without venturing a solution. He seems to have lost sight, moreover, of the relevant unit of analysis: the particular political risk events or managerial contingencies with which TNCs are confronted.

Frost and Sullivan's "World Political Risk Forecast" (WPRF), developed by Coplin and O'Leary, employs a specific political model in evaluating political risks. Having identified the political risk events or issues to be forecast, the WPRF framework calls for the identifying of those political actors--decision makers, individuals, groups, institutions, or organizations--that will be important in

determining whether the event occurs. Each actor is scored in terms of "orientation" (for, against or neutral towards issue); "certainty" (of orientation); "power" (with respect to the relevant issue); and "salience" (or importance attributed to the issue) (see Figure II.5).⁵⁸

WPRF conceptualizes political risks, and all political events, as the product of the interaction of key political actors. Multiply the variables and add the scores to predict what will happen. The model borrows from the logic of decision making analysis in pluralist societies. It is questionable, however, whether the political processes function as "rationally" as WPRF implies.⁵⁹ It is politically jejune to think that political events can be forecast by a simple weighting of the influence various actors exercise upon an issue. The assumption that outcomes are simply the resultant of the influence exercised by political actors, moreover, is an erroneous conceptualization of the policy making/implementation process. Such a simplification flies in the face of political reality. Political decisions are not made in a vacuum; they occur in a complex social, political, and economic environment which WPRF takes into account only indirectly in terms of how this affects political actors. The WPRF model assumes a smooth, pluralistic political process⁶⁰ which is at best barely approximated in the liberal democracies and bears little resemblance to most of the political systems around the world.

Channon and Jallard's "Political Acceptability Profile" does not assume a particular political model, but is politically sensitive. Political risks should be evaluated, they claim, in light of the goals and interests of the host government, as "individual nation states

**Figure II.5: Frost and Sullivan
"World Political Risk Forecast"
Sample "Prince" Chart**

1. PRINCE CHART OF SUPPORT FOR OR OPPOSITION TO RESTRICTIONS ON INTERNATIONAL BUSINESS.

(An extremely certain supporter of restrictions would be an ideologically based actor which opposes all forms of international business; an extremely certain opponent of restrictions would welcome all foreign investment under extremely liberal conditions.)

nder extremely liberal conditions.)

ORIENTATION

+ Supports

N Neutral

- Opposes

CERTAINTY, POWER, SALIENCE

1 Little/None

2 Slight

3 Moderate

4 High

5 Extremely High

REVIEWER

Either indicate with a check you agree with estimate or forecast or make changes with a different color. You may also add actors

ACTOR

	ORIENTATION	CERTAINTY	POWER	SALIENCE	PRINCE SCORE
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	
	X	X	X	=	

Check the box above the number which best represents your estimate of the **CURRENT LEVELS OF RESTRICTIONS ON FOREIGN BUSINESS.**

0	1	2	3	4	5	6	7	8	9	10
Low Restrictions			Moderate Restrictions				High Restrictions			

Check the box above the number which best represents your estimate of the **LIKELIHOOD OF NEW RESTRICTIONS WITHIN THE NEXT 18 MONTHS.**

0	1	2	3	4	5	6	7	8	9	10
Very Unlikely		Unlikely		Uncertain		Likely		Very Likely		

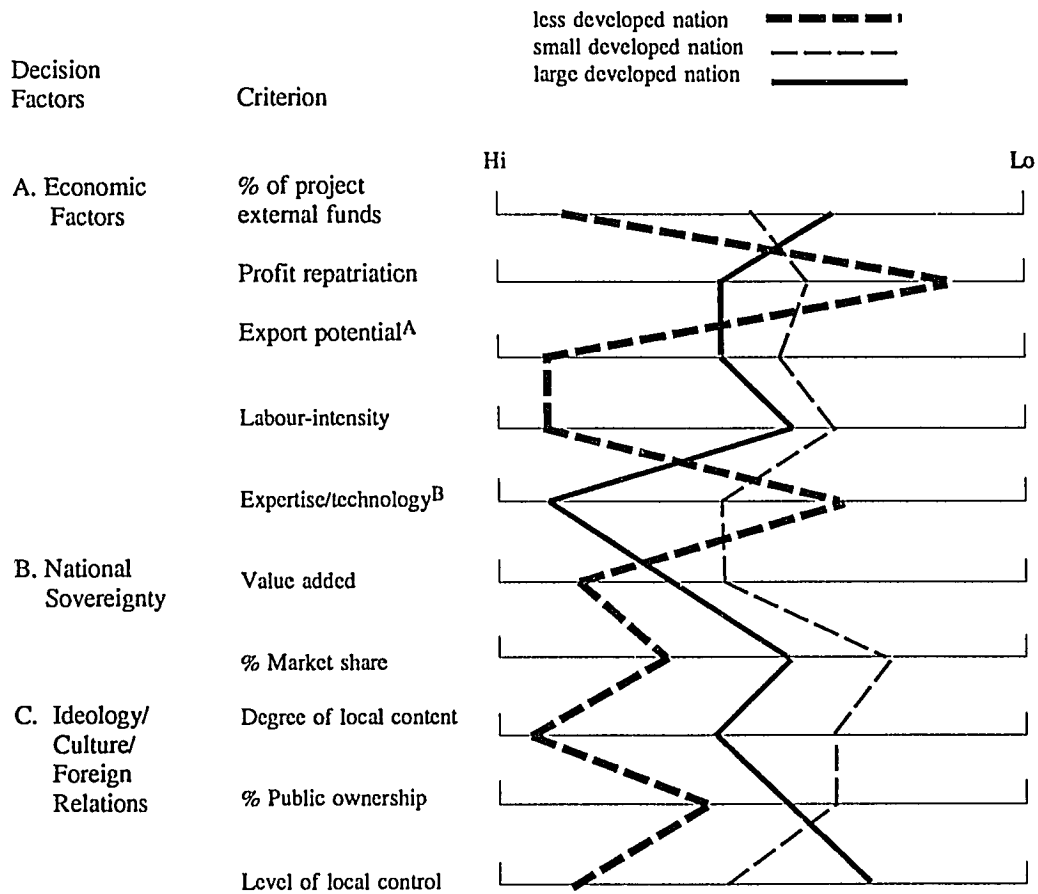
Source: Reprinted from Frost and Sullivan Inc. Copyright 1982.

will regard particular investments with more or less favour dependent upon their own goals."⁶¹ State goals with respect to foreign investment are operationalized in ten factors that are clustered into three categories: economic, national sovereignty, and ideology/culture/foreign relations. These variables can be plotted for a given host country and compared to the characteristics of a particular project (see Figure II.6).

The political acceptability profile lacks substantive political analysis, but at least implicitly states an assumption shared by this dissertation: other things being equal, the decision by political leaders to take actions which adversely affect TNCs often is a logical policy in light of the respective interests of host and firm. Jodice shares this perspective, concluding that "expropriation is a reasonable response to economic discontent which is directly linked to the operations of foreign firms in the national economy."⁶²

The focus on political risks as a policy response undertaken by government is evident in an earlier piece by Lloyd and in recent works by Poynter, Kobrin, and Lax. "Political risks," Lloyd remarks, "are primarily a reflection of the activity of governments,"⁶³ and Poynter speaks in terms of "government intervention risks," the probability of a "political decision" that forces a "change in the operations, policies, and strategies of the foreign investor."⁶⁴ Similarly, Kobrin, based on an empirical study of forced divestiture in which he moved beyond an undifferentiated notion of expropriation and identified four types of forced divestments, has stated that in the large majority of cases forced divestment is a means, not an end. It is "one of a number of policy options available to attempt to

**Figure II.6: Channon and Jallard's
Political Acceptability Profile**



^A Operationalized in terms of the percentage of profits that will be reinvested in the host country.

^B Operationalized in terms of whether the investment introduces new techniques and additional training of personnel.

Source: Reprinted from Derek F. Channon and Michael Jallard, Multinational Strategic Planning (New York: American Management Associations, 1978). Copyright 1978, by Amacom.

increase national control over foreign investors."⁶⁵ Kobrin, perhaps the most prolific author in the field of political risk, has been critical of the conceptual failures of many analysts.⁶⁶ Rather than focus on methodological sophistication, Kobrin feels that the field would be better served by developing an understanding of the nature of the problems TNCs face abroad. In particular, analysts should not lose sight of the relevant unit of analyses: "all potentially significant managerial contingencies that result from political events or processes."⁶⁷ "Political risks are contingencies arising from the political environment, not political events and processes per se."⁶⁸

Lax, writing about risks in the oil and gas industry, also sees political risks as stemming from policy initiatives by governments. "It is in policy changes that most political risks are rooted. From the host government's perspective, the petroleum industry is a policy tool that can be effectively used to pursue a number of goals, directly or indirectly. For the firm, this means the chronic presence of political risks."⁶⁹ Host governments have different interests with respect to petroleum issues than TNOs do.⁷⁰ The pursuit of state policy interests, Lax concludes, inherently pose political risks for foreign oil companies. This dissertation builds on these earlier works by Lax and assumes that political risks are the product of legitimate policy initiatives undertaken by host states. Taking this one step further, political risks are seen as inherent or structurally rooted in the host/firm relationship.

II.2 Political Risk and Instability: Developing and Developed States

Perhaps no simplification of political reality is as frequently

stated as the claim that political risks are mainly a result of instability and, therefore, political risks are greater, by definition, in developing as opposed to developed states. Instability often is left undefined and assumed to be a trait of Third World states. Instability, however defined and measured, moreover, bears at best an uncertain relationship with political risks: there have been numerous cases in which political instability has had no impact upon TNOC operations and in which TNOCs have been exposed to substantial political risks without the occurrence of antecedent instabilities. Similarly, while there are substantial differences between the political processes of developing and developed states, resource nationalism, nationalistic sentiments which focus on a country's mineral wealth, is as apparent in Canada, the United Kingdom, and Australia as any Third World state. While modern, Westernized states may appear more genteel and accommodating to foreign firms, they have proven themselves frequently willing to exercise the authority of the state against the interests of the TNOCs.

Political instability is not irrelevant to corporations operating abroad. At the very best, instability is the source of uncertainty and tension. At the very worst, political instability and disorder may manifest themselves in violence that interferes with corporate operations. Installations and personnel may be subject to attack or operations may be restricted. Oil fields are physically vulnerable to disruption, while pipelines are even more vulnerable than the fields. Often spanning hundreds or thousands of miles of uninhabited or sparsely populated areas, with most lines running above ground,

pipelines are easy, enticing targets for guerrilla groups. There are numerous instances of pipelines being the object of attack:

- o the Tripoli pipeline carrying Iraqi crude to northern Lebanon was bombed in January 1982, 10 days after it reopened following a five-year closure;
- o in April 1982, the same pipeline carrying Iraqi oil through Syria was shut by the Syrian government, which supported Iran in its war with Iraq;
- o the Guatemalan pipeline connecting the Rubelsanto field with the Caribbean was sabotaged in 1981; and
- o in December 1979, protestors in the Indian province of Assam seized the key pipeline in the region and subsequently forced the stoppage of all exploration and production in Assam and the closure of the Digboi refinery.⁷¹

In most instances, however, political instability has no real impact on TNOCs. Either the disorder and instability are short-lived or too insubstantial to affect oil firms or the problems are effectively contained by the host government. In any event, the foreign oil companies often are not targets of violence or acts of civil disorder.

While the Nigerian civil war did interrupt the flow of crude oil and left Shell, BP, and ERAP vulnerable to political losses--particularly ERAP, which supported the "wrong" side--the civil war in Angola did not interfere with Gulf's operations in Cabinda. Gulf paid the taxes and royalties provided for in the concession agreement to the socialist MPLA government, which enjoyed Soviet and Cuban support. Perhaps the gravest risks Gulf faced were the result of pressures

exerted by the Ford Administration to get Gulf to pay royalties and taxes to the U.S. backed FNLA/Unita coalition and the threat of U.S. intervention in the civil war. The "instability" in Angola, including the presence of Cuban troops, did not create specific political risks for Gulf; in fact, Cuban troops protected Gulf's installations.

Despite popular preoccupation with political instability, with its numerous definitions, as the root of corporate problems, there are numerous examples throughout the history of the international petroleum industry in which civil disorder and instability did not adversely affect TNOCs. The foreign oil firms operating in Mexico from 1910 to 1921 not only enjoyed bountiful profits in spite of the revolution, but perhaps because of it: during the years of political turmoil, the government was not able to raise taxes. As soon as the government stabilized in 1922, taxes were increased by some 50%.⁷² Coups d'etat were frequent occurrences in Iraq in the second half of the 1930s. While the IPC concessionaires (BP, CFP, Exxon, and Shell) were concerned about the frequent and sudden changes in government, the British presence in Iraq was strong and the changes, for the most part, had little impact on the concession. The only real threat to IPC was the 1941 coup d'etat by a pro-Nazi group.⁷³ Almost three decades later, the abrupt termination in 1969 of the 18 year reign of King Idris of Libya initially did not affect TNOC operations in Libya: the companies and their home governments were assured that the Libyan Revolutionary Command Council headed by Colonel Muammar Qaddafi would honor the existing agreements between Libya and the TNOCs.⁷⁴ Even in the context of the Iranian revolution, while domestic disorder did affect petroleum operations, the unilateral

decision to terminate the agreement with the Iran Oil Participants was not a radical break with the renegotiation discussions initiated by the Shah and the plans developed by the short-lived Bakhtiar government to limit further the role of foreign oil firms in Iran.⁷⁵ Most internal conflicts, which typically are considered the most severe form of instability, numerous exceptions notwithstanding, do not affect the flow of oil⁷⁶ or the operations of TNOCs.

Political instability and political risks typically are identified with developing countries. Vernon speaks of the "endemic condition of political instability" among Third World states⁷⁷ and melodramatically speaks of the risks which occur "when a foreign investor in raw materials takes the plunge into the dark and chilling waters of a less-developed country."⁷⁸ While admitting that political risks "occur to a greater or lesser extent in all countries,"⁷⁹ Lloyd contends that "the problems presented by political risks are usually associated with operating in less developed countries which tend to be renowned for their political instability."⁸⁰ And Moran alleges that natural resource firms can expect higher effective tax rates in LDCs, within eight to twelve years after the start of a project, than will be applicable in developed countries.⁸¹

The assumption that risks are greater in LDCs is confirmed by industry investments and exploration activities. Interviews with oil industry executives indicate that while a 15% discounted cash flow (DCF) might be acceptable in developed states, rates of less than 20% or 25% rarely are considered acceptable in a developing country.⁸² Exploration and development, accordingly, have been heavily concen-

trated in the developed countries,⁸³ despite the concentration of oil resources in the Third World: some 50% of the world's potential oil producing lands are in Africa, Latin America, and Southeast Asia, areas which have received only 5% of global investments in exploration and development.⁸⁴

Political instability often is a byproduct of modernization⁸⁵ and, as such, is a common condition among developing nations. There is a tendency on the part of Europeans and Americans, however, to judge other states by Western standards. Events are irregular and destabilizing only to the extent they "violate established role expectations in a given political system."⁸⁶ Events which are unusual by Western norms often are characterized as signs of disorder and political instability even if those events are common to the political culture and traditions of the host country.⁸⁷ Regardless of the merits of arguments that LDCs exhibit greater degrees of political instability than DCs, for our purposes the point is almost moot, as "there is a clear distinction between political instability and political risk:"⁸⁸ political instability is not the same as political risk.⁸⁹

The problem, to a large extent, is semantic. Because of the risky nature of exploration, the capital intensive nature of oil exploration and development, the "sunk," fixed nature of petroleum investments, and the long lead times in commencing production, generating income, and recovering costs, the stability and permanence of the investment regime is of vital importance to TNOCs. "An operating hydrocarbons project is a permanent hostage in the hands of the host government," leaving the oil firms highly vulnerable to

changes in the investment regime.⁹⁰ It is in terms of the stability, the continuity of the investment regime that TNOCs are concerned with "political stability." By instability, firms mean "the sense of arbitrary and unpredictable changes in host government "legal, regulatory, and administrative measures."⁹¹

By instability, the [transnational] companies do not necessarily mean political upheavals accompanied by changes in regime...much more important are those forms of instability that need not result from internal political upheavals: threats of political action, changes in conditions of operation such as ownership and remittance regulations, complex and drawn-out bureaucratic procedures, and more generally, the prospect of arbitrary and unpredictable alterations in the rules⁹² of the game after investment decisions have been made.

This distinction between instability in the investment regime and political instability is echoed by the Committee for Economic Development.⁹³

It is instability in the terms governing operations abroad that present serious political risks. Political instability in the form of civil disorder or violence is of only incidental concern, as such instability only rarely has an impact on TNOCs. Political instability is relevant to TNOCs only insofar as it leads to constraints on operations.⁹⁴ As political instability rarely is targeted against TNOCs, the real importance of political instability is its potential impact on policy changes.⁹⁵ It is policy changes, as such, with which firms need be concerned. It was not the political disorder, the violence in Iran's Islamic revolution that created political risks for the foreign oil firms operating in that country; rather, it was the changes in policy enacted by the new regime that affected the fate of the TNOCs.

The occurrence of political risk events in states, both developed and developing, without any antecedent instabilities further reveals the shortcomings of concentrating on instability as the cause of political risk. Most political risks are not accompanied or preceded by political instability, including such risk events as:

- o changes in the petroleum taxation regime imposed by the British Parliament and Norwegian Storting in the 1974-1982 period;
- o the Venezuelan nationalization of Exxon's operations in 1976;
- o the Libyan production cut-backs of 1980;
- o the forced relinquishment of territorial rights held by and harsher tax regime imposed on Dansk Undergrounds Consortium (AP Moller, Shell, Chevron, and Texaco) by the Danish government;
- o Indonesia's refusal to renew Atlantic Richfield's production sharing agreement in 1982; and
- o the implementation of Canada's 1980 National Energy Program.

"If Canada can be classified as a country where there is a high political risk," lamented The Times of London, "it does not leave much hope for the rest of the world."⁹⁶ The implicit assumption that developed, Western, politically stable states do not present the threat of political risks belies a prejudice against Third World states and misperceptions about the nature of political risks. There are, in general, differences between developed and developing states which might be associated with a varying likelihood of political risk. Some of the differences, however, are perceptual on the part of the companies,⁹⁷ while in some instances the differences may indicate a greater possibility of certain types of risks in developed countries. It can be argued, for example, that developing countries

are more likely to channel demands through the government than the market;⁹⁸ do not share the dominant capitalist philosophy prevalent among developed states;⁹⁹ are less restrained by domestic industrial interests limiting intervention in the market;¹⁰⁰ and "place higher values on the goals of national sovereignty and economic development than on a rigid adherence to Western concepts of property and contract."¹⁰¹ With equal validity, however, it merits being pointed out that the "validity" of tax increases implemented by Norway and Britain have not been questioned as critically as tax changes in developing states;¹⁰² the best examples of neo-mercantilist policies, supported by strong rather than weak national bureaucracies, are Japan and Western Europe;¹⁰³ Western states recognize as legal the principles of eminent domain and the right of the government to expropriate private property; and democracy increases the scope and number of demands placed upon a government and may stimulate increased government intervention in the market.¹⁰⁴ Perhaps the real distinction between developed and developing states is that "the more developed the nation, the more subtle the methods. The net result, however, is still a takeover"¹⁰⁵ or some other constraint on corporate operations.

This is not to say that developed and developing states are the same. The Third World is far more heterogeneous than the developed nations: Switzerland, with the highest per capita income among the industrialized market economies, has a per capita income three times that of Ireland, which has the lowest individual income among these states; even ignoring the oil exporters, Singapore's per capita income is more than 28 times that of Bangladesh's.¹⁰⁶ Developed nations, by

definition, are more likely to have their own TNCs, making their governments more familiar with large corporations and sensitive to the possible risks facing their TNCs operating abroad.

Besides the common traditions and Western values shared by developed states, these countries tend to have well-institutionalized political structures and processes. The oil companies understand and are able to work with the political processes in these states. TNOCs know how to mount publicity campaigns for and against government policies in Western states and how to lobby government decision makers. Developed states, moreover, have better developed interest groups, with which TNOCs can cooperate to aggregate and articulate industry interests, thus increasing their ability to influence government policy.¹⁰⁷ These activities, all of which are common to Western democratic traditions in the market economy states, have been used by U.S. oil firms in the United Kingdom, for example. To register their dissatisfaction with the Supplementary Petroleum Duty (SPD) imposed by the British government in March 1981, for instance, U.S. oil firms worked with the two leading British oil industry interest groups, the United Kingdom Offshore Operators Association (UKOOA) and the Association of British Independent Oil Companies (Brindex) in their efforts to change the national oil regime in the North Sea.

In contrast to the ability of oil companies to participate in the political processes of the Western democracies, Third World states usually have less well developed political structures and channels for companies to influence political decisions. The often restricted nature and circulation of the press and other media limit publicity

efforts, and similar problems confront lobbying efforts. Most developing countries are not elected democracies. These regimes often are highly personalized and lack domestic legislative and democratic traditions. Coping with government by fiat presents many difficulties to oil companies, as both currying and failing to curry political favor with such regimes might lead to political risks.

These rejoinders aside, political risks are not the exclusive or even primary domain of developing states; nor is political instability the most relevant type of political risk. Rather, political risks stem from policy changes, which might or might not involve a measure of political instability and which occur in both developed and developing states.

Notes to Chapter II

¹See Prast and Lax, "Political Risk."

²See, for example, Aharoni; Robert B. Stobaugh, Jr., "How to Analyze Foreign Investment Climates," Harvard Business Review, 47 (1969); and Franklin R. Root, "U.S. Business Abroad and Political Risks," MSU Business Topics, (1968).

³The ensuing discussion of problems in the study of political risk and the review of the literature draw heavily on Lax, Political Risks, pp. 109-148.

⁴See, for example, Herman Kahn, William Brown and Leon Martel, The Next 200 Years (New York: William Morrow, 1976); Mihajlo Mesarovic and Edward Pestel, Mankind at the Turning Point: The Second Report of the Club of Rome (New York: E.P. Hutton, 1974); and Paul Hawken, James Ogilvy, and Peter Schwartz, Seven Tomorrows (New York: Bantam Books, 1982).

⁵Jeffrey D. Simon, "Political Risk Assessment: Past Trends and Future Prospects," Columbia Journal of World Business, xvii (1982), p.62.

⁶Warnock Davies, "Unsticking the State of the Art of Political Risk Management," Sloan Management Review, 22 (1981), p.59.

⁷See, for example, Harry G. Johnson, "The Efficiency and Welfare Implications of the International Corporation," in the International Corporation: A Symposium, ed., Charles P. Kindleberger (Cambridge, MA: MIT Press, 1970); Lester B. Pearson, Partners in Development (New York: Praeger, 1969); Herbert K. May, The Contributions of U.S. Private Investment to Latin America's Growth (New York: The Council for Latin America, 1970); and Global Companies: The Political Economy of World Business, ed., George W. Ball (Englewood Cliffs, NJ: Prentice-Hall, 1975).

⁸See, for example, Michael Tanzer, Race for Resources (New York: Monthly Review, 1980); Mike Faber and Roland Brown, "Changing the Rules of the Game: Political Risk, Instability, and Fair Play in Mineral Concession Contracts," Third World Quarterly, II (1980); Harry Magdoff, The Age of Imperialism (New York: Monthly Review, 1969); and Stephen Hymer, The Multinational Corporation: A Radical Approach, ed., Robert Cohen et al. (London: Cambridge University Press, 1979).

⁹See, for example, Gilpin; Johan Galtung, "Power and Global Planning and Resource Management," in Global Planning and Resource Management, ed., Anthony J. Dolman (New York: Pergamon, 1980); and World System Structure, eds., W. Ladd Hollist and James N. Rosenau (Beverly Hills: Sage Publications, 1981).

¹⁰See, for example, William Stoeber, Renegotiations in International Business Transactions (Lexington, MA: D.C. Heath, 1981); T.H. Moran, Multinational Corporations and the Politics of Dependence: Copper in Chile (Princeton, NJ: Princeton University Press, 1974); Raymond F. Mikesell et al., Foreign Investment in the Petroleum and Mineral Industries (Baltimore: The Johns Hopkins University Press/Resources for the Future, 1971); Raymond Vernon, Sovereignty at Bay (New York: Basic Books, 1971); and Gladwin and Walter.

¹¹Moran effectively makes this point.

¹²Aharoni, p.95.

¹³Aharoni, p.95.

¹⁴Root, pp.78-80.

¹⁵Root, p.75.

¹⁶Stobaugh, pp.101-103.

¹⁷Draws on Simon and Kobrin, "Political Assessment."

¹⁸Stobaugh, p.101.

¹⁹The problems encountered in quantification are significant. See Lax, Political Risk, pp.125-127.

²⁰R.J. Rummel and David A. Heenan, "How Multinationals Analyze Political Risk," Harvard Business Review, 56 (1978), p.72.

²¹Business International, p.86.

²²Stefan H. Robock, "Political Risk: Identification and Assessment," Columbia Journal of World Business, xi (1971), p.7.

²³Robock, p.8.

²⁴Robock, pp.9-10.

²⁵Robock, p.7.

²⁶Simon, p.64.

²⁷Jean Boddewyn and Etienne F. Gracco, "The Political Game in World Business," Columbia Journal of World Business, vii (1973), p.47.

²⁸Boddewyn and Gracco, pp.47-48.

²⁹See, for example, J. Frederick Truitt, Expropriation of Private Foreign Investment (Bloomington, IN: Indiana University Press, 1974), pp.49-50.

- ³⁰Robert T. Green, "Political Structures as a Predictor of Radical Political Change," Columbia Journal of World Business, ix (1974), p.29.
- ³¹Green, p.29.
- ³²Robert T. Green and Christopher M. Korth, "Political Instability and the Foreign Investor," California Management Review, xvii (1974), p.23.
- ³³Rummel and Heenan.
- ³⁴The Futures Group, Glastonbury, CT.
- ³⁵See Leonard Binder, James S. Coleman, Joseph La Palombara, Lucian W. Pye, Sydney Verba, and Myron Weiner, Crisis and Sequence in Political Development (Princeton, NJ: Princeton University Press, 1971).
- ³⁶Howard Johnson, Risk in Foreign Business Environments (Cambridge, MA: A.D. Little, 1980), p.10.
- ³⁷Howard Johnson, p.6.
- ³⁸See, for example, Truitt; Kobrin, "Foreign Enterprise;" and Stephen Blank, Assessing the Political Environment: An Emerging Function in International Companies (New York: The Conference Board, 1980).
- ³⁹Dan Haendel, Robert G. Meadows, and Gerald T. West, Overseas Investment and Political Risk (Philadelphia: Foreign Policy Research Institute, 1975), p.74.
- ⁴⁰Haendel et al., Overseas, p.58.
- ⁴¹Haendel et al., Overseas, p.61.
- ⁴²Haendel et al., Overseas, p.67.
- ⁴³Truitt, pp.35-51.
- ⁴⁴Vernon, Sovereignty, p.46.
- ⁴⁵David N. Smith and Louis T. Wells, Jr., Negotiating Third-World Mineral Agreements (Cambridge, MA: Ballinger, 1975).
- ⁴⁶Mikesell et al.
- ⁴⁷Moran, Multinational.
- ⁴⁸David A. Jodice, "Sources of Change in Third World Regimes for Foreign Direct Investment, 1968-1976," International Organization, 34 (1980), pp.189-198.

- ⁶⁹Lax, Political Risk, p.104.

- ⁷⁰Lax, "Natural;" and Lax, Political Risk, p.38.
- ⁷¹Lax, Political Risk, pp.97-98.
- ⁷²George Philip, Oil and Politics in Latin America (London: Cambridge University Press, 1982), pp.16-17.
- ⁷³Leonard Mosley, Power Play (Baltimore: Penguin Books, 1973), pp.125-131.
- ⁷⁴Weisberg, p.38.
- ⁷⁵Shaul Bakhash, The Politics of Oil and Revolution in Iran (Washington, D.C.: The Brookings Institution, 1982), pp.6-7.
- ⁷⁶Rustow, Oil, p.207.
- ⁷⁷Vernon, Sovereignty, p.260.
- ⁷⁸Vernon, Sovereignty, p.46.
- ⁷⁹Lloyd, p.53.
- ⁸⁰Lloyd, p.3.
- ⁸¹T.H. Moran, "Overview: International Political Risk Assessment," in "International Political Risk Assessment: The State of the Art" (Washington, D.C.: Georgetown University Press, 1981), p.4.
- ⁸²Hossain, p.68.
- ⁸³Hossain, p.67.
- ⁸⁴North-South: A Program for Survival. The Report of the Independent Commission on International Development Issues (Brandt Commission) (Cambridge, MA: MIT Press, 1980), p.75.
- ⁸⁵See, Apter; Moran, International Political; and Samuel P. Huntington, Political Order in Changing Societies (New Haven: Yale University Press, 1968).
- ⁸⁶Stephen Kobrin, "When Does Political Instability Result in Increased Investment Risk?" Columbia Journal of World Business, xiii (1978), p.120.
- ⁸⁷Thunell, p.12.
- ⁸⁸Kobrin, Managing, p.36.
- ⁸⁹Kobrin, "When," p.114; and Joseph V. Micallef, "Political Risk Assessment," Columbia Journal of World Business, xvi (1981), p.48.
- ⁹⁰Lax, Political Risk, p.147.

- ⁹¹Committee for Economic Development, p.3.
- ⁹²Frank, p.26.
- ⁹³Committee for Economic Development, p.25.
- ⁹⁴Kobrin, "When," p.115.
- ⁹⁵Kobrin, Managing, p.28.
- ⁹⁶The Times (London), 10 February 1981.
- ⁹⁷Lax, Political Risk, p.36.
- ⁹⁸Stoever, Renegotiations, p.10.
- ⁹⁹Spero, p.120.
- ¹⁰⁰Merrie G. Klapp, "The State--Landlord or Entrepreneur?" International Organization, 36 (1982), p.603.
- ¹⁰¹Stoever, Renegotiations, p.322.
- ¹⁰²Faber and Brown, p.112.
- ¹⁰³Eells, p.96.
- ¹⁰⁴Michael Hodges, Multinational Corporation and National Government (Lexington, MA: D.C. Heath, 1974), p.7.
- ¹⁰⁵Don R. Beeman and Sherman A. Timmins, "Who Are the Villains in International Business?" Business Horizons, 82, No.5 (1982), pp.7-10.
- ¹⁰⁶Committee for Economic Development, p.18.
- ¹⁰⁷Lax, Political Risk, p.35.

III. THE RELATIONSHIP BETWEEN HOST STATE AND THE TNC

There are three primary approaches to the analysis of the relationship between the TNC and the state. Both the radical and globalist approaches see the state and the TNC as antagonists, the former as a critic of the corporation, and the latter as a critic of the state. Between these extremes is the liberal or traditional approach, in which the state and the firm are conceptualized as complementary institutions, one political, one economic. The liberal model, which is the dominant approach in the West, especially in the U.S., sees the relationship as cooperative.

Without adopting the normative perspective of either the radical or globalist schools, Section III.1 presents the argument for positing that the structure of the relationship between host state and TNC gives rise to inherent conflicts between the actors. These structurally determined differences manifest themselves in conflicting interests and issue hierarchies, which are analyzed in Section III.2.

Because of the inherent differences between host state and firm, the two actors pursue contradictory interests and goals. The pre-modern host state, with its focus on solidifying power and private enrichment, is compatible with the TNC. The modern host state, however, has interests that are inherently antagonistic to the TNC. As the host pursues its interests and progresses along its issue hierarchy, it increasingly conflicts with the TNC.

The degree of conflict, however, is mediated by economic and political conditions that typically necessitate some degree of collaboration between host and firm. While their long-term goals are mutually exclusive, day-to-day interests often are compatible,

particularly when other parties are involved. While purely conflictual in the abstract, market and economic conditions dictate a host/firm relationship with a mixture of conflict, cooperation, and reluctant collaboration.

III.I. The Structural Setting and the Roots of Conflict

There are three primary schools of thought, with numerous variations, on the relationship between the TNC and the state. These will be referred to as the globalist, radical, and liberal or traditional paradigms. The first is highly critical of the state as an outmoded form of interference with the globalizing influences and scope of the TNC; the second sees the TNC as the instrument of the dominant states in the exercise of some form of imperialism; and the third framework continues to adhere to the position that the TNC and the state are complementary institutions, the former being a leading force in the market, the latter being the primary political unit.

Globalists are advocates of the TNC. They see the transnational firm as filling a void in the international system and moving beyond the limited capacity and perspective of the state. One reason cited for the emergence of the TNC, in fact, is the inability of the state to deal with world economic problems.¹ Problems increasingly are global not national, this argument runs, exceeding the capacity for territorially defined states to resolve such problems and manage the system. As the only entities which treat the world as a single unit and have a system-wide perspective, they continue, TNCs represent the most viable solution to system-wide problems.²

In the globalist framework the TNC is politically "neutral," being governed by laws of economic efficiency, not politics. The TNC is

considered a unifying force that can overcome the centrifugal political forces that stem from a fragmented international system of states. "The multinational corporation is, beyond doubt, the most powerful agency for regional and global economic unity that our century has produced,"³ the globalist argues. National currencies and exchange rates, and even the state itself, are seen as anachronisms.⁴ To the globalist, the state is a counterproductive throw-back that should, indeed must, give way to the world citizenship of TNCs.⁵

Globalists see TNCs as resolving the squabbles between petty state interests but fail to appreciate the obvious: TNCs also have interests of their own which they strive to promote. There is no reason to assume that corporate interests are any "better" than national interests. At least the latter have a claim to legitimacy stemming from the sovereignty of the state. The former can appeal to the principles of capitalism and claims to serving global interests in economic efficiency, but these are thin veils for the private interests of the firm. "International firms, including the oil companies, have not yet found a way of operating in the modern world which would make them generally acceptable as truly international institutions."⁶ True, the TNC has system-wide objectives.⁷ The pursuit of policies of global maximization of corporate interests, primarily defined in terms of profits, however, is not the equivalent of pursuing a global social welfare function in the interests of all peoples in all countries.

The radical perspective, on the other hand, is highly critical of TNCs. This approach typically equates the corporation with the home state⁸ or at least the capitalist class of the home state. In the

radical paradigm the TNC is subsumed within and seen as an agent of the home government.⁹ The TNC is pictured as a "capitalist tool," a neo-imperialist extension of the dominant states in the world capitalist system.¹⁰ The TNC is considered the modern vehicle of economic imperialism.

Much of the radical critique focuses on the natural resources sector and the importance of the mineral wealth of developing countries. "Since minerals are a key to economic and military power (which are obviously interrelated), the most powerful countries of the capitalist world normally have to control a large share of the mineral industries."¹¹ The term radical critics typically employ to characterize the relationship between home state and TNCs is "symbiotic."¹² In the radical framework, the TNC is a projection of the state, the means by which the center manipulates the world economy and controls (and exploits) the periphery.

The relationship between the home government and the TNCs is "a subtle and changing one," however, in which the companies are not simply an extension of the government and not all firms have the same interests or strategies as the government.¹³ Transnational corporate interests, by definition, reach beyond the home state, thus reducing the degree to which firms identify with the interests of the home government.¹⁴ Even the United Nations recognizes that corporate interests are not necessarily the same as home government interests.¹⁵ The home government is both nuisance and necessity to the firm; the TNC both contributes to national power and frustrates national policy.¹⁶ This is not to say that there are not broad areas of shared interests between firm and home state. Neither, however, is

the tool of the other, even though both try to, and are able to, exercise a measure of influence over the other.

TNCs neither direct nor serve their home governments.¹⁷ The TNC and its home government influence each other and share some common objectives, much the same as the U.S. and its allies. And like political allies, home governments and TNCs have numerous differences in interests, priorities and tactics. Corporate resources are expended in pursuit of corporate interests. At times, corporate energies coincide with home government policies; at times they do not. There is a "lack of intrinsic relationships" between the TNC and any state.¹⁸ For example, "whereas previously the charge by the oil producers was that the companies were instruments of U.S. foreign policy, the new one from another camp holds that they have become tools of the oil-producing states."¹⁹ There is no contradiction or apostasy in corporate actions, only myopia on the part of critics on both sides of the fence: "In the face of increased profits, [the TNC] will serve any country holding out the promise of its survival."²⁰ The TNC is faithful unto itself. Like the state, the TNC chooses "allies" and sides with those actors whose cooperation is most important to its success.

Between these extremes--the globalists representing free trade laissez-faire purists, the radicals including an assortment of structuralists, dependency theorists, and Marxists--is the liberal paradigm. The liberal or traditional perspective is the dominant school of thought in the West, particularly in the U.S., be it on the relationship between the TNC and the state or on other issues of international affairs.

Reared in the intellectual tradition discussed in the opening pages of Chapter One, the liberal approach continues to draw a sharp distinction between economics and politics.²¹ In the liberal eye, TNCs are economic and commercial entities which have no or minimal impact on political events. This group sympathizes with the plight of supposedly politically impotent commercial units trying to stay clear of political interferences and sees TNCs as playing a constructive role in the world economy. They do not, however, think it is the role of the TNC to address global political problems, nor do they see TNCs as powerful enough to deal with such issues. Liberals are sharply critical, moreover, of corporate involvement in political affairs abroad and interference in the domestic life of host states. The liberal framework has high standards of good corporate citizenship.

The liberal framework is concerned about allegations of imperialism and exploitation and reports of corporate "foul-play." But incidents of such behavior are taken to be the exception, not the rule. In the context of the transnational oil companies, the liberal mind identifies with the "corporate thinking [that] perceives a distinct economic function...that of carrying on the tasks of exploring, producing, transporting, refining, and marketing oil and, in the process, of balancing world supply with demand."²² TNOCs are portrayed as--or are supposed to be--non-political buffers between importing and exporting governments²³ that too often get caught as the "monkeys in the middle."²⁴

While the globalist and radical perspectives come from opposite ends of the political spectrum, they share a theme in their vision of the relationship between TNC and host state as conflictual. The

dominant, liberal framework, on the other hand, views the two actors as complementary institutions which have both shared interests and manageable differences.²⁵ The overall theme of this approach is the opportunity for mutual benefits based on cooperation. Conflicts of interest are resolvable through collaborative efforts aimed at shared goals.

The liberal approach typically assumes the primacy of the state is unthreatened by TNCs. Sovereignty is distinguished from autonomy: the former is considered "the formal ability of countries or other political units to make their own decisions--and to renounce decisions previously made--but not necessarily to achieve those objectives, while the latter is addressed as "the ability to frame and carry out objectives of domestic economic policy which may diverge widely from those of other countries."²⁶ This implicitly draws a distinction between politics and economics. TNCs are seen as restricting autonomy, in that the marketplace and economic forces are constraints on the states, but having no impact on sovereignty.

In the liberal model, TNCs are wielders of influence but not power, the "ability, in a specific situation, to translate resources into capability to compel a settlement of an objective conflict in terms favorable to the actor."²⁷ (emphasis in original) It "is power that inspires" the state and "the concept of sovereignty in international relations."²⁸ To the extent there is corporate economic dominance, the liberal argument continues, this does not necessarily "mean the removal of decision making from national control," as the host retains restrictive and regulatory authority.²⁹ With the exception that the government cannot obtain

technology and managerial skills from the TNC on terms unrewarding to the company, which would violate the logic of the marketplace, the liberal approach insists that government policies and interests can prevail over those of foreign firms.³⁰ Reflecting upon the oil sector, the liberal conclusion is that "national sovereignty has prevailed over corporate power," and "nation-states have always dominated the structure of the petroleum industry in one way or another."³¹

The liberal approach admits to "a wide scope for substantial conflicts of interests between firms and governments."³² Conflict is recognized as unavoidable,³³ even endemic to the relationship.³⁴ But this is considered a "complementary conflict" which stems from the different functions performed by government and TNC, rather than a "duplicative conflict" representing a zero-sum struggle based on similarity of function.³⁵ The relationship is considered variable-sum, with each actor having an interest in the survival of the other and their differences mitigated by differences in function.³⁶ In the liberal paradigm, TNC and state not only can work together, they need each other. While these "two powerful systems...respond to different principles" and "operate in different dimensions," they neither can nor want to displace each other.³⁷ In the liberal model, conflict between host and firm "is incidental to each institution's performance of its respective functions, and the conflict between the institutions is limited by their differences in functions."³⁸

Despite their differences, the liberal continues, host state and TNC share broad areas of mutual interests. "Corporate and national goals are not identical. However, the fact that they are different

does not imply that they are necessarily conflicting. On the contrary, many of the goals of transnationals are fully compatible with those of the (developing) nations in which they operate.³⁹ To the extent the two institutions have conflicting interests, the liberal framework believes that the conflict can be managed and amicably resolved. The focus is on so-called "joint maximizing solutions"⁴⁰ which provide the best attainable mix of satisfaction for both parties. Or the problem is stated in terms of a need for both parties to take a long-term view of mutual positive gains instead of seeking short-term maximization, which engenders antagonism.⁴¹ Conflicts can be resolved by first reducing the range of conflict by a definition of interests and then negotiating the "residual conflict" based on the power relationship between state and TNC.⁴² In this way, the liberal argument concludes, the actors can get away from the "misconceived range" to the "true" or "valid scope" of conflict defined by interests.⁴³

From the companies' point of view, the liberal advice is to try to "depoliticize" itself while remaining responsive to host country needs.⁴⁴ This strategy also has been dubbed "political adaptation."⁴⁵ The liberal preference is for a "legal" or contractual rather than political relationship. The aim of the "legal framework" is "to provide a basis which sufficiently safeguards the interests of each to provide a mutually acceptable basis for collaboration."⁴⁶

The host governments, on the other hand, the traditional argument continues, "have come to realize that transnationals can have a spectrum of efforts and that the task of policy is to maximize beneficial effects and to minimize detrimental effects."⁴⁷ "For host country governments, the real issues are how to provide an environment in which

transnational corporations can contribute to national goals while minimizing costs and maximizing the benefits of private investment."⁴⁸ The government needs "to reconcile" the potentially contradictory forces pulling in favor of domestic control and autonomy on the one hand and the gains from corporate activities on the other.⁴⁹ The host government's position is pictured as one of balancing the pros and the cons and making decisions which entail trade-offs between different domestic policy interests.⁵⁰

Host governments have control over access to their economies.⁵¹ The government enjoys the unquestioned prerogative of limiting investments by TNCs and regulating the range of their activities.⁵² Conversely, it is recognized that TNCs cannot be compelled to invest in a given country; they must be induced.⁵³ Governments must try, the liberal asserts, to attract investment while "harness(ing) it to their goals."⁵⁴ The entire relationship is conceptualized in the traditional framework as competitive but collaborative, taking place in an environment of manageable conflicts against a backdrop of broad shared interests and reconcilable differences. TNC and host state are considered complementary institutions which provide mutual reinforcement.⁵⁵ In the liberal paradigm, differences in objectives and goals of TNC and host state are seen as ephemeral, the core relationship as cooperative.

Statements made by advocates of the liberal framework, such as "governments, in the self-interest of their countries, can thus be expected to take action to blunt the negative consequences of MNC activities and to foster positive consequences"⁵⁶ or contentions that the tension between host and TNC stems from "incompatible attitudinal

orientations"⁵⁷ or are rooted in history,⁵⁸ totally miss the inherent dynamic of the relationship between host state and transnational firm. The host/TNC relationship rotates on an axis of inherent differences and conflicting interests. While often below the surface, these differences, moreover, are structurally rooted in the respective roles both entities play in the international system and in the domestic life of each country. This structural conflict gives rise to divergent interests and issue hierarchies on the part of state and TNC and is the cause of political risks. Economic and political conditions and the needs of host and state, however, dictate that the natural conflict usually remains below the surface, where the two players interact on a practical basis of dealing with each other.

The state is a territorially defined unit with a given institutional structure and which enjoys the prerogatives of sovereignty. States are legally equal entities. The state is sovereign unto itself and is recognized as the most authoritative political unit in the international system. Simultaneously, the state is the primary socio-economic unit in the world system. The state recognizes no other legitimate authority with respect to its internal affairs and recognizes no superior political unit.

The transnational corporation is neither territorially defined nor sovereign. By definition, TNCs operate in many countries, with each operation subject to the authority of the sovereign state within which it operates. The TNC is perhaps best described in terms of its functional reach, across multiple jurisdictions, in the ownership, management, production, distribution, and marketing of goods and services.⁵⁹ While there may be differences between parent company

and subsidiary,⁶⁰ the TNC is an interdependent whole within which the parent firm seeks to maximize "the sum of the values of the international activities under its control."⁶¹

As complex as the inter-relationships between home state, TNC, and host state are, the transnational firm is best conceptualized as an autonomous actor pursuing self-defined interests within the constraints and opportunities presented by the international system, its home government, and host regimes. The transnational company is autonomous in that it does not execute orders or policies on behalf of another body; rather, it makes its own policies and decisions.⁶² TNCs "are autonomous in the sense that they are effectively accountable to no outside body for their actions, although they are constrained by the policies of governments, by the actions of competitors, by the demands of the financial markets, and by similar considerations."⁶³

The world is a patchwork of states, each a sovereign entity. The mere existence of transnational companies which operate in multiple sovereignties but are not subject to the control of any one is antithetical to the concept of the state. "The fact that big business alone has discovered the institutional form required to move freely without being tied by national boundaries has wrought a fundamental change in the balance of power between industry and government."⁶⁴ Conversely, states are obstacles to transnational business activities, hindering the development of global maximizing strategies and integration. The state, which sees itself as the highest form of authority and the essential "unit of count" by which interests are defined is merely one of many "operational environments" of corporate activities.

At the broadest level, the state and the transnational corporation represent divergent modes of human organization. The "vertical" nature of the corporation and the "horizontal" position of the state⁶⁵ are inherently at odds. Each pursues self-defined interests to promote its form of organization. The forms of organization overlap and conflict; hence, the areas of interest overlap and conflict. "The confrontation between the multinational firm and the nation-state may be regarded as the natural interaction between imbricated organization forms."⁶⁶ As the major alternative to the state for the organization of human affairs and the allocation of scarce resources the TNC presents an inherent challenge to the state.

Both state and corporation are allocators of resources, organizations of power. The major distinction between types of political systems is the balance between market and government:⁶⁷ both operate as authority systems and perform allocative functions. Power is indispensable to both actors. Like states, TNCs have an interest in power both as a valued outcome in its own right and as an instrumental means of achieving other goals.⁶⁸ The power of the state is nationally (territorially) defined. The power of the TNC is its control over the means of creating and allocating wealth on a global scale, the ability "to transform the world political economy."⁶⁹

The traditional framework conceptualizes the TNC as a commercial/economic entity and the state as a political entity. From this dichotomy the two actors are considered complementary. In the final analysis, however, both state and TNC are allocators of scarce resources and organizations which pursue power and the exercise of power to fulfill self-defined interests. Despite their differences,

state and corporation perform many similar functions in shaping the socio-economic and political life of countries and the international system. "The closer functions come to one another, the more points of contact they have; the more, consequently, they are exposed to conflict...(As) they satisfy similar needs by different means, they inevitably seek to curtail the other's development."⁷⁰ The destiny of state and firm are intertwined, but fulfilling the destiny of one would entail the crippling of the other, as the ultimate goals of each are mutually exclusive.

Within any given country the state and TNC interact in a similar dialectic of a natural conflict of interests. The TNC prefers a passive host government which will afford the company the opportunity of complete control over all decisions and operations and unrestrained earnings. The host state, by contrast, prefers a TNC which is directed by government policy and national needs. In effect, the TNC prefers a government which does not govern the corporation, and the state prefers a firm which maximizes the social welfare function and minimizes corporate earnings.

To the TNC, abrogation of agreements by governments is simply a breach of contract.⁷¹ Agreements are made to define the parameters of the business relationship. For the state, violating investment agreements is a prerogative of sovereignty and is unquestionably valid as a means of advancing national interests. The corporation views a country as an economic unit within a larger economic system. The state's decision to permit or not permit a particular investment, in turn, should be a function of economics only, a measurement of relative costs and prices. The TNC sees the investment relationship as a

variable sum game in which both actors can reap profits.⁷² While the firm is pointing attention to the absolute gains generated by investment, the state looks at relative gains in the broader context of the state's interests. While economics shows a preoccupation with absolute gains, politics focuses on relative gains. "The more one looks at the available facts with regard to the operations of foreign-owned enterprises, the more one feels obliged to turn away from economic questions and to look for political or social factors as an explanation of the tensions associated with such enterprises."⁷³

The fundamental disharmony between TNC and state is innate. There is a basic "asymmetry of goals and objectives between host country and investing firm."⁷⁴ These differences reflect the inherent structural relationship between the two entities. The interests of the state, however broadly defined, reflect the concerns of a territorially delimited entity; the interests of the TNC point outward, are transnational rather than national, and know no territorial restrictions.⁷⁵ While the state is treated as sovereign, the ultimate unit of political responsibility and authority, TNCs owe no allegiance to the state. As a matter of self-interest the TNC uses its resources to exact concessions from governments.⁷⁶ In pursuing their interests, TNCs do things that make them politically active and influence the behavior of states. While developing nations pursue full realization as states, "the principles and standards of permanent sovereignty are metaphysics" to the transnational company.⁷⁷ That TNCs seem to court favor and cooperation of different states at different times is only further confirmation of the TNC as an autonomous entity pursuing self-defined interest.

To the TNC, the state is a necessary problem with which the firm must contend. "General policies and particularly financial policies in multinational companies are specifically designed to further the goals of the parent company and only incidentally those of subsidiaries or host-countries. Such a built-in bias is bound to create conflict."⁷⁸ As a private institution the TNC "cannot be expected to make more than a token contribution of its corporate resources to public interest (i.e., non-profit making) purposes."⁷⁹ The TNC, moreover, operates in a number of states. The interests of the TNC could no more be identical with the many states any more than those states could share identical interests among themselves. "There is no conceivable way in which the philosophy, interests, and objectives of an international corporation can be identical with those of the governments of all countries in which its subsidiaries do business."⁸⁰ The differences are not ephemeral; they are structural. The differences, moreover, are logical: "the most honest corporate manager allocating resources rationally within a transnational perspective is bound to have conflicts of interest with the most reasonable of statesmen whose rationality [and domestic responsibility] is bounded by national frontiers."⁸¹

In many instances, political leaders must depend on foreign corporations to perform tasks important to national well being and the policy programs of leadership.⁸² TNCs can frustrate public policy initiatives and call into question the economic sovereignty of the state. It is one thing for states to be interdependent. While such interdependence between states can be seen as reducing the sovereignty of the state, all states share the same legal status and the

interdependencies are between legally equal units. To the extent the state experiences a type of interdependency with the TNC it suffers reliance on an entity which lacks sovereignty and political legitimacy. Yet, the TNC is evidence of "dated unreality about the idea that the state can control the 'commanding' heights of its own economy" and "to suppose that 'national' industry can now be directed for 'national' planning purposes."⁸³

The state plays an active role in the social and economic life of society. In all countries, the state has assumed extensive social welfare responsibilities. Along with its traditional role as protector against external threats, the state must be recognized as the authoritative regulator of social, economic, and political activities and allocator of scarce social, economic, and political resources. "Most national security policies in today's world," moreover, "are designed not merely to insure the physical survival of individuals within national boundaries, but to assure some minimal expected level of economic welfare, a certain political and social autonomy for the nation, and a degree of national political status."⁸⁴ (emphasis in original)

The TNC, in performing its own allocative functions, limits the authority of the state and reduces the state's ability to implement policy. "Because multinational corporations are private economic organizations, chains of command leading outside the state may multiply without ostensible loss of political sovereignty. Yet, national autonomy, the ability of a nation-state as a collectivity to make decisions which shape its political and economic future, has been diminished."⁸⁵ Public policy options are considered a function of

national sovereignty. But as a private organization wielding power based on private goals, benefits, and costs⁸⁶ the TNC constrains the internal autonomy of the state. To the extent the TNC allocates resources it is challenging the authority of the state.

By definition, TNCs pursue a degree of control over operations in host countries.⁸⁷ One of the primary motivations for foreign investment is "the acquisition of managerial control over a production unit in a foreign country."⁸⁸ TNCs differ from foreign firms which engage in international trade in that the former develop extensive involvement in the host economy while the latter do not.⁸⁹ Similarly, the TNC is unlike national companies domiciled within the host state. The TNC has "a more complex mix of benefit-cost options than is available to national firms," and "foreign direct investment can cut short the sort of symbiotic link that relates the interests of a national government and the interests of its national firms."⁹⁰ While the national firm may also be a private organization, it falls wholly within the scope of authority of the state. The TNC is beyond the jurisdictional reach of any single state. The state "exercising its sovereign rights, now lacks the scope effectively to match that of a truly international company."⁹¹ There results an "inherent dual standard"⁹² which renders the state's relationship with TNCs inherently conflictual, while the state's relationship with national firms is manageable and self-contained within the agreed upon parameters of the state. Regardless of the size of or power exercised by TNCs, foreign direct investment is an "act of intrusion and transmission"⁹³ that implies a degree of corporate control that is fundamentally at odds with the nature of the state.

The national company, moreover, is a legitimate participant in the domestic political life of the state. "From the point of view of a host government, an absentee corporate management represents power without legitimacy, since where can one find a legitimate base for the power of corporate managements to make decisions that can affect the economic life of nations to whose people they have no defined responsibility and to whose governments they are beholden in only a limited way?"⁹⁴ "The TNC has no legitimate role in the domestic political life of the host beyond that of articulating and defending the firm's narrowly defined interests."⁹⁵ Even this limited "legitimate role," however, is suspect. Virtually any efforts to influence political decisions and actions in the host state, however subtle or overt those efforts may be, raise questions of foreign interference. Yet, the very presence of the TNC is an act of interference. "What governments face [in the TNC] is a challenge to their power and control by an entity which has no legitimate claim to such power."⁹⁶

The state, in developing and developed countries alike, is experiencing a loss of control over decisions. Moreover, it "is not that these decisions [being made by TNCs] are necessarily or always adverse, just that they are made elsewhere."⁹⁷ Even if one accepts the relaxed assumption that host states and TNCs share similar interests in "joint maximizing solutions" and ignores the inherent structural differences between the state and TNC, there is no avoiding the problem that TNCs do make decisions about and affect the allocation of resources in host countries but do not have any legitimate political authority in those countries. Corporate benevolence, "good

citizenship," or sense of social responsibility beg the larger issue that the TNC exercises power in host countries without enjoying the authority vested in the national government. By permitting TNCs the exercise of power the state endures a "silent surrender" in which "decisions concerning what is to be produced, where it is to be sold, from whom supplies are to be purchased and what funds are to be transferred in the form of interest, dividends, loans, stock purchases, short-term balances, charges for management, research or advertising services, and so on, are made externally with considerations of global strategy for foreign corporations."⁹⁸

TNCs are huge and command vast economic resources. As an economic entity, the TNC rivals the state in size. A ranking of state GNPs and corporate revenues side-by-side indicates that in 1978 some 40 of the 100 largest economic entities in the world were corporations.⁹⁹ These firms account for substantial portions of world production and trade, particularly in the high technology and minerals industries. They control extensive capital resources and are major players in national and international money and credit markets. TNCs employ millions of people around the world, with many corporations employing more people than the host states in which they operate.

This economic power gives the TNC "the ability significantly to influence the use of resources, the distribution of goods, the prices of products, the tastes of consumers, the development of new technology, and the distribution of income"¹⁰⁰ both nationally and internationally. TNCs make fundamental decisions which affect the international allocation of scarce resources. On a national basis, corporations exercise "direct control over the allocation of [the host]

country's resources."¹⁰¹ Macro-economic policy at the national level takes place in the context of a world economy which is strongly influenced by the global macro-economic policies of TNCs.¹⁰²

Governments have always ceded a considerable degree of national control in the economic arena.¹⁰³ The TNC, as the most important change "in conception and practice of international economic affairs" since the days of the classical advocates of free trade,¹⁰⁴ has carried the erosion of the state economic autonomy further than ever before." The state's "claim to legal pre-eminence [remains] difficult to contest,"¹⁰⁵ but "however sacred and inviolable national sovereignty may be from the political point of view, few national boundaries correspond to economic demarcation lines and few states are self-contained economic entities."¹⁰⁶ While it may be extreme to conclude that the state's "economic authority can be exercised only at some risk,"¹⁰⁷ it is readily apparent that the TNC has "diminished the regulatory capacity of individual nation-states on both the macro-economic and micro-economic levels."¹⁰⁸

With the exception of the centrally planned economies that pursue self-sufficiency, the regulative capacity of the state has been diminished. At least in part, this decline in the ability of the state to regulate its internal affairs and manage international relations has been both cause and effect of the growing capacity of the TNC to influence national and international affairs. "Changes in the structure of the global economy have resulted in a withering of the governmental control of certain activities presumed to be de jure within the domain of governments."¹⁰⁹ No force has been as

influential in the restructuring of the international economic system as the TNC.

The scope and intensity of the conflict of interests between TNC and state continue to increase. The increasing scope of government activity in and responsibility for social welfare issues only heightens the inherent differences between host state and TNC. "The more responsibility for economic growth and stability the government accepts, the greater its control over the economy, and the greater the possibility that the multinational enterprise will be viewed as a potential disturber of economic plans."¹¹⁰ The focus on building the power and autonomy of the state, which is apparent in both developing and developed countries, contributes to the conflict between the state and the TNC.¹¹¹ In developing and weaker states the forces of conflict may be growing even more pronounced than among developed states, as conflicts in policy goals increase in tandem with the "role and importance of national economic policy-making for development" and the state enjoys a widening "array of available policy instruments" with more group demands being articulated.¹¹²

The ever broadening scope of the responsibilities of the state is confronted with the continuing growth of TNCs.¹¹³ "If the firm stops growing it dies."¹¹⁴ The larger the TNC's investment, the more of a vested interest it has in protecting and controlling that investment. Conversely, the larger a foreign investment project, the more impact it has on the host country, the more important it is for the government to control that investment. Bigger TNCs mean bigger threats to the host state. As such, whether or not TNCs improve the economy of the host state is a moot point. Economic contributions by TNCs do not mitigate

tensions.¹¹⁵ If the TNC does not make any positive economic contributions, the state has no reason to tolerate the intrusion. If the TNC is contributing to the national economy, the state has a vested interest in directing and controlling these contributions and keeping a wary eye on the policies and growth of the TNC.

The degree of conflict will be affected by how integrated the TNC and its subsidiaries are. "If the individual subsidiaries act as autonomous national entities, they pose little challenge to the policies of the individual nation. If they can be coordinated from the center to respond to supranational goals, the multinational enterprise is indeed a challenge to the concept of sovereignty."¹¹⁶ The more integrated the TNC, the more divergent the interests of state and firm.¹¹⁷ There always is, however, some coordination and control between the various parts of a TNC; such control is a hallmark and defining characteristic of the TNC.¹¹⁸

The international oil industry has grown around the concept of a global network controlled by TNOs. The major TNOs historically have been vertically integrated from the wellhead to the pump. "In few industries has this pattern [of vertical integration] become as entrenched or widespread as in oil."¹¹⁹ "The lesson that the oil companies demonstrated first and most conclusively is that, in an industry with heavy capital requirements and where the end product is without national characteristics, the only viable long-term strategy is one that ignores as far as possible the political and cultural divisions of the world into countries."¹²⁰ As firms which have thrived upon transnational corporate integration in a global network

the TNOCs have experienced even greater natural frictions with host states than would be experienced by less integrated TNCs.

The natural conflict of interests between state and TNC does not mean the two actors are enmeshed in a relentless daily struggle which permits no cooperation. At the practical level, host and firm have no choice but to deal with each other. At the very least, this reflects mutual needs. At the other extreme, there are instances in which the immediate interests of the two are compatible and can be pursued to their mutual gain. Both, for example, want a balance of price and supply that maximizes overall revenues.

Despite the inherent differences in both organizational form and concept, host and firm interact on a day-to-day basis. For the foreseeable future, they need each other: neither can achieve its goals without some degree of cooperation from the other. To the extent there is a convergence of interests and even cooperation, however, it should be borne in mind, this reflects short-lived arrangements of necessity and convenience reflecting immediate, proximate concerns.

"While it should certainly be recognized that fairly harmonious government-company relationships have occurred at various times...cases of overt conflict have been more frequent."¹²¹ The shared interests between host state and TNC are conditional; they are short-term reflections of the continued inability of host states to control fully the international oil industry and their continued reliance on TNOCs. "Conflicts between the host government and foreign investor tend to be more or less continuous, and the greater the profitability of the [natural resource project] the more intense will be the demand for renegotiation of the contract on the part of the host government."¹²²

The host state/TNC relationship is akin to a bilateral monopoly.¹²³ Each actor is in a position of control with respect to resources wanted by the other. Both entities, moreover, are autonomous and seek to maximize self-defined interests. In this sense, the conflict between TNC and host state is a "collision of sovereignties."¹²⁴

Host governments face a threat to their sovereignty. TNCs constrain the policy options available to the state. The TNC, moreover, has the capability to act independent of the state, pursuing courses of action which contradict or hinder public policy initiatives. But the TNC operates beyond the full control of the state and lacks political legitimacy. Similar dilemmas confront the state internationally: "governments are afraid that decisions will be made as to the future of the world economy without their having a chance to effectively participate. Policy will have been determined by a private sector or group outside of the country."¹²⁵

The increasing focus on the economic role of the state only serves to accentuate the importance of TNCs. The shift away from traditionally defined national security objectives to a broader sense of economic and social welfare objectives is a shift from an area of corporate weakness to an area of corporate strength.¹²⁶ "The more economic issues overshadow military security, the more the global corporation is likely to take power away from the nation-state."¹²⁷ National security remains a paramount concern; but economic and welfare issues are increasingly being recognized as primary components in the national security formula.¹²⁸

The TNC is more than just a commercial enterprise writ large. It is an autonomous actor which is capable of decisions and actions which

affect the course of states and world politics. Both TNCs and states are capable of unilateral actions, both are autonomous to a degree.¹²⁹ Both, moreover, are a limitation upon and can frustrate the policies of the other. "In the last twenty-five years, the multinational corporation has become one of the critical institutions of power in the world's political economy."¹³⁰ Making what are, in effect, binding decisions regarding the allocation of resources, TNCs have come to constitute a "matrix of non-state governments" exercising "nonsovereign governance."¹³¹ "When the modern corporations acquire power over markets, power in the community, power over the state, power over beliefs, it is a political instrument different in form and degree but not in kind from the state itself."¹³²

Neither the state nor the TNC are about to disappear. "It is clear that the MNC is no mere epiphenomenon."¹³³ Simultaneously, it is premature to sound the death knell of the state. The rise of one form of socio-economic organization, one actor, does not necessarily displace another form of organization.¹³⁴ The continued existence of both actors, each controlling resources valued by the other, mitigates the natural conflict of interests, necessitating collaboration and, on occasion, cooperation.

The challenge of the TNC is systemic¹³⁵ reflecting the evolution of international politics. "The rise of the multinational corporation as a global force with implications for home and host countries and the international system ranks as one of the key features of the second half of the twentieth century."¹³⁶ The transnational corporation and the state co-exist in a natural condition of a conflict of interests. This conflict of interests stems not from policies and actions by

either actor. Rather, the conflict is rooted in the structure of the relationship. Policy differences stem from these different interests. "Just as it was inevitable that great enterprises should feel driven to organize themselves on a world scale, it was also inevitable that there would be an increasing collision between multinational corporations and nation-states."¹³⁷

III.2 Interests and Issue Hierarchies

The structural differences between TNC and host state give rise to conflictual long-term, overall interests. The issue hierarchies, or relative salience of various issues, are equally divergent. Contradictory interests are expressed in incompatible goals. Arguments that conflicts between host and firm arise from different goals¹³⁸ miss the point. Goals may be modified, but they are merely proximate expressions of structurally defined interests. In other words, the conflicts between host state and TNC reflect fundamentally incompatible interests. As structural antagonists, the interests and goals of TNC and host are inherently at odds. This structural antagonism is the source of political risks.

Interests are not merely theoretical abstractions. They stem not only from ideals but also reflect tangible circumstances and conditions. Interests are expressions of both general interests at the abstract level and objectives and priorities as shaped by the tangible realities within which different groups and political actors exist and compete for resources. In this sense, interests reflect the relative positions of political groups and actors.

While our model sees the "nation-state and multinational corporation opposing each other in a natural conflict of interest,"¹³⁹

there are numerous instances in which host and TNC appear to pursue complementary and even shared goals. The actors may have "parallel interests," for example, in promoting sales, maintaining a sellers' market, blocking the entry of substitutes, and maintaining business stability.¹⁴⁰ These "parallel interests" tend to be at the third party level, that is, looking at an investment agreement the two parties share relative to the workings of the larger industry and world economy. Of course, host and firm want a successful project and an environment conducive to the success of that project. Underlying these surface third party goals, however, are the same fundamental conflicts: both TNOC and state want to promote sales (an assumption which can be subject to question under certain circumstances), but each looks towards promoting sales as a means of maximizing its interests, not as a means of satisfying the other's interests. When third-party, arms-length interests vis-à-vis other actors or the market are reduced to direct host/TNC issues, the "parallels" typically disappear.

The structural relationship, moreover, is mediated by other variables. According to our model, the inherent conflict of interests is mediated or constrained by the relative market power of the actors, as well as domestic conditions in the host country. These mediating variables tend to mitigate the basic conflict between host and transnational corporation. Because of the traditional interdependencies between host states and TNOCs, in which the behavior of each actor has affected the ability of the other to pursue its interests, the fundamental conflict has been masked or temporarily put on hold while the actors tend to necessary "business."

This interdependency restricts the ability of the actors to pursue their fundamentally divergent interests. The underlying differences are no less intense. Temporal conditions, however, force host and firm not to push their respective interests to the maximum. The mediating variables, which have favored one or the other actor at different times, restrain the centrifugal forces between TNOG and host. The apparent "parallel" interests which result are but expressions of the relative inability of one or both actors to push for their demands vis-à-vis each other. The fundamental, long-term differences remain; short-term conditions, however, may gloss over the conflict and give the illusion of shared interests and compatibility.

There are three main "baskets" of issues between host and firm:¹⁴¹

1. the division of net revenues;
2. the use of the domestic oil industry to further national/corporate goals; and
3. the control of operations and power derived from such control.

The traditional model looks upon each of these as variable sum issues in which "rational behavior" dictates cooperation.¹⁴² The assumption is that mutually supportive behavior will benefit both parties: each will realize greater revenues, permitting each to use the oil industry to promote its respective goals and enjoy an enhanced sense of control over and power from successful operations. This is wishful thinking reminiscent of the "harmony of interests" school.

Political reality is far more severe. While a larger pie may permit everyone a larger slice, no matter how large the pie, none of the actors is ever sated. The sense of scarcity still pervades. In

the direct tête-à-tête between host and TNC the revenues received by one represent potential revenues foregone by the other. Both prefer the whole pie. To the extent the entire pie is beyond its respective control, each tries to get as much as it can, begrudgingly conceding the share commanded by the other.

The other issues provide no less ground for conflictual positions. As national and corporate goals are inherently at odds, there can be little ground for accommodative behavior in efforts to use oil operations to promote host state and TNOC goals. Similarly, both pursue maximum control over operations; to the extent one party is successful, the other fails. Power, moreover, is relational. In this case, it involves the relative ability of each actor to influence the behavior and perceptions of the other. If each gains proportionally even "amounts" of influence over the other, neither has achieved greater power. To the extent one enjoys enhanced power, the other suffers diminished power.

There is no shortage of lists of host government goals regarding foreign investment projects in the resource sectors. Bosson and Varon enumerate ten: maximize total revenues of national firms; maximize the government's share of revenues; promote geographical and sectoral development; build backward and forward linkages; expand domestic processing, refining, and other downstream activities; develop a skilled pool of indigenous labor; build national infrastructure; earn hard currency; provide inputs for domestic industries; and create jobs.¹⁴³ Hossain identifies six objectives: rapid and thorough exploration; rapid and effective development; production levels tied to satisfying national needs; pricing and marketing strategies that maximize national

economic returns; the transfer of skills and technology; and maximizing the overall benefits realized by the host economy.¹⁴⁴ Zorn sees five classes of government goals: maximizing revenue and foreign exchange benefits; promoting national ownership and control; obtaining transfers of technology, employing nationals, and reducing dependence on foreign expertise; linking operations to the domestic economy; and promoting national sovereignty.¹⁴⁵

Some of these government objectives--maximizing host earnings and control or transferring technology--are directly antithetical to corporate goals. Others--sectoral development and foreign exchange earnings--are not directly relevant to corporate interests. To the extent there is any agreement in objectives--using local labor, building infrastructure, effective exploration and production--the area of agreement is shallow. Beneath the surface, these apparent common goals diverge: the host wants to develop a skilled labor force capable of running the industry without foreign firms, while the companies want inexpensive, accessible labor; the state seeks national infrastructure to promote overall economic development, the company wants to invest only in the infrastructure absolutely necessary to project operations; and the definitions of "effective" exploration and production hinge on the question of effective for whom and according to whose interests.

The nature of the state and TNC and the structure of their relationship give rise to two sets of interests and issue hierarchies. The interests of host and firm are both descriptive and prescriptive, plotting the evolving host/firm relationship and indicating appropriate courses of action. The respective interests of the parties, as previously identified in I.4, are ranked as follows:¹⁴⁶

Host Government

1. Solidify power base and authority
2. Increase economic returns
(satisfice)
3. Further domestic policy goals
4. Exercise control over resources
5. Further foreign policy goals

TNOC

1. Increase economic returns
(satisfice)
2. Insure transfer of supply
and funds
3. Control operations
4. Retain ownership

The first priority of any government is to solidify its power base and authority. This is essential to the government's ability to govern and remain in power and an obvious prerequisite before the host state can turn its attention to subsequent interests along the issue hierarchy. This primary host interest is particularly important in developing countries. Newly independent states often have the task of building the state and asserting the authority of the national government. Prior to independence the "host governments" typically were colonial administrations which shared the same interests as the TNOCs and/or home governments in maintaining the orderly flow of inexpensive resources.¹⁴⁷ Upon independence, the colonial administrators were gone but the states remained weak both internally and externally. The new states had neither the sophistication nor power to challenge the TNOCs. The TNOCs, moreover, were important sources of revenue and support for local elites.

In many instances the government was national in name only. Beyond the immediate reach of government forces, typically concentrated in the more urban areas, the government lacked authority. The government was weak and lacked the resources to extend its power. Oil was the answer. The TNOCs were willing to pay unheard of amounts of

money in exchange for a resource that had no local value or utility. Almost from the start of the oil industry host governments have continuously tried to increase their share of economic returns. "Governmental efforts constantly to raise their share of profits from raw material exploitation can be cited as a near-immutable law of governmental behavior."¹⁴⁸

As soon as they realized oil was a thing of value abroad host leaders began to push to increase the national share of revenues. This pressure is best understood in terms of the "satisficing"¹⁴⁹ rather than maximizing concept. Boosting host earnings lent further support to efforts at solidifying the power base of the national government. Simultaneously, national leaders and elites enriched themselves. Economic gains from the oil industry were appropriated for private ends.

The drive to increase host income was coupled with a more general focus bolstering national elites. Government leaders and national elites reaped previously undreamed of wealth, while the industry and national oil income had no positive material impact on the lives of the people. In Venezuela, for instance, until the death of General Juan Vincente Gomez in 1935, a handful of Venezuelans grew wealthy from oil, "but hardly any benefits were gained by the workers, the communities," or the country.¹⁵⁰ The popularity of IPC (International Petroleum Company) in Peru in the 1920s and 1930s, despite huge profits, was due in no small part to the continued willingness of the company "to make small loans or gifts to Peruvian governmental figures, and also to the government itself."¹⁵¹ In the Middle Eastern countries, which attained statehood much later than most of South America, a similar

pattern of enrichment by leaders and elites took place during this first phase. While social welfare functions went largely ignored, there are numerous stories of abuses of oil wealth by elites in the Middle East.¹⁵² During the 1950s, for example, Shakhbut bin Sultan, the ruler of Abu Dhabi, expressed no interest in using oil money to help the people: he kept his money in gold bars and stacks of notes under his bed and in his home.¹⁵³ Until the 1930s and 1940s in most of South America and the 1960s in the Middle East, the oil industry was seen more as a source of wealth for national elites than a vehicle for national economic development. Most host government leaders were content in reaping vast personal rewards without considering the needs of the country at large.

While the host government leaders and national elites grew wealthy, the host country suffered from "exploitation," "an outcome in which the national interest is not being maximized because actors crucial to the decision-making process are using payoffs to foreign investors to advance their own private good."¹⁵⁴ In defense of the self-enriching policies pursued by host elites, it should be borne in mind that at this time the state generally did not exercise broad socio-economic responsibilities. Host leaders, moreover, were climbing the "learning curve" in their knowledge of the political economy of oil and their dealings with the TNOCs.

Gradually, the idea of a social welfare function and public utility displaced the treatment of the national economy exclusively as the private domain of national elites. This shift in perspective from private interests to public interests is a part of the modernization process and the evolution from traditional societies to the modern

state. Modernization is a process that involves social, political, and economic changes to reflect the growing efforts of man to control his environment and his ability to exercise such control. These changes redefine how men relate to each other. Part and parcel of modernization and the trend to organize human resources to control and shape man's environment is the emergence of the state and a sense of national identity.¹⁵⁵

Initially, the consolidation of power in the earliest phases of modernization leads to the growth of highly centralized, absolutist authority. Gradually, however, as the intellectual ideas and concepts of modernization spread and governmental authority becomes increasingly dependent on the allegiance, loyalty, and consideration of the people, the absolute power of a single ruler devolves upon a government entrusted with representing the interests of people as a whole and the state.¹⁵⁶

The modern state plays a much broader role in promoting national socio-economic development than the government in traditional societies. The idea of the state playing an active role in promoting the welfare and well-being of its inhabitants replaced the model of a society in which the people are merely subjects to be controlled for the interests of the central authority. The emerging national aspirations of the modernizing world, with the drive for industrialization and modernization, necessitated looking upon people as resources that should be treated well.¹⁵⁷

Following the death of Vincente Gomez, General Eleazar Lopez Contreras and subsequent Venezuelan leaders aggressively pushed the TNOCs to increase the country's share of economic returns--a new labor

law in 1936, the 1942 income tax law, and the hydrocarbons law of 1943, for example--and distribute the benefits to all sectors of the Venezuelan people and economy.¹⁵⁸ Similarly, Sheik Abdullah al Salim al Sahah sought to avoid the model of private gain set by Ibn Saud in Saudi Arabia and Shakbut bin Sultan in Abu Dhabi and turned Kuwait into an oil based welfare state in the 1950s. While he and his relatives suffered no want of oil wealth, the Kuwaiti leader made a conscious effort to channel revenues to promote the standard of living of all Kuwaitis.¹⁵⁹

It is at this point--when the host begins to think in terms of increasing economic returns used for social welfare functions--that the interests of the host country diverge from those of the transnational firm. While attempting to solidify power the host government needs the TNOC. Similarly, aggrandizing the private wealth and power of local elites was possible primarily because of the wealth commanded by the TNOCs. While placating greedy leaders was a cost to the TNOCs, satisfying the extravagant personal demands of a private few was relatively inexpensive. When private motives are replaced with public motives, however, as inevitably happens during the modernization process, the relationship undergoes a basic change from indulging the idiosyncratic extravagances of elites to a structural confrontation between actors.

Historically, the primary determinant of the share of economic benefits realized by host and firm has been the taxation regime. The host government was a rent collector: it increased its revenues by renting to the highest bidder or raising the rent.¹⁶⁰ The host seeks "to induce the firm to operate (an investment project) as close to

optimally from the point of view of the government as possible, and to minimize the rents earned by the firm which the firm keeps."¹⁶¹ For the TNC, on the other hand, taxation policy "should be regarded as those considerations and measures which, by minimizing the incidence of taxation in the field of foreign connections, in the long run maximize the total profits" of the firm and contribute to the company's "maintenance and growth."¹⁶² While host states are constantly encouraged by the companies to look towards maximizing the total earnings of a project rather than their proportion of total earnings,¹⁶³ revenues earned by one party represent rents foregone by the other. At bottom, therefore, there is a "basic trade-off between government revenues and company profit increases."¹⁶⁴

Greater economic returns permit the host state to begin addressing other domestic policy goals. At the same time, moreover, general domestic policy interests help shape the host's economic interests from an investment agreement. Economically speaking, the host seeks to maximize the present value of revenues, given the country's social rate of discount, that is, the ability of the host society to absorb and put to good use revenues earned.¹⁶⁵ The social rate of discount will reflect, among other things, government policy preferences with respect to national investment and consumption patterns and general socio-economic development policies. While the state looks to the social discount rate, the TNC looks to the internal rate of return (discounted cash flow) on capital.¹⁶⁶

For the firm, preferences can be stated in strictly economic terms. Given the various opportunity costs foregone by making an investment decision (which precludes using that sum of capital in an

alternative investment), the firm seeks the highest internal rate of return on its investment. For the host, however, an investment project is a component in a broader socio-economic environment. The true measure of value obtained from an investment, therefore, is the project's contribution to that socio-economic environment. This includes not only maximizing the present value of revenues based on the social rate of discount (direct benefits), but promoting indirect benefits as well. The host, for example, tries to limit the cost of externalities--social costs borne by the country which are not reflected in an agreement's accounting of economic costs¹⁶⁷ (i.e., adverse impacts on domestic cultural values or higher local interest rates). In the broader picture of the national socio-economic environment, the value of a local petroleum industry is its ability to contribute to the country's welfare and well-being. It is for this reason that host governments have increasingly focused on the importance of integrating the oil sector into the overall national economy and looking to the petroleum industry as a means of realizing various policy goals.

The push for higher economic returns and using the oil industry to promote domestic policy goals naturally extend into a general push in favor of state control over petroleum projects. "For host government leaders to maximize the development benefits realized from an oil or mineral project, it was necessary to challenge the authority traditionally exercised by the foreign investors."¹⁶⁸ Control, "the power to influence the broad policies and daily questions that shape and determine the investment's present activities and future directions"¹⁶⁹ is integrally related to efforts to maximize earnings,

promote national development, and assure the institutional integrity and sovereignty of the state. A national oil company, for example, is a vehicle for asserting national control over oil policies, increasing revenues, and promoting other policy goals.

The less mature an investment and the state's experience with TNOCs and the oil industry is, the less important control is. "In the earliest stages of raw materials investment, of course, the issue of control generally was quite unimportant."¹⁷⁰ As revenues and the industry's ability to contribute to economic development grow, the demand for national control rises in tandem.¹⁷¹ It was only after the OPEC countries raised prices and takes (i.e., returns) that they turned to issues of control.¹⁷² Similarly, the rising assertiveness of the newly independent states fueled the demand for national control. Finally, the further along the project life cycle an investment is, the more important the issue of control becomes.¹⁷³ It was because of the differences in the maturity of oil operations and state experience in those operations that issues of control surfaced earlier in South America than in the Middle East.

Regardless of ideology, the national concern "inevitably shifts toward the potential for national control."¹⁷⁴ Every major oil exporter has developed a national oil company. To maximize national control many producers have eliminated the TNOCs from production. According to the Petroleum Economist, a number of states hope to push national control even further by cutting-out the marketing functions performed by TNOCs.¹⁷⁵ Following the Iranian abrogation of the arrangement with foreign firms in 1979, for example, NIOC assumed all marketing responsibilities.¹⁷⁶ While it is not about to happen that

the TNOCs are going to disappear and even if we concede a permanent role to the transnational oil companies, "the host states will strive to the greatest extent possible to exercise total control over their interests in the world (oil) industry."¹⁷⁷

As a last concern oil producers try to use the oil industry to promote foreign policy ends. The most direct use of oil for foreign policy purposes is the embargo. The first effort at a general embargo (1967) was ineffective. For a few months during 1973/74 the OAPEC (Organization of Arab Petroleum Exporting Countries) members embargoed selected countries, including the United States, the Netherlands, and Portugal. Almost every oil importing country has softened its support for Israel in recent years, a tactical switch more related to the oil muscle than the sense of right wielded by Israel's adversaries in the Middle East.

Selective embargoes are maintained by the OPEC states against Israel and the Republic of South Africa, while threats of embargoes have been invoked against the U.S. and Western Europe. In October 1979, amidst a tightening world market, Abdulhady Hassan Taher, the head of Saudi Arabia's Petromin, hinted at the increased ability of OPEC to manipulate the industry for international political purposes. "New criteria," he hinted, "may be developed to determine the allocation of scarce oil, where political and other considerations may override commercial judgments."¹⁷⁸ Similarly, in 1980, Algeria and Libya agreed to prohibit the sale of oil and gas to countries supporting Israel,¹⁷⁹ although the policy was never implemented. And in 1981, Libya's Union of Petroleum, Mining and Chemical Workers called on Arab oil exporters to embargo the U.S. in protest of the increased

American military presence in the area surrounding the Persian Gulf and the Mediterranean Sea,¹⁸⁰ while Iraq recommended a cut in crude sales to consumer countries stockpiling oil.¹⁸¹

Oil revenues, of course, can be used to fund foreign policy ventures as well as domestic policies. The oil exporters are a prime market for arms and munitions. Petroleum revenues fund Libya's intervention in Chad, as well as Iran's and Iraq's efforts at each other's annihilation. Oil money also has permitted the OPEC members to finance major foreign aid packages. As a percentage of GNP, the OPEC states spend far more on foreign aid than either the Western or communist states.¹⁸² And OPEC has proven itself no more altruistic or less political in its giving of foreign aid: "two-thirds of (OPEC's) 1975 aid went to Syria and Egypt, both net exporters of oil, as 'good faith' money in the political struggle against Israel. Less than 10 percent of direct aid went to non-Moslem countries."¹⁸³

In contrast to the host government, the primary concern of the TNC is company profit making. "The chief goals of multinational corporations like those of all business enterprises, are profit and growth."¹⁸⁴ Despite corporate preoccupation with profits, the TNC is better understood as a "satisficer" rather than a maximizer. Unlike a domestic firm, however, the TNC's vision of profit making encompasses a diverse range of operations, the value of each being judged in terms of its contribution to total profits.¹⁸⁵

A closely related priority of the firm is the ability to transfer abroad supply and profits, dividends, and remittances in hard currency. These transfer privileges are essential to the profit making drive of the company. Transfer of the commodity is the literal

lifeline of the international oil industry: it provides the raw material which TNOCs refine and use to maintain their own operations and sell to third parties. Restrictions on transfer of supply isolate local operations, separating them from the global network which is the TNOC. Similarly, restrictions on the movement of funds in hard currency effectively frustrate the corporation's profit making motive. Soft currency is useless outside of the host country. Repatriation restrictions prohibit the TNOC from realizing profits earned in the host country and sever the integrated financial relationship between TNOC and subsidiary. Such a break creates, in effect, an independent subsidiary bearing little resemblance to an integrated subsidiary in the framework of a TNOC.

Actually, the ability to transfer product and funds abroad is a subset of a larger basket of corporate interests involved in maintaining control over operations. "Control is desired not only to deal with uncertainty but also to ensure that the operations of the subsidiary are related to those of the parent in ways that best serve the investor's total interests."¹⁸⁶ While exercising control can be seen as a value in its own right, control is a valued means by which the TNOC can assure operations serve corporate interests. Corporate interest in maintaining control is a natural offshoot from concern with profit making and risk minimization.¹⁸⁷ Operational control is necessary if the TNOC is to rationally utilize its network of exploration, production, refining, transportation, and distribution capabilities.

The final priority is ownership. Traditionally, TNOCs exercised the full prerogatives of ownership under concession agreements.

Ownership, however, has proven to be a less important issue than many analysts previously predicted, as ownership often has little impact on the more pressing interests of the firm.¹⁸⁸ The main concern is not "with title to property or tenure of mining rights" but with the broader contractual framework on which the profitability of an operation depends.¹⁸⁹

When the concessions initially were granted, the TNOCs were able to satisfy all of their interests, while the host government concentrated on its first priority of solidifying the power base and authority of the state.¹⁹⁰ During the period from the turn of the century until the 1960s, with some exceptions, host governments and elites remained fixed on narrowly defined interests of government power and personal riches. Social welfare issues received minimal attention, at best.

As the oil producing countries began to mature socially, politically, and economically, they increasingly saw the interests of the state in terms of a broader social welfare function. This is part of the modernization process for all states. It is at this point that host interests emerge as the diametric opposites of TNOC interests. The host state's efforts to further national interests and benefits "translates into increasing demands on the oil companies over time and an ongoing effort to take control of the industry."¹⁹¹ The more aggressive the host is in advancing national interests, the more host interests will diverge from those of the TNOCs.¹⁹² As the host moves further along its issue hierarchy, the likelihood of political risks increases. The TNOC is forced to retreat "down" its issue hierarchy and tries to minimize its losses. At the point where the host has

managed to maximize all of its interests, the TNOC has been reduced to a mere vendor of services to the host or has been totally displaced from playing any role in the national oil industry.

There are, of course, differences among states, as there are differences among corporations. Neither is a wholly monolithic organization. The interest rankings and issue hierarchies of the two actors apply to a greater or lesser degree, however, to all states and TNOCs. The interests stem not from the particular state or particular TNOC but from the nature of the state and the firm and their interaction. "Democracy or autocracy, capitalism or socialism, North or South --when it comes to regulating foreign investment in a state's petroleum and natural gas resources, countries tend to pursue similar goals of maximizing domestic economic returns and political control."¹⁹³

There is a natural progression on the part of host states to move along the issue hierarchy towards maximizing domestic control over the national oil industry. This is a descriptive process illustrated time and again by demands made by oil producing states over the years and reflects the inherent conflict between host state and firm. The issue hierarchy also can be viewed as prescriptive, outlining a natural path for host government leaders to follow, as market and political conditions permit. Failure to follow that path, to push to maximize host interests is to court political disaster, as it will result in the loss of popular support and loyalty. The October 1968 military coup deposing Belaunde in Peru and the downfall of the Shah of Iran, for example, both were related to perceptions on the part of important and large groups in the two countries that their leaders were not

advancing national oil interests and were not sufficiently aggressive in their dealings with the TNOCs.¹⁹⁴

A conflict of interests is the natural state of affairs between TNOC and host state. This conflict is not a reflection of personalities or unreasonable policies. Rather, it is a reflection of structural differences which manifest themselves in contradictory interests and issue hierarchies. Market and political conditions mediate the degree of conflict, often bringing host and firm together to address immediate concerns of both. The result is a practical relationship in which both parties are unable to attain their long-term interests and are forced to deal with each other for their mutual short-term benefits.

This relationship typically is mistakenly assumed to be a cooperative, variable sum game amenable to rational solution. This ignores the fundamental underlying relationship, however, in which host and TNC interests are inherently at conflict. Unable to do without each other and having to attend to business involving other actors, host and firm maintain a shaky modus vivendi. The basic relationship, however, is no less conflictual.

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IV. POLICY AND RISKS

In all modern societies, the state plays a leading role in directing the national economy. The state directs the economy by making and implementing policy decisions, two of the basic responsibilities of government. Policy changes are made at the discretion of the government. Changes in those policies that affect corporate operations are the immediate source of political risk to TNCs.

Oil, because of its economic value and importance to modern societies, is a particularly important policy tool for exporter states. Among developing states, petroleum is the crux of the national economy of oil exporters, accounting for a disproportionate share of the GNP and government revenues. For these states, controlling oil policy is tantamount to directing national economic and development policies. Even among the major oil exporters of the West, which have diversified, industrialized economies, oil plays a central role in national policy.

To assure that a country's oil resources are used to promote the state's interests the state must exercise control over those resources. Under the control of TNOCs, local resources can be expected to be used to maximize the interests of the firm, not the host state. Conversely, the state strives to gain control over its oil to promote local interests, which will not be consistent with the interests of the firm.

The TNC and liberal Western thought see nationalism in the modern world as an irrational commitment that interferes with the otherwise smooth working of the world economy. Nationalism, however, is a natural and rational expression of self interest. Because of the

importance of natural resources and the development of these resources by TNCs, nationalist sentiments often have focused on oil and minerals. While in this century nationalism is considered a Third World phenomenon, to varying degrees nationalism is characteristic of all states.

Political risk events are rooted in the structural conflict of interests between host and firm but are directly caused by policy decisions on the part of the state.

The final section of Chapter IV identifies and gives examples of seven types of political risk events: (1) costly fiscal changes; (2) other cost increases; (3) increased host state control over operations; (4) expropriation; (5) reduced access to supply and supply interruptions; (6) adverse price manipulations; and (7) reduced access to income. Each of these is related to host state interests and stems from policy decisions by the state. The categories are closely related and, at some points, overlap. While each risk event presents its own types of problems, they all are related to the ultimate concern of the TNC: control and profits.

IV.1 Policy Roots of Political Risks

The focus on national economic well-being as one of the primary functions of the state places a premium on effective government management of a country's economy. While the state has always been a central economic actor, it is only since the turn of the century that the state has come to be recognized as being responsible for broad social welfare functions. The day-to-day role of the state in a country's economy and the conceptualization of the state as an economic manager are relatively recent phenomena.

As government policy responsibilities and objectives have increasingly included economic considerations, the state has increasingly had to realize, cope with, and overcome (when possible) the constraints imposed by economic forces and other economic actors. Prior to the state's assumption of broad economic responsibilities, TNCs generally were not a limitation upon government policy objectives. In fact, TNCs, and the additional resources they brought from abroad, often increased the capabilities of the host government. On the whole, with parts of Latin America as an important exception, before World War Two, government objectives were limited in scope and did not encompass general designs upon shaping and directing a country's economic future. Across large parts of the globe, moreover, the "state" as an autonomous, sovereign entity did not exist. Most of the globe was part of one of the European colonial empires, which tended to have very close, favorable relationships with their own TNCs. Upon independence, moreover, host government leaders were concerned with extending their political authority throughout the state and their own enrichment (the first two interests on the host's issue hierarchy). The TNCs actually helped the newly formed governments attain these goals. In many instances, consequently, early TNCs were not considered particularly threatening to government policy objectives.¹

Political independence and the accession to statehood and the changing nature of public demands upon and expectations with respect to the state have cast governments as the leading actors in the national economies of all countries. To exercise its responsibilities, the state must exercise policy control over the national economy. While the extent of control which is appropriate and the

best means of exercising such control forever will be disputed, the state directs the economy by making and implementing policy decisions. These policies, reflecting the interests of the state, as defined by the government, are the immediate source of political risks with which TNCs are confronted. While most policy decisions will have no bearing on corporate activities, policies define and redefine the rules under which TNCs operate.

Policy making and implementation are among the basic responsibilities of government. Given a set of conditions, preferences, constraints, and capabilities, policies are the means by which governments try to achieve their goals. If the conditions or environment surrounding an issue, the preferences or goals of decision makers, or the constraints and capabilities of the state change, this will be reflected in a revision of policy.² Changes in those policies that affect TNCs present these firms with political risks.

Political sovereignty, which implies the authority of the state to set policy, however, does not mean economic sovereignty,³ the power and authority to control and direct the economic fate of the country. While political sovereignty is a prerequisite for the effective exercise of state economic policy initiatives, the national government may not have economic control or autonomy. In a sense, a state's first policy goal is to gain control over policy. In the natural resources sector, this desire is best expressed in the persistent demand for "permanent sovereignty over natural resources." For natural resource producing countries, particularly in the Third World, permanent sovereignty is nothing less than the demand that the state be free to exercise its sovereign authority to make and

implement policy on behalf of the country. Translating the call for permanent sovereignty into actual control entails the implementation of policies that will affect the operations of TNCs active in the natural resources sector.

The call for permanent sovereignty, first heard in the United Nations General Assembly in 1952, in addition to its rhetorical flourishes and political overtones, is a call for state control over a country's economic life. The doctrine of permanent sovereignty is a statement of the supremacy of state policy within national boundaries. Implicit in permanent sovereignty is the state's right "a) to regulate and exercise authority over foreign investment within its national jurisdiction in accordance with its laws and regulations and in conformity with its national objectives and priorities. No state shall be compelled to grant preferential treatment to foreign investment; and b) to regulate and supervise the activities of transnational corporations within its national jurisdiction and take measures to ensure that such activities comply with its laws, rules and regulations and conform with its economic and social policies."⁴ In short, permanent sovereignty means subjecting the TNOC and other natural resource producing firms to the policy control of the state.

While Western states, the home of most natural resource TNCs, have been reluctant to acknowledge the legitimacy of permanent sovereignty, these countries recognize dominium eminens--the power of eminent domain--as inherent in the concept of sovereignty. The modification of property rights for reasons of "public utility, security or the national interest" and without discrimination between domestic and foreign ownership, is a recognized doctrine of international

law.⁵ Although Western governments have been adamant in their insistence on "prompt and adequate compensation" for any losses TNCs have suffered at the hands of foreign policy makers, even by Western standards expropriation or the infringement of property rights in the exercise of the state's police power need not be compensated.⁶ In their insistence on permanent sovereignty and the development of a new international economic order, Third World states have asserted a similar categorical prerogative to modify property relations in implementing government policy and do not recognize an obligation upon the state to compensate property holders.⁷

TNCs, by and large, reject permanent sovereignty, as well as other principles and policies which threaten their interests. Companies acknowledge the right of governments to regulate their economies, but reject state authority to alter the terms and conditions of investment agreements or modify property rights.⁸ The distinction between regulation and changing property rights, however, is unclear. Denial of the state's authority to alter property rights, moreover, is, in effect, a limitation upon the state's ability to regulate, a limitation which no host government can recognize. In practice, state policy making is constrained by national capabilities and needs and environmental factors. All areas of economic life, particularly natural resources, the ownership of which usually is vested in the state (with the United States as the only major exception), are subject to the policy choices of the state.

Private firms, in all industries, pursue preferences which reflect private interests. The relative merits of free enterprise aside, without sufficient inducement and/or compulsion, private com-

panies cannot be expected to comply with public policy preferences. To assure some measure of corporate compliance with the state's policy objectives, governments impose various requirements upon TNCs.⁹ It is policy making and implementation, as such, which are the wellspring of political events which affect the operations of TNCs. "The most important source of politically generated managerial contingencies is routine policy making."¹⁰ Government actions which adversely affect a particular firm or group of firms are the result of government efforts to maximize the political and commercial ends of the state.¹¹

The renegotiation of investment agreements usually is caused by a purposeful "reallocation policy," the adoption of state policies to promote national goals and shift the benefits of agreements from the TNCs to the host.¹² While crises can create "nonvolitional problems" for foreign firms, "the majority of renegotiations appear to grow out of policies deliberately chosen by host country decision makers."¹³

Even expropriation, the most extreme political risk event, is best understood not as "the outcome of irrational economic nationalism...(but as) the product of a political-economic strategy undertaken by host country governing elites."¹⁴ Given a set of state objectives and environmental constraints, the government's decision to expropriate reflects its perception of the relative costs and benefits of the various alternatives it considers.¹⁵ Forced divestment, moreover, is more often a means than an end; it is an instrument for realizing politico-economic objectives, not an objective in its own right.¹⁶ Even the U.S. Government Accounting

Office recognizes that "in almost every case where a country has seized the assets of foreign firms, the motivating reason has been to gain, maintain or increase control over their economy."¹⁷ In other words, expropriation is a policy of forced divestment, the seizure of assets to promote the interests of the state.

Host countries do not merely want to attract foreign investment. Rather, the state has a compelling interest in harnessing foreign companies to government goals.¹⁸ Despite the classical liberal belief in the basic principle of laissez-faire--that government is best which governs least--all governments are becoming more involved in their countries' economic life. Every state imposes standards on foreign TNCs and implements policies in its efforts to maximize national gains and minimize costs. In recent years, this trend has taken on some new aspects:¹⁹

- o virtually all host countries are becoming more demanding of TNCs, while previously only a handful of host states "interfered" regularly with foreign corporations,
- o state policies are becoming more explicit,
- o host objectives have become broader and deeper, and
- o host efforts are more likely to be successful.

States pursue a broad range of goals in their dealings with foreign firms. As is not uncommon in other areas of policy making, not all of the state's goals with respect to foreign investment are necessarily consistent. Goals often are mutually exclusive or contingent upon each other. In particular, strict economic goals of maximizing economic returns may conflict with political goals regarding national control or the distribution of scarce resources. Policy

making entails trade-offs, which can work in favor of or against the position of TNCs.

There also is a gap between policy making and policy implementation: states often fail to do what they say they will. While state decisions are legally binding and can create a general attitude which is unfavorable for corporate operations, it is implementation, or the threat thereof, that has the most direct impact on foreign companies. If the state lacks the organizational and material capabilities to implement policies, decisions may be of only rhetorical value to the government and have little impact on TNCs. Even if implementation is slack, decisions are indicative of state goals and policies that the government plans to enforce when possible. "Voluntary" compliance may be less costly to the TNC in the long-run, rather than risk wrathful policy initiatives at the hands of a government that feels it has been snubbed by a foreign company.

Across all states, both developed and developing, policies are the primary source of political risks. Whether developing countries are less constrained by domestic industrial interests and, therefore, Third World governments are less restrained than developed states in their policies vis-à-vis TNCs,²⁰ or policy outcomes are more important in the developed world, while instability and war are more relevant to developing states,²¹ is moot. Claims that developing nations are "obsessed with their own economic problems and care not a bean for 'world allocative efficiency,'"²² totally miss the point. The only states not "obsessed with their own economic problems" are states without economic problems; the only states which care a "bean"

for global economic efficiency are those states which enjoy the greatest prosperity from such efficiency.

In effect, all states are "obsessed with their own economic problems" because they are "their own." And policies are the means of self-help states employ in their efforts to control and manage their economic problems, including the operations of foreign TNCs. The circumstances with which each state is confronted differ in their particulars: states differ in their needs, wants, capabilities, and specific environment. In all instances, however, the state deals with and attempts to exercise control over its circumstances--and the TNCs--via policy.

IV.1.1 Oil as a Policy Tool

In developing countries with substantial mineral resources, government minerals policies are the functional equivalent of national economic and development policies. As Table IV.1 shows, oil accounted for almost 95% of the combined total exports of the OPEC states and represented almost 50% of the combined 1980 GNP of member countries. The 1980 figures probably are the highest of any single year, but oil consistently dominates the exports and GNP of the OPEC states. With the exception of Ecuador and Indonesia, oil sales account for more than 90% of the value of annual exports for every OPEC member. Petroleum exports contribute two-thirds or more of the GNP in six OPEC countries and account for more than one-fifth of the GNP of every OPEC nation except Iran and Ecuador. Even among the more diversified and developed economies of Venezuela, Iran, and Algeria, oil is the key to the economies of every OPEC country. Subtract petroleum sales from the OPEC states and you remove half of the total value of annual econ-

omic activity, more than 90% of their hard currency earnings, and the overwhelming majority of government revenues. For OPEC and other Third World oil exporters, petroleum is literally the lifeline of the national economy: oil is virtually the only significant policy tool. Without oil, the OPEC states would be totally impoverished. Oil is not only the key financial resource of the state and the government, it is virtually the only financial resource.

For the leading petroleum exporters in the West--Norway, the United Kingdom, and Canada--oil is not as essential as it is to Third World exporters. As developed countries, the economies of these states are not totally reliant upon petroleum: each has other export-oriented industries, other sources of government revenues, and relatively advanced standards of living. In both Norway and the United Kingdom, however, oil exports are an important source of government revenues and have become essential to the oil welfare state. The oil and gas industry, for example, was the source of more than 20% of the Norwegian government's tax revenues in 1981.²³ Both Norway and the United Kingdom have come to regulate their economies by means of their oil policies: national GNP, exports, exchange rates, engineering and construction, the demand for oil related goods and services, and regional and national industrial policy are regulated via government control over production, exports of and investments in petroleum.²⁴ Not surprisingly, in both Norway and the United Kingdom, "oil has become increasingly politicized," increasingly used as a policy pawn and tool in implementing government goals, as the petroleum industry has become increasingly important to the national economies and ways of life.²⁵

Table IV.1: The Contribution of Petroleum Exports to the National Economies of the OPEC countries, 1980

Country	Value of Petroleum Exports (\$ Millions)	Petroleum Exports as Percentage of Total Exports	Petroleum Exports as Percentage of Gross Natl Product
Algeria	11,384	91.7%	28.0%
Ecuador	1,294	54.1%	12.9%
Gabon	1,803*	95.3%	53.4%
Indonesia	13,303*	62.1%	21.0%
Iran	12,724	94.5%	17.1%
Iraq	26,140	99.2%	65.8%
Kuwait	18,331	91.9%	68.7%
Libya	22,567	99.9%	66.9%
Nigeria	25,484	95.3%	35.6%
Qatar	5,377	95.2%	95.2%
Saudi Arabia	102,416	99.9%	87.1%
UAE	19,377	93.6%	93.3%
Venezuela	17,787	94.7%	30.4%
Total	277,987	94.3%	49.1%

* Estimated

Source: Organization of Petroleum Exporting Countries. Annual Statistical Bulletin 1980 (Vienna: OPEC, 1981)

Canada, although a significant oil exporter, nevertheless, is a net importer of petroleum. Because of the value of domestic production and the importance of energy to the nation's economic life, the Ottawa government has adopted an increasingly assertive posture in regulating the oil industry to further national economic goals. The Canadian government believes that the oil and gas industry is a "special case" requiring special measures needed to ensure more Canadian control.²⁶ (What is "special" about petroleum is its value and the tremendous amounts of money to be made from its sale.) Reacting against what it perceived was excessive foreign ownership and control over Canada's hydrocarbons industry, the government announced its Canadianization program in October 1980 to indiginize control and ownership of the industry.

In every significant oil producing country the state plays an active, assertive role in directing national oil policies and explicitly linking petroleum policy with the broader goals of the state. The politico-economic importance of petroleum breeds a "special relationship" between governments and oil²⁷ and attaches special political significance to ownership and control of the industry. Because oil is of such importance to the economic and social well-being of the petroleum exporting states, control over hydrocarbon developments has been a prime political target for decades. Oil issues are a major factor in determining the fate of those countries. To control their own fate, these states must control their oil. "To a large extent, political risks associated with deliberate governmental changes in policy are a result of the importance

petroleum plays in the economies of oil [exporters]."²⁸ This is true of both developed and developing states.

Noreng has identified at least six policy considerations shared by Norway and the United Kingdom with respect to oil:

- o control macro-economic effects on such areas as economic growth, inflation, and the balance of payments
- o maximize public revenues
- o maximize the positive spin-off effects by contributions to economic linkages with other sectors of the economy and assuring a maximum share of the economic rents go to nationals
- o control the industry's regional and social impact
- o control the industry's impact on the national environment
- o integrate the oil industry into the nation's energy policy.²⁹

With varying degrees of intensity, these same policy considerations are of universal application to all oil producing states. While Third World states may pay less attention to environmental issues, they pay closer attention to oil as a source of government revenues and hard currency. While control is most important for its utility value--its value as a means of achieving other goals--control also is an end in itself. Policy outcomes aside, the policy making process is within the legitimate domain of the state and is an important component of independence, if not sovereignty.

While governments can try to direct oil policy through legislation and/or regulatory bodies, the most popular means of exercising a direct role in petroleum development is by means of a national oil company (NOC). National oil companies, a natural extension of the doctrine of state ownership of subsoil mineral rights,³⁰ date back

to the 1920s and 1930s. The earliest producer state NOCs include YFP (Yacimientos Petroliferos Fiscales) in Argentina and PEMEX (Petroleos Mexicanos), founded in 1922 and 1938, respectively. NOCs became popular in the 1950s and 1960s. Beginning with Iran's NIOC (National Iranian Oil Company) in 1951 and concluding with Gabon's formation of Petrogab in 1979, all of the OPEC states have created their own NOCs, while Norway's Statoil (Den Norske Stats Oljeselskap) was born in 1972, followed by BNOC (British National Oil Corporation) in 1974. By the mid-1970s, there were more than 90 NOCs throughout the world.³¹ Saudi Arabia's Petromin is the largest. Initially, the authority of the NOCs was limited to those parts of the country not included in a foreign concession or which had been relinquished by concessionaires.³² Subsequently, the role of the NOCs has steadily expanded to cover all of the host states' hydrocarbon policies.³³

The NOCs serve a number of functions. On the immediate and practical level, they are instrumental in supplying product to the domestic market, developing a trained cadre of nationals, and are the primary vehicle through which the government makes and/or implements its petroleum policies. NOCs also provide host governments with direct access to markets, permitting direct export without reliance on foreign firms. On a more general plane, the NOCs are a source of national pride, the means by which governments assert their will to permanent sovereignty, and a standard against which the performance of foreign firms can be measured.³⁴ In short, the NOC is the arm of the state for exercising control over oil development.

IV.2 Oil and Development

The natural resources industries in Third World countries, with oil as the pre-eminent example, always have been export-oriented. As it is industrial development which spurs the consumption of natural resources, the demand centers for petroleum and other minerals have been, by definition, in the industrialized states. Many underdeveloped areas, rich in petroleum resources and mineralization, with pre-modern economies and little indigenous demand for oil or other minerals, became the sites of mines and oil wells which were operated by transnational firms supplying foreign demand. Poor, underdeveloped areas with local economies based largely on subsistence agriculture and marginal standards of living at best became the centers of production and export in the world's natural resources industries.

Minerals and natural resources rapidly became, and still remain, the main export of developing countries.³⁵ Modern facilities for the exploration, production, and transportation of oil and other minerals were built alongside the local subsistence economy. As an export oriented, foreign controlled industry, the extractive sector appeared as an "enclave" with little integration with the remainder of the national economy or the lives of the majority of the local population.³⁶ This relationship gave rise to a "dual economy," in which "the essential distinction is between (1) that small and rapidly growing sector which uses relatively large amounts of capital, with labor hired for a contractual wage or salary, and (2) the much larger sector dominated by subsistence agriculture, where little capital is used, labor productivity is low, and where payment is more in kind than in cash."³⁷

The export sector did not substantially improve the local economy or standard of living. The oil industry created many wealthy local rulers and a handful of very rich TNOCs without having a major impact on the general economic life of the exporting countries. The extractive industries faced virtually no local competition³⁸ and rapidly came to dominate the only modern, dynamic sector in otherwise stagnant economies.

While the TNOCs never pretended to be good samaritans dedicated to advancing the standard of living throughout the world, it was popularly believed that the transnational oil firms would be able to supply crucial "factors of production" and stimulate economic development by means of exports. The TNOCs were considered "engines of development," providing scarce resources in the form of capital, technology, skills, and marketing and managerial know-how and making efficient use of indigenous material resources.³⁹ The new industry was to generate employment opportunities, develop local infrastructure and provide hard currency for capital investment and the purchase of goods and services abroad. Relying upon the traditional view of economic development and the "models" of the U.S., Canada, and Australia, developing countries were to achieve export-led growth through their comparative advantage in primary resources.⁴⁰

As early as the 1950s, however, the foreign investment, export-led model of development came under attack. The primary issue in the nationalization of the Anglo-Iranian Oil Company (AIOC) in the early 1950s was the failure of the oil industry to have a positive, substantive impact on the local economy.⁴¹ The Latin American countries never accepted the Western assumption that foreign investment was, by

definition, healthy for the host economy.⁴² Led by articulate spokesmen such as Raul Prebisch, the first head of the United Nations Economic Commission for Latin America (UNECLA) and first Secretary General of the United Nations Conference on Trade and Development (UNCTAD), representing the interests of the increasing number of independent Third World countries, there emerged a number of alternative viewpoints which questioned the traditional model of development. The gains from foreign investment were questioned, and the benefits of Third World natural resources were seen as flowing to the developed world at the expense of the developing world. In lieu of development, the Third World struggled with the prospect of dependency and permanent underdevelopment.⁴³

Mineral resources are part of the natural patrimony of the land and represent an important component of the capital endowment of a country. Petroleum development is a conversion process of changing the physical product into a flow of financial resources.⁴⁴ Oil, however, is a non-renewable resource; once reserves are exploited, they are gone. If the proceeds from petroleum production are consumed or repatriated abroad rather than invested, the host country and TNOC are literally consuming or living off the country's capital stock.⁴⁵ In effect, petroleum and other natural resources represent the only capital asset of most developing countries. As a non-renewable asset, oil will have a lasting impact on the standard of living of producer states only if oil wealth is used to build a self-sustaining economy.

Whether or not export oriented natural resource industries can ever generate broad based socio-economic development continues to be

mooted. Advocates,⁴⁶ opponents,⁴⁷ and skeptics⁴⁸ of the possibility of Third World countries developing under the direction of natural resource exporting industries abound. Development theory aside, in practice, natural resources are the only substantial economic asset for most of the Third World. Whether oil or other minerals can provide a stepping stone to the development of a diversified economic base will be proven over time. As they have little alternative, however, developing states will continue to rely on their natural resources as their only possible means of developing. "For most developing countries today, the relevant question is not whether they will produce primary commodities for export or engage in manufacturing for home use and export. They recognize the need for both types of activity. Rather the significant questions are how the export oriented primary commodity sector can make the maximum contribution to broadly based development, and what kind of materials policy will best serve this goal."⁴⁹

Oil, many hope, is the "exception" to the argument that natural resource exporting industries are unable to promote development. Oil revenues may be sufficiently vast to fund economic diversification and industrialization.⁵⁰ The oil industry enjoys low production costs relative to the value of the product,⁵¹ which may enable sufficient revenues for reinvestment, increased consumption, and investment in national development.

The traditional corporate approach has been to assume that no matter what, developing countries are better off having minerals production than not having any production. "Minerals which remain undiscovered or underdeveloped," it is argued, "are as useless to a

country's people as if the country was barren of those minerals."⁵² As pointed out earlier, however, mineral wealth is part of a country's capital stock and, as such, represents a tangible economic asset. Although not immediately liquid, natural resources can be--and regularly are--transformed into a liquid form. Resources in the ground, moreover, represent an investment in the future, something that can be handed down through the generations. It is unfair to assume, that developing states, if left to their own independent destiny, would not at some time have begun to develop their natural resources for their own consumption.⁵³

While it is difficult to maintain that Third World countries are worse-off because of foreign investment in the petroleum sector,⁵⁴ it has become increasingly apparent in the post World War Two era that oil resources are a key element in approaching the broader issue of development. It has become equally apparent that development is not a goal shared by the TNOCs. Foreign oil firms are less "catalysts for industrialization than instruments for maintaining and promoting the established structure of the international oil industry."⁵⁵ If the national oil industry is to be a tool in pursuing socio-economic development, the host government has to take the leading role directing oil policy and, accordingly the activities of TNOCs. "The purpose of control for the government is to influence the micro-economic behavior of the firms involved, so that it conforms more to national economic and social considerations than would have been the case without control."⁵⁶

Traditional petroleum agreements failed to address development issues. There were at best minimal contacts between the oil industry

and other sectors of the local economy. The host measured its benefits in terms of the sum of foreign exchange earnings retained (wages and salaries plus domestic purchases of goods and services plus government revenues plus reinvested profits).⁵⁷ These agreements also left host states with a bad taste of neo-colonialism and exploitation.

The true development value of oil operations resides in the overall set of "linkages" between the industry and the country's national economy. Building local infrastructure and providing jobs is not enough contact for the petroleum sector to have more than a superficial, uneven impact on a country. Rather, to stir development the oil sector must be integrated into the national economy.

The oil industry must be "linked," both forward and backward, with the rest of the economy. "Backward linkages," entail the use of local goods, services, and labor rather than reliance upon imports from abroad. "Forward linkages" include supplying the oil needs of the local market and developing downstream petroleum related industries, such as refining and petrochemicals. Simultaneously, host governments have sought to strengthen "consumption linkages" stemming from the local incomes generated by means of the oil industry and "fiscal linkages," the government revenues realized from oil operations. This set of linkages is a network which defines the extent to which the oil sector is integrated in the socio-economic fabric of the country.

To maximize and coordinate these positive linkages, the host state must play an active role in setting national oil policies. As mentioned earlier in this chapter, state control typically is

exercised by means of the national oil company. The building of a viable NOC, in turn, usually has been predicated upon a type of "intra-industry linkage," in which nationals received the technical, managerial, and marketing training necessary for the operation of an efficient oil industry. In most instances, this type of training was provided only upon the insistence of the host government, as the TNOCs, not suprisingly, were less than eager to train nationals who might someday displace the TNOCs.

It is only in the broader context of development concerns that Third World states can make wise decisions with respect to their oil industries. Insofar as host policy maximizes the development oriented goals of the state, the more it is exercising control over its domestic oil resources and the more likely it is to be acting in a manner which is not consistent with the interests of the TNOCs.

IV.3 Nationalism

If the state is considered a necessary problem with which TNOCs must deal, nationalism, generically defined as that which "holds the people together in common support of national objectives,"⁵⁸ is abhorrent to the transnational corporation. "The international corporation has no country to which it owes more loyalty than any other, nor any country where it feels completely at home."⁵⁹ The state, as such, is considered an obstacle to corporate operations. Transnational firms would prefer a global system in which the firm is held responsible to an international authority of some sort which would resolve corporate-host country differences "by harmonizing and rationalizing national policies" and determining "policies on a global basis."⁶⁰

The state is seen as an anachronism which has outlived its economic utility and interferes with the smooth operations of the world economy.⁶¹ Private business in a free market, the sine qua non of the TNC, is considered the most efficient path to rational economic development. Nationalism is seen as an irrational force which interferes with the firm and the "true" economic interests of the state. Typically identified with Third World states, nationalism is considered "the major political influence responsible for the fact that many features of the policies, concepts and methods of economic development planning in [less developed] countries either do not make economic sense, or else would make economic sense only in certain specific and rather exceptional economic circumstances, the actual presence of which no one has felt it necessary to establish by empirical economic research."⁶² "Almost always characterized by irrational feelings of internal loyalty and of aversion to things external and foreign,"⁶³ nationalism has "time and again" led to "the deemed political requirements of the moment [overriding] the nation's longer term interest in maintaining conditions that would attract new mineral investments."⁶⁴

To transnational corporations and Western economists alike, issues of foreign investment present economic questions which are amenable to arms-length, rational analysis. "As such," it is argued, natural resources "qualify for foreign investment. Whether to sell them to foreigners or not is a question of price."⁶⁵ Foreign direct investment, however, is more than an economic issue. "It is also a political phenomenon. Foreign control means the potential shift outside the country of the locus of some type of decision making... To

the extent decision making is eroded, national independence--being, in a broad sense, the ability to make decisions in the national interest --is reduced."⁶⁶ "It seems unlikely that any government can see as desirable or even tolerable a situation in which key sectors of its economy fall under the control of foreign interests,"⁶⁷ and, for oil producing states, the petroleum industry is the economic sector.

Nationalist sentiments often have focused on the natural resource wealth of a country, particularly in those states that are mineral exporters. Resources are considered the common patrimony of the land and its people, whether they are seen as a gift from Allah or simply a vast reservoir of potential wealth. Every barrel or ton exported means that much less left in the ground, that much less for domestic consumption, that much less to pass on to future generations. Net outflows mean the continuous depletion of this reservoir, in return for which host governments want appropriate payment.⁶⁸ To a large extent, the vital importance of this depletable resource explains the emotions which surround questions of foreign control over and profits from local oil industries.⁶⁹

Resource nationalism involves the bundle of national concerns involved in the development of a state's natural resources. In its most tangible form, it is embodied in the concept of permanent sovereignty over natural resources.⁷⁰ Throughout most of the states which support the call for permanent sovereignty and a "new international order," the main object of economic sovereignty is national control over natural resources.⁷¹ While permanent sovereignty is a nationalist expression, it is simultaneously a policy of striving on the part of major mineral producing countries to

gain control over their economic fate, which will be determined by their mineral industries. The founding of OPEC, moreover, has been characterized as the first instance of "practical significance" in moving toward permanent sovereignty, and the "effective practice of this right was the real impetus for all recent radical developments that have occurred in the international oil industry."⁷²

To a large extent, current-day nationalism in general, and resource nationalism in particular, is identified with Third World states. The years of imperialism and foreign domination suffered by most of the developing nations often were identified with foreign corporate control over all aspects of local mineral resources. The roots of the modern transnational petroleum industry are firmly entrenched in a period of Western imperialism and penetration of underdeveloped areas unable to withstand foreign political and economic control. As much as foreign governments represented distant, unwanted military and political conquerors, Western TNCs were immediate, tangible forms of foreign economic control and exploitation.

Upon attaining independence, every Third World oil exporter was host to a foreign petroleum firm that exercised uncontested ownership of and control over its domestic oil operations. The governments and economies of the exporting countries remained "dependent" upon the Western states and TNOCs. Foreign control over such a central sector of the national economy was characterized "as a form of economic colonialism incompatible with the status of a sovereign nation."⁷³ As one analyst has expressed it, "Peru was a sovereign state, but within its borders there existed another state--not necessarily an American

colony, but part of a multinational concern (the International Petroleum Company) with supranational loyalties."⁷⁴ As a result, the de facto sovereignty of Peru and many other developing countries was undermined by the effective control over the host national economy exercised by foreign oil firms serving their own interests.

In addition to their sense of economic dependency, Third World states have a perceived sense of second class citizenship. Compared to the Western world, developing countries suffer from a sense of impotency in world affairs, as well as socio-economic deprivation. The pursuit of economic sovereignty "is seen as inseparable from the objective of more nearly approaching equality in international economic power relations."⁷⁵ The exercise of "oil power" by developing countries, a process which, by definition, entails challenging the position of the TNOCs, is aimed at both the foreign oil firms and the home governments. The relative military, political, and economic impoverishment Third World nations must endure, with the accompanying frustration felt by local elites, fuel nationalist sentiments.⁷⁶ The level of frustration, or sense of relative deprivation felt by developing nations is, at least in part, a function of the gap between national aspirations and expectations, on the one hand, and national welfare conditions, on the other.⁷⁷ As visible symbols of foreign affluence and power, compared to local poverty and impotence, TNOCs have been attractive scapegoats for fragile governments trying to retain domestic support in light of faltering economic performance.

Nationalism is not, however, simply a negative reaction to foreign firms nor exclusively a phenomenon of Third World societies. Developed as well as developing countries exhibit economic nation-

alism. "Almost all countries...define as 'sensitive' or 'vital' certain areas in which dependence on the performance of a foreigner constitutes a potential threat to national sovereignty, welfare, or security."⁷⁸ "All national powers resist transnational forces that threaten--or are suspected of threatening--sovereign authority over their territorial jurisdictions."⁷⁹ Economic nationalism is part and parcel of Canadian efforts to gain control over and develop their economy.⁸⁰ Similarly, "'oil nationalism' is in keeping with the traditions of government in the United Kingdom and Norway" of having industry serve national needs.⁸¹

There is a tendency on the part of Westerners, particularly in the U.S., to speak of nationalism abroad and the "national interest" at home.⁸² In effect, however, the national interest is an expression of nationalism. In contrast to inter-, supra-, multi-, or transnational forces, nationalism and national interests are defined in terms of the state or the nation. States, by definition, pursue policy goals which further a country's interests. Economic policies--be they domestic content laws in the U.S. or domestic refining policies in oil exporting countries--are inherently nationalistic.

The state is a mercantilist entity, in that it always wants to promote its own interests and strengths. The state has no rationale for its existence other than to maximize its interests, economic and political. "The essence of contemporary mercantilism is the priority of national economic and political objectives over considerations of global economic efficiency."⁸³ The concept of "global economic efficiency" is an abstraction. The only actors, be they states or TNCs, that pursue so-called global economic interests are those that

stand to benefit from the pursuit of such interests. Few states have ever been in the position of having their narrowly based interests coincide with what are perceived to be broader world interests. States are not altruistic entities. The mercantilist or nationalist interests of the state are paramount; world interests are only secondary at best.

Mercantilism, the policy of putting the national interests of the state ahead of the interests of any group within the state or group of states, is the secular religion of the state. Economic nationalism is part of the definition of the state. All states, developed and developing, exporter and importer, home and host, pursue nationally defined economic interests. Mercantilism is a universal economic philosophy of the state.

Economic nationalism or mercantilism, moreover, is a rational economic policy. Historically, nationalism has been a means rather than an end.⁸⁴ For developed states, mercantilism means policies aimed at maintaining and furthering high standards of living and socio-economic development. For developing countries, it means policies aimed at industrialization and modernization. For all states, it means policies aimed at promoting national interest in competition or collaboration with other political actors or groups of actors.

Resource nationalism, by and large, has been channeled towards satisfying government policy goals. With a handful of exceptions, host governments have pursued the orderly assumption of control over the oil industry. Efforts at national control and ownership stem from an "economic philosophy to be seen in all societies."⁸⁵ The exercise of national sovereignty through regulation of the marketplace

and the use of regulation as a discriminant policy aimed at particular goals are "predictable" actions on the part of host governments.⁸⁶

In addition to the traditional economic policies pursued by developed states, Third World countries increasingly approach resource and other economic issues as cost/benefit problems subject to rational analysis.⁸⁷

Nationalism yields both tangible benefits in terms of host government control and economic returns and intangible rewards as a "collective consumption good" affording psychic "income."⁸⁸ National elites, in particular, strive "to avoid a sense of dependence" on foreigners.⁸⁹ While most states strive to attract foreign investment, the more foreign investment and foreign influence there is in an economy, the greater the sense of "disutility" felt by nationals.⁹⁰

The mere presence of foreign firms stirs a sense of nationalism. The TNC's allegiance is to itself. In fact, transnational firms exhibit a type of "corporate nationalism," a sense of "devotion to the growth and well-being of the corporation."⁹¹ By their very nature, TNCs present a threat to the autonomy and integrity of the state.⁹² Foreign firms, moreover, are not considered legitimate participants in the domestic political processes of a state.⁹³ The larger and more powerful TNCs become, furthermore, the more threatening they become, and the more local nationalism grows. "Each increase in the revenues derived from the foreign-owned enterprise, each enlargement in the role of the enterprise as a buyer of local goods and services or as an employer of local talent, simply increase

the apparent vulnerability of the local economy to the foreign enterprise."⁹⁴

IV.4 Political Risk Events

The objectives of the host government with respect to TNCs are "to tilt the benefits brought by multinational companies as far as possible in their favor and to minimize the costs to them which can be associated with such investments...The issue is how to get foreign investment on the terms which are best for them and indeed to use the power of the firms to promote their own national goals."⁹⁵ In every major oil exporting country, the oil industry is recognized as a type of public utility,⁹⁶ the purpose of which is to further national economic and political ends. While TNOCs pursue the oil business as a vehicle for profit making, host governments see their national oil industries in the context of national goals. The legitimacy and value of the operations of foreign oil firms hinge on the contribution such operations make to furthering national interests, not on the profitability of the companies.

In pursuing nationally defined interests, the host state, by necessity, regulates, limits, controls, and sometimes prohibits the operations of foreign oil firms. The efforts of host states to implement policies aimed at furthering the national interest translate into political risk events, specific outcomes in the host country that are likely to have a negative impact on a project. The violation of contractual agreements by states is commonplace.⁹⁷ Such acts are a prerogative of sovereignty. As the interests of host and TNOC are inherently divergent, moreover, political risk events should be expected.

As policy outcomes, political risks are not undifferentiated, homogeneous phenomena affecting all foreign companies in the same manner.⁹⁸ Political risks are situation specific: the vulnerability of firms varies between countries and industries, changing over time. Most political risks occur at the "micro" level, affecting individual firms or a group of companies, rather than all TNCs.⁹⁹

At the broadest level, political risks mean reduced profitability and reduced managerial control. The ultimate purpose of corporate control, in effect, however, is to maximize profitability, although control can be conceptualized as an end as well as a means. From a policy point of view, political risk events, the specific managerial contingencies which threaten corporate interests, can be grouped in terms of:

- 1) costly fiscal changes
- 2) cost increases, other than fiscal changes
- 3) increased host state control over operations
- 4) expropriation, "creeping" or outright
- 5) reduced access to supply and supply interruptions
- 6) adverse price manipulations
- 7) reduced access to income

While the ultimate outcome in each event is an expected loss of potential earnings, each class of risk events represents a different type of problem for TNOs. The classes of political risk events are closely related, however, and in places even overlap to an extent. More importantly, they are interrelated in being the outcomes of host state policies aimed at pursuing the state's interests. Each class of

risks stems from policies which address one or more of the state's interests.

For oil producing states, gaining control over the national oil industry is a prerequisite for the state to begin to be in control of its own destiny. Increased taxes or prices mean greater economic resources at the disposal of state authorities, while government control enables the host regime to implement policies which will strengthen its political position. Expropriation can be a means not only of contributing to and demonstrating the power of the state, but of assuaging the demands of an important domestic constituency or defusing the appeal of an opposition group. In some instances, as in Argentina and Brazil, for example, oil nationalism historically has been part of the national government's drive to assert its authority over provincial powers and landowners with whom TNOCs have courted favorable relations.¹⁰⁰ For Third World states, the "power maintenance" or "survival function is most often observed against the foreign-owned multinational corporation, rather than directly against other nation-states."¹⁰¹

Changes in the fiscal regime and higher prices are the primary means by which host governments have increased national economic returns from oil development. Government control over operations also might be aimed at increasing economic returns: direct government-to-government sales cut the middleman role played by (and revenues captured by) TNOCs, and domestic refining permits the host government to increase the value added retained by the domestic economy. Although the debate about the cost effectiveness of expropriation may never be

resolved, expropriation often is perceived as a means of increasing the economic returns to the host state.

Domestic policy goals typically require the higher revenues host governments earn via increased taxes and prices. On a broader level, however, host governments typically demand that the TNOCs train and use as much local labor and management as possible. Similar demands for the use of local goods and services are aimed at generating "backward" linkages with the local economy to spur local economic activity. Forced investments in infrastructure have the similar effect of furthering domestic policy goals at the expense of greater costs to TNOCs. Conservation and demands for local consumption may result in reduced access to supply, while efforts to stimulate local reinvestment may mean reduced access to income on the part of TNOCs.

Political risk events are outputs in host states that are likely to carry adverse consequences for the operations of foreign firms. They are specific outcomes which threaten the interests of TNCs. All of the categories of political risk events are evidence of local exercise of control over natural resources. While total operational control may be the sought after goal, the ability to raise taxes and prices or force the training and employment of nationals also are examples of some measure of domestic control. The seven classes of risks are generally applicable to other sectors as well, particularly mining. Some of the events may be relevant only to certain types of investment agreements. Price increases, for example, are important only when the oil firm is buying crude from the host country under contract as part of an overall investment agreement and typically pre-

sents no risk to companies producing oil under other types of arrangements.

There is no direct correlation between the type of investment agreement or identity of the host state and the profitability of a foreign investment project in petroleum. Regardless of these variables, increases in the fiscal burdens which must be borne by TNOCs present specific managerial contingencies or political risks to transnational oil companies. The fiscal regime governing a project is composed of direct and indirect taxes. Direct taxes on net revenues --income taxes--are a post World War Two phenomenon in the oil industry, beginning in Venezuela in the mid 1940s and spreading throughout the Middle East during the early 1950s. Prior to this period, indirect taxes--royalties, import duties, service taxes, etc.--were the prevalent means of taxation.¹⁰²

In general, the host state can collect its portion of economic "rent" from an investment project either through taxation or forcing the foreign firm to provide services or benefits to the host country.¹⁰³ While both approaches have been employed by host states since the onset of the world oil market, the primary vehicle used by the state to increase its share of the petroleum pie has been the power to tax. The focus on taxation issues is so prevalent that the evolution of the oil industry can be studied in terms of the history of tax increases host states have fought to impose on TNOCs.

As a group, oil exporting countries, under the umbrella of OPEC, launched a systematic attack on the traditional fiscal arrangements between TNOCs and states during the first half of the 1970s. In December 1970, OPEC moved beyond the "50/50" split which had become

the industry norm in the 1950s and demanded a 55% minimum tax rate. This rate was imposed on the oil companies by the Tehran and Tripoli Agreements the following year. This fiscal arrangement generally prevailed until the second half of 1974, when TNOCs were subject to a series of fiscal shocks.

- o In June of 1974 the royalty on production was raised from 12.5% to 14.5%.
- o That September, royalties were pushed to 16.6%, and the income tax rate was boosted to 65%.
- o And in November/December 1974 royalties were set at 20% and income taxes at 85%.

In the course of six months, the TNOCs' cost of equity oil rose from 61% of the posted price (12.5% royalty off the top plus 55% of the remainder) plus production costs to 88% of the posted price (20% royalty plus 85% of the rest) plus the cost of production.¹⁰⁴

This series of political risk events during 1974 led to a dramatic increase in the tax burden imposed on TNOCs. These events did not, however, occur in a vacuum. During this same period prices were rising and demand remained strong. While higher taxes cut into the TNOCs' share of industry revenues, other market forces, particularly the ability to reap windfall gains on inventories in the light of rapidly rising prices and slow moving oil tankers, mitigated the adverse impact of the general increases in taxes. In fact, despite tax increases, rising prices and inventory profits made 1974 a record year for oil industry profits. The group of large petroleum companies studied by Chase Manhattan, for example, reported net foreign earnings (non-U.S. operations) of \$7.54 billion and a rate of

return of 20.9% in 1973, compared to \$9.97 billion and 23.2% in 1974, and \$5.5 billion and 12.7% in 1975.¹⁰⁵

Examples of costly fiscal changes as political risk events are legion and can be studied on a country-by-country basis. While early host/company battles over taxes focused on Venezuela and continued to be centered around the OPEC members in the 1970s, there is no shortage of documentation on tax increases in developed states as well. The U.K. and Norway, have, in effect, taken advantage of their political reliability in the eyes of the West to impose a measure of "political rent" on North Sea Oil.¹⁰⁶ The Petroleum Revenue Tax in the U.K. was instituted in 1974 at 45%, rose to 60% in 1979, climbed to 70% in 1980, and was topped by a 20% Supplementary Petroleum Duty in 1981. The top marginal tax take, in turn, has risen from 75.9% in 1978, to 83.2 in 1979, 87.4% in 1980, and 90.3% in 1981.¹⁰⁷

TNOCs also may be subject to reduced access to income at the hands of host governments. This can take many forms: restrictions on the repatriation of income abroad, reinvestment requirements, foreign exchange controls, or currency revaluations/ devaluations or exchange rate manipulations. Each of these present TNOCs with the threat of not being able to reap profits or use revenues in the most economically efficient manner. Revenues are earned, but their value is discounted by government policies regulating the use and placement of such revenues.

We previously identified two general means by which states collect their share of rents from an investment agreement: the first is taxes, the second is services or benefits provided by TNCs. Many political risk events translate into a direct increase in costs for

TNOCs.¹⁰⁸ Companies can be required to invest in additional infrastructure to satisfy host government demands or be forced to rely on (and help develop) local goods and services and labor. Unanticipated increases in capital or operating costs can have a disproportionately adverse affect on the discounted cash flow from a project. In recent years, for example, Algeria and Libya have required some TNOCs to invest some amount (between \$1 and \$3) in new exploration for every barrel of oil purchased from these states.¹⁰⁹ Similarly, in November 1982 the Indonesian government ordered foreign oil companies to replace some 3,000 expatriate rig workers with Indonesian nationals within two months.¹¹⁰ Proper technical training has its costs. To the extent qualified labor is not available, the TNOCs are forced to absorb the additional costs created by reduced efficiency. Inferior "inputs," in the form of goods, services, or labor, mean increased costs. Typically, the quality of inputs in many oil exporting countries is not as good as that which could be obtained from the world (or home country) market.

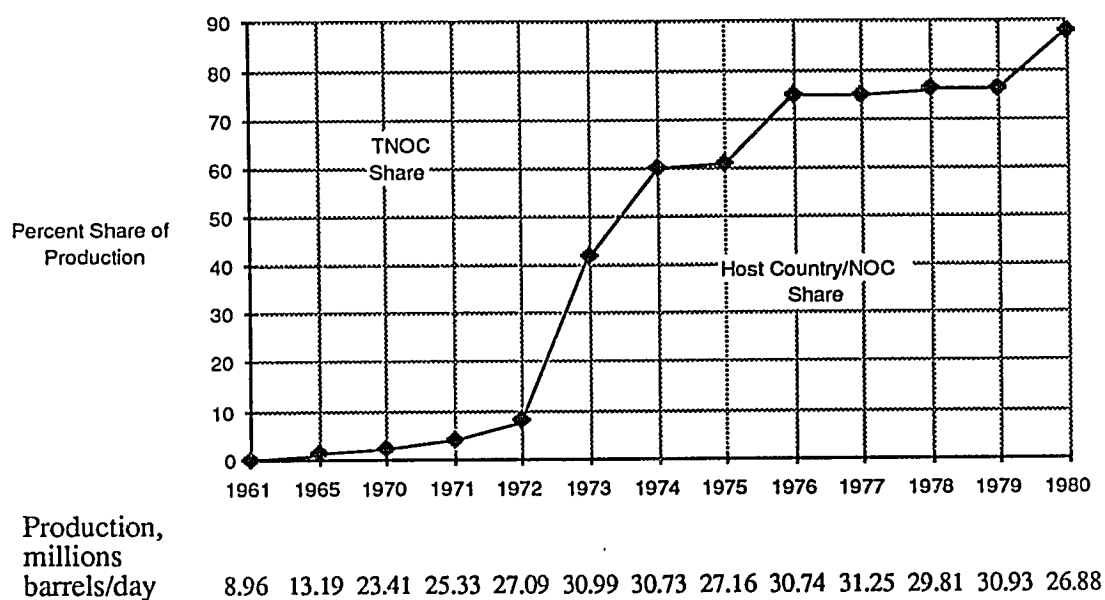
The category of government control over operations, in a sense, involves the broadest goal of host states: total control over the national economy. Usually, control is aimed at promoting national economic development or protecting national interests. From the TNOC's point of view, however, control is unwarranted interference in operations. In fact, the more benefits a state realizes from oil operations, the more sensitive it becomes to the need to maintain and increase those benefits, the more cognizant it becomes of its reliance on TNOCs, the more assertive it is in seeking control over petroleum operations and activities.¹¹¹ There is an ironic increase in the

state's sense of vulnerability as it comes to rely upon oil operations. This places a premium on state efforts to assure the continuation of operations in a manner which best serves the interests of the state.

At the broadest level, total government control might mean the end of private TNOCs. While the transnational oil firms are not about to disappear, their role in (and control over) the market has been substantially reduced. In 1980, the 13 OPEC national oil companies, for example, directly marketed more than 50% of OPEC exports, compared to direct host exports of virtually zero in 1970 and barely 5% in 1973.¹¹² In 1975, the Federal Energy Administration estimated that by 1985 75% of world oil output would be controlled by host governments.¹¹³ In terms of the OPEC countries, the FEA estimates were too low and too late. As Figure IV.1 shows, the OPEC governments increased their share of production from less than 10% in 1972 to 88% by 1980. TNOCs will still be able to play middleman, but they will increasingly be operating under the shadow of control exercised by host states.

More specifically, host government control as a political risk entails a range of ancillary demands on TNOCs which negatively affect corporate operations. Perhaps the best example of such demands is the insistence on local refining. Given the economies of scale of large tankers transporting crude of specified qualities to markets for local refining (again to specifications) and distribution, in the post World War Two period TNOCs developed an integrated network relying on refineries in the consumer countries. This system makes "economic sense," as it is more expensive to ship smaller volumes of refined products

Figure IV.1: TNOC and OPEC Host State Share of Crude Oil Production (% Production)



Sources: (1) 1961-1974: Dankwart A. Rustow and John F. Mugno. OPEC: Success and Prospects (New York: Council on Foreign Relations and NYU Press, 1976)

(2) 1975-1980: Organization of Petroleum Exporting Countries. Annual Statistical Bulletin 1980 (Vienna: OPEC, 1981)

(which cannot be mixed) of different qualities over long distances than to ship larger volumes of crude.¹¹⁴ Local refining, however, permits host states to capture a larger share of the economic rents and increase domestic value added to the final product, as well as contribute to industrialization. Domestic processing, in short, makes "economic sense" for the host state in the form of increased value added, employment, and foreign exchange earnings.¹¹⁵ Despite the additional costs, to assure supplies many companies have "offered" to build refineries in OPEC countries.¹¹⁶ While in the late 1970s, 85% of OPEC oil exports were in the form of crude,¹¹⁷ exports of refined products were 1.5 million barrels per day in 1980, and are expected to reach 3.5 mn b/d in 1985 and 5.7 mn b/d in 1990.¹¹⁸ The result is a continuous increase in government control over the industry and a proportionate erosion of the control and flexibility of corporate operations.

Recent years also have seen the introduction of other "controls" which affect operations, such as the abolition of traditional volume tolerance levels, requirements that lifting be continuous and even throughout the course of a year, restrictions on the exchange or resale of crude, and destination controls.¹¹⁹ Another area of increased host control is shipping. Despite over-capacity in tankers the world's tanker fleet is growing, primarily through the construction of tankers to be owned and controlled by oil exporting countries. Shipping oil in nationally owned tankers will further increase both national value added and control; TNOCs experience a proportionate erosion of both. Contracts for Kuwaiti crude, for example, permit Kuwait to demand that 50% of purchases be carried in

Kuwaiti tankers, as well as permit the state-owned Kuwait Oil Company and Kuwait National Petroleum Company to refine in purchasers' refineries, for their own account, a quantity up to 25% of the contracted volume.¹²⁰ The net result of government controls and demands is reduced managerial control on the part of TNOCs, typically coupled with increased costs.

Expropriation is the most dramatic of political risk events. The expropriation of producing assets is nothing new, dating back to 1917 in Russia and 1938 in Mexico. Expropriations became frequent occurrences in the 1960s, including an assortment of refining and distribution assets in Algeria, Ceylon, Syria, and the U.A.R. and culminating in the dramatic Peruvian expropriation of the International Petroleum Company (IPC, a subsidiary of Standard of NJ). Throughout the 1970s, expropriations became commonplace and involved virtually every major foreign investment project. The majority of the Venezuelan concessions, for example, were binding through 1981; the Aramco agreement was to run until 1999; the Iraq Petroleum Company's agreement extended to 2007; and the concession held by the Kuwait Oil Company (KOC, owned 50% each by Gulf and BP) was not to expire until 2026.¹²¹ Yet, IPC was nationalized in 1973, the Venezuelan concessions were fully nationalized in 1974-75, KOC was 100% nationalized in 1975, and Saudi Arabia completed its takeover of Aramco (begun in 1973) in 1980.

Expropriation usually is conceptualized as a sudden act in which all of a TNCs operations are seized by the host state. Such an "all or nothing" view is a gross simplification of what in reality often is a slow, piece-meal process. "Creeping expropriation," the process by which the state gains ownership of assets and operations over time, is

more common than outright seizures. The concept of "participation," the prerogative of the state to assume a direct ownership position in foreign controlled oil ventures, was introduced by Saudi Oil Minister Yamani in 1973 to describe the evolutionary process through which the OPEC countries planned to gain total ownership of their oil industries. In October 1972, Saudi Arabia, Qatar, Kuwait, and Abu Dhabi came to an agreement with their concessionaires under which participation was to begin at 25% in 1973 and increase to 51% by 1982.¹²²

The principle of participation actually dates back to the Iraq Petroleum Company agreement of 1925 and Anglo-Iranian (BP) agreement of 1933.¹²³ The companies, however, resisted implementation of early participation clauses. The first time one of the majors offered host state participation was in 1961, when Shell gave Kuwait the right to a 20% participation in any offshore finds.¹²⁴

Beyond the distinction between outright and creeping expropriation, moreover, there is a broader conceptualization of the political risk event labeled expropriation as any seizure of a property or contractual right. "The cancellation of contracts and revocation of concessionary rights for the exploration and development of petroleum and mineral deposits may rightly be considered an expropriatory deprivation of property."¹²⁵ The state's seizure of privately owned property privileges is, in effect, a cancellation of a potential income or wealth producing activity which has some economic value. The loss of this value via government decision is an expropriation of the rights and privileges implicit in ownership or stated in a contract of control. The forced relinquishment of part of the territory or rights covered by an agreement--such as the 1961 act by Iraq

to seize more than 99% of the area over which the IPC concession extended,¹²⁶ the 1963 decision by Argentine President Umberto Illia to nullify the exploration and development contracts negotiated by his predecessor,¹²⁷ or the 1981 decision by Iran to cancel all agreements with the 14 member consortium which previously had operated the Iranian fields¹²⁸--are expropriatory in their effect.

In terms of the foreign policy interests of oil producing states, "given the strategic and economic importance of oil, particularly when scarcity looms on the horizon, exporting oil (or not) is also a form of foreign policy."¹²⁹ The foreign investment regime develops over time as a combination of domestic development strategy and foreign policy.¹³⁰ While the targets of foreign policy traditionally are seen as other states and the international system as a whole, host governments, in effect, maintain external relations and policies with other international actors, including TNOCs. TNOCs, moreover, may be employed as vehicles for implementing policies (as when prices are raised) or be subject to risks in the course of pursuing foreign policies. Expropriation, in particular, often has been justified, at least in part, in terms of foreign policy concerns: the August 1979 nationalization of BP's production and marketing assets in Nigeria was justified by the Lagos government as retaliation against BP because the oil company supposedly supplied oil to South Africa, a contravention of Nigerian foreign policy¹³¹ (the nationalization also occurred immediately prior to the Lusaka Conference to determine the fate of Southern Rhodesia and may have held some not so hidden meaning for the British government, which was seen as dragging its feet on the transfer of power to blacks); the December 1971 expropriation of the

British Petroleum Exploration Company by Libya was justified as "retribution" for British "complicity" in Iran's taking of three islands in the Persian Gulf;¹³² the Libyan expropriation of the Nelson Bunker Hunt Oil Company in June 1973 was called "a warning to the United States to end its recklessness and hostility to the Arab nation" and a necessary "blow against U.S. policy...in view of... American impudence and the continued disregard for Arab rights and Arab destinies;"¹³³ and following President Carter's April 1980 decision to ban oil imports from Iran in the midst of the hostage crisis the Iranian government retaliated by banning sales to U.S. oil firms.¹³⁴

The traditional control over supplies entering international trade was one of the strongest points of market power commanded by the TNOCs. The major TNOCs maintained vertically integrated global operations which linked upstream (production) operations with downstream (distribution) activities. These transnational production networks enabled the TNOCs to balance global and regional supply and demand in the most cost effective manner. Quality and price differentials could be matched to company needs and managed to maximize profits.¹³⁵ A continuous flow of supply was assured, insulating the company from costly interruptions in operations.

Since the early 1970s, however, the TNOCs have become increasingly vulnerable to shortages and supply interruptions. "The events of the 1970s destroyed entirely some vertically integrated linkages"¹³⁶ in TNOC operations. Most oil companies have lost their equity crude, forcing them to rely on purchases from the host state.¹³⁷ Many of the TNOCs find themselves "short," necessitating

reliance on spot purchases and buying under contract. BP, for example, once enjoyed a cushion of 66 billion barrels in OPEC reserves. Following its losses in Nigeria and Iran in 1979 and Kuwait in 1980, BP saw its reserves fall to 2 billion barrels.¹³⁸ The company, in turn, has been forced to turn to spot purchases and short term deals to satisfy at least 10% of its oil needs.¹³⁹ The other TNOCs have suffered similar losses of access to supply, and by mid-1980 the majors were buying some 7% of their crude requirements on the open market.¹⁴⁰

This reliance on purchases is inseparable from TNOc vulnerability to price increases, particularly when supply is tight. When prices are rising--as after the Iranian Revolution--the exporting states have strong motivation to abrogate existing sales agreements and sell at the higher spot price or simply tag "premiums" on top of the originally agreed upon price. If a firm refuses to pay, supply may be cut. In 1980, for example, Iran diverted an increasing share of its exports away from traditional buyers to the spot market.¹⁴¹ When Japanese firms refused to pay the premium Iran tagged on to the selling price in 1980, the Iranian government suspended the sales.¹⁴² The sales resumed ten months later.¹⁴³ Similarly, when Gulf, BP, and Shell refused to pay the premium levied by Kuwait on sales previously contracted for, the Kuwaiti government suspended loadings by the three firms.¹⁴⁴ When the dispute was resolved, the three firms signed agreements without premiums--but each firm would be entitled to buy only 50,000 barrels per day, as opposed to the 75,000 b/d, 150,00 b/d, and 225,000 b/d to which Gulf, BP, and Shell, respectively, had previously been entitled.¹⁴⁵

Regardless of price issues, host states may reduce TNOC access to supply for other policy reasons. In 1980, for example, Libya cut production by all foreign firms operating in that country. Occidental's liftings were slashed 37%, Elf Aquitaine 29%, Esso 27%, Agip 20%, the Oasis Group 16%, Mobil 10%, and National Oil Corp. 4%.¹⁴⁶ Although a subsequent agreement between the Ottawa government and the province of Alberta averted the problem, in late 1980 Alberta's Premier Lougheed threatened to cut oil and gas production 15% because of opposition to the central government's oil policy.¹⁴⁷ In October 1981, Pertamina, the Indonesian state owned oil company, ordered Atlantic Richfield to terminate production in the Kalimantan region of Borneo.¹⁴⁸

Actually, the decision came the day after the company's ten year production sharing agreement expired, but Arco officials were operating under the implicit assumption that the agreement would be renewed.¹⁴⁹ While the U.K. has not acted to limit production, oil depletion policy is a hotly contested subject, and 1982 was the first year the government had the express authority to limit output from North Sea fields discovered before 1975.¹⁵⁰

Adverse price manipulations have a mixed impact on TNOCs. On the face of it, higher prices mean higher costs, and higher costs translate into lower profits. If prices can be passed on to consumers, however, price manipulations by host states may not always be "adverse" in impact. In fact, sudden price increases have yielded TNOCs windfall profits on inventories acquired under the old price structure and sold according to the new, higher prices.

This rejoinder aside, prices are controlled by host states in an effort to maximize their interests, not the returns of TNOCs. The

TNOCs find themselves particularly vulnerable to price manipulations in the 1980s because of their loss of equity crude. As buyers of crude from host governments, TNOCs are directly affected by oil prices. Not all price increases can be passed through to consumers, particularly when the increase is based on the fortuitous market position enjoyed by one or a few countries. In the winter of 1980, for example, Kuwait imposed a \$5.50 per barrel premium on sales under new and old contracts to Shell, BP, and Gulf,¹⁵¹ and earlier that year Iran demanded a \$2.50/bbl. premium from Japanese oil companies.¹⁵²

Adverse price manipulations can also reduce the benefits a company reaps from a service contract. If, for example, a TNOC is entitled to recover the costs of exploration or to share in output at some agreed upon price, an increase in prices will mean that the company receives less supply to offset its costs; in effect, the company is paying more for its share of production.¹⁵³ A similar economic logic left BP vulnerable to additional losses after its 50% share in the Shell-BP Development Company and 60% stake in BP Nigeria were expropriated by Nigeria in August 1979. Two years after the expropriations Nigeria agreed to compensate BP with approximately \$134 million worth of crude on the basis of \$40.02 per barrel.¹⁵⁴ The official selling price of Bonny Light (on which the compensation was based), however, was under \$25 at the time of the expropriation.¹⁵⁵ Using the official price which prevailed at the time the decision was made in 1981 (at which time the market was soft and Nigerian oil was sorely overpriced) rather than the market price from two years

earlier, Nigeria reduced almost by half the quantity of oil BP received in the compensation award.

Reduced access to income, such as restrictions on repatriation of revenues or limitations on conversion of local currency to hard currency, severs the financial relationship between the local operations managed by the subsidiary and the parent company. If the subsidiary cannot remit revenues abroad in the form of hard currency it is, in effect, the financial hostage of the host. Such a policy forces the subsidiary to reinvest in the national economy. At this point, the subsidiary no longer is acting as part of a transnational unit but as a national firm under nominal foreign ownership.

Our seven categories of political risk events--fiscal changes; other cost increases; increased host control over operations; expropriation; reduced access to supply and supply interruptions; adverse price manipulations; and reduced access to income--overlap. In some instances, occurrences have application and relevance in more than one category. At the very least, political risk events converge in their ultimate impact upon TNOC activities: reduced profitability and reduced control.

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- ¹⁶Kobrin, "Foreign Enterprise," p.85.
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- ¹⁸Frank, p.35.
- ¹⁹Bergsten, pp.136-137.
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- ²¹Kobrin, Managing, pp.117-119.

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⁵¹Tanzer, Political Economy, p.134.

⁵²Raymond Mikesell, The World Copper Industry (Baltimore: Resources for the Future/Johns Hopkins University Press, 1979), p.4.

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⁵⁵U.N. Commission on Transnational Corporations, p.80.

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- ⁸²Hartshorn, p.33.

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V. CONSTRAINTS AND OPPORTUNITIES

Given the structural differences and conflict of interests between the host state and the TNC, it is impossible for both actors to realize their respective long-term interests simultaneously. Political risks stem from this situation. Political risk events, however, do not always materialize, despite the implicit political risks inherent in the foreign investment relationship.

The intensity of the conflicts inherent in the host state/TNC relationship is mediated by other variables. These variables constrain and define the degree of actual conflict which occurs between host and state. Despite the inherent differences between the two actors, they do not appear to be in a condition of endless conflict. If surface conflicts were continuous, there would not be any foreign investment projects. The mediating barriers form a buffer between the antagonists and shape the immediate environment within which host and TNC interact on a day-to-day basis.

The primary mediating variable between host and firm is the bargaining relationship, which can be defined in terms of the relative market power and bargaining positions of the actors vis-à-vis each other. The bargaining relationship is the conceptual key to interpreting the vicissitudes of the relationship between foreign investor and host state and the relative ability of either actor to impose its will upon the other. Interests are constrained in action by what is feasible.¹ Unable to challenge the TNOs, for many years the oil producing countries were unable to translate their

interests into action. They were unable to impose binding decisions upon the TNOCs.

While the bargaining model explains the relationship between host and TNC, the respective bargaining positions of the two actors define what is possible and the range of opportunities. That which is possible, however, does not always occur; opportunities are not always seized. Two other inter-related mediating variables are important in determining political risk events: domestic demands and supports and the style and ideology of leadership. "Domestic political circumstances have a fundamental impact on whether and how a country uses its power over multinational corporations."² Domestic conditions determine the political necessity and/or willingness of decision makers to try to impose changes on the TNCs. If conditions "mature" before the state is in the bargaining position to enforce its position, host leader efforts to revise the host/firm relationship are destined to fail. The ill fated effort by Mossadegh to restructure Iran's relationship with Anglo-Iranian (BP) is testimony of this. Given the parameters of possibility defined by the bargaining relationship, domestic political conditions will determine the timing and form of specific political risk events.

Bargaining power is a reflection of the relative dependencies of the actors, their ability as well as their willingness/need to exploit those dependencies. In the early years of the oil industry bargaining power was in favor of the TNOCs. As conditions both within and without the industry changed, bargaining power began to shift in favor of the host states. TNOC exposure to political risks rose as the bargaining power of the firms declined. Following a presentation of

the bargaining model and development of the components of bargaining power, this chapter shows the relationship between bargaining power and political risk in a historical context.

V.I. The Bargaining Model

Investment agreements are determined by the dynamics of the bargaining relationship between the host government and the TNC. This bargaining process takes place in a fluid, changing international and domestic environment of ongoing political and economic activities. The bargaining process lends shape and structure to the divergent interests of host and state, permitting agreement to be reached out of differences. Bargaining is a process, a continuously evolving set of conditions with no definitive solution. Each agreement is but one of an ongoing series of agreements which change to reflect the respective bargaining strengths of the actors involved. Differences between host and TNC, regardless of how cooperative or combative each may be, are managed (as opposed to resolved) on the basis of the relative bargaining positions each can command. The terms of agreements reflect the bargaining power wielded by host and TNC.³

The bargaining model sees the relationship between host and firm as essentially that of a bilateral monopoly:⁴ the state enjoys a monopoly position regarding whether or not an investment can be made in a country, while a small group of companies monopolize the financial, human, technical, and managerial resources to initiate a given natural resource investment project. There is a strong degree of interdependence,⁵ as each side has something of value to offer the other and neither can pursue an investment project without the participation of the other. There is, in effect, an exchange of the

respective commodities held by the two parties.⁶ Each side, it is assumed, seeks to maximize or at least "satisfice" its respective interests.⁷

At the same time, the bargaining process involves mixed motives. The mutual pursuit of an agreement and the best possible terms lends incentive both to cooperate and to compete.⁸ This general bargaining framework sets the stage for negotiations and agreements between state and foreign firm.

The ongoing bargaining relationship or "concession process"⁹ has a critical time factor. Over time, the bargaining relationship changes to reflect changing conditions and the changes in bargaining power held by host and TNC. In general, bargaining power initially favors the TNC but inexorably shifts in favor of the state. The state, in turn, is better able to have its interests reflected in investment agreements, while the TNC experiences a diminished ability to maximize its interests. The result is increased political risk for the foreign firm.

There is no set time period during which the bargaining relationship shifts in favor of the host state. For the major Middle East concessions, it took perhaps half a century before terms between the TNOCs and the states began to reflect the demands of the host governments. This does not mean that for 50 years the governments had no influence and TNOCs were free to ignore local interests. Shifts in power usually do not occur all at once; rather, they are phased in over time. But during those fifty years, even as the terms gained by the states improved, the TNOCs held the upper hand in the bargaining

relationship and the agreements reflected the stronger position held by the companies.

In Latin America, where independent states pre-dated the oil industry, the shift occurred more quickly, perhaps spanning some thirty years. The Latin American states enjoyed more mature political systems and better developed economies than their Middle East counterparts and, therefore, were quicker and better prepared in challenging the dominance of the TNOCs. In Libya, on the other hand, where the development of the local oil industry did not begin until the mid-1950s, the aggressive leadership of a Qaddafi was able to exploit favorable market conditions and circumstances and reverse the bargaining relationship in an industry barely 15 years old.

For the most part, prior to World War Two, the TNCs monopolized the capability to turn physical resources into an industry¹⁰ and income producing asset. There is a high degree of uncertainty in initiating a natural resource project in a country which has no operating wells:¹¹ the economic viability of the project remains unknown. For the developing countries in which initial foreign investment agreements for natural resource production were undertaken, there was little choice but to accede to TNC terms or forego development of natural resources. The countries lacked the resources and expertise to proceed on their own.

At this stage in the relationship, the transnational firm was able to receive extremely favorable terms from the host government. At the beginning of the concession process, the host has nothing "and is prepared to yield a part of its sovereignty, i.e., grant a concession to the foreigner in return for the promise of a small share

of the gain."¹² "The conditions under which a foreign company will agree to invest must initially reflect both his monopoly control of skills and his heavy discounting for risk and uncertainty...(T)he strength of the bargaining is on the side of the foreign investor, and the terms of the initial concession are going to be heavily weighted in his favor."¹³ The country, lacking any bargaining power, typically was willing to "accept virtually any terms to induce some company to develop the resources."¹⁴ The resulting agreements, in turn, were dictated primarily by the demands of the TNCs, which enjoyed the additional advantage of political and economic (and sometimes military) support from their home governments.

Once a resource project becomes commercial, however, bargaining power begins to shift towards the state. The initial uncertainties surrounding the viability of a project disappear. Once a project has become commercially operational, it becomes apparent that "if the multinationals are bases for the exercise of economic power, they also are hostages within the nations in which they have settled."¹⁵ At this point, the company's monopoly over resources has been severely eroded. Natural resource production is highly capital intensive. By the time commercial production commences, virtually all of the investment is sunk cost. An operating well or mine is "permanent hostage in the hands of the host government, which then has not only the fuel in the ground but the means to lift it" as well. While "the geological and economic risks of a project--which the host wants the oil companies to assume--have all but vanished by the time production commences, the political risks confronting the firm become intensified."¹⁶

As the risks assumed by the TNC are forgotten,¹⁷ there is a tendency for the state to begin to question the high rate of return enjoyed by the investing company and feel that it is giving away a precious resource without adequate return to the country. The TNC's contribution to a project is greatest in the early stages; the relative bargaining power of the actors, however, reflects, in part, the relative contributions each can make.¹⁸ With its contribution mostly "sunk" and in place, the TNC suffers from reduced bargaining power. The host finds itself less dependent on the TNC, while the corporation has that much less to use as a bargaining chip and that much more sunk investment it must try to protect.¹⁹

At the same time, host leaders begin to climb the learning curve regarding the political economy of mineral investments and TNCs. The TNC's monopoly on information and knowledge at the early stages begins to erode, as this information and knowledge is acquired by the host government and is embodied in the stages of the project already completed.²⁰ From this perspective of enhanced host bargaining power, the sense of "fair" returns is radically different than in the initial dealings with the TNCs. From this vantage, host leaders realize that they are in a position to force a change in the host-TNC relationship.²¹ At this point, the state pushes to change the terms of its investment agreements so that the respective terms reflect the new "realities" of the situation,²² i.e., the host wrenches concessions from the TNC in an effort to realize more state interests.

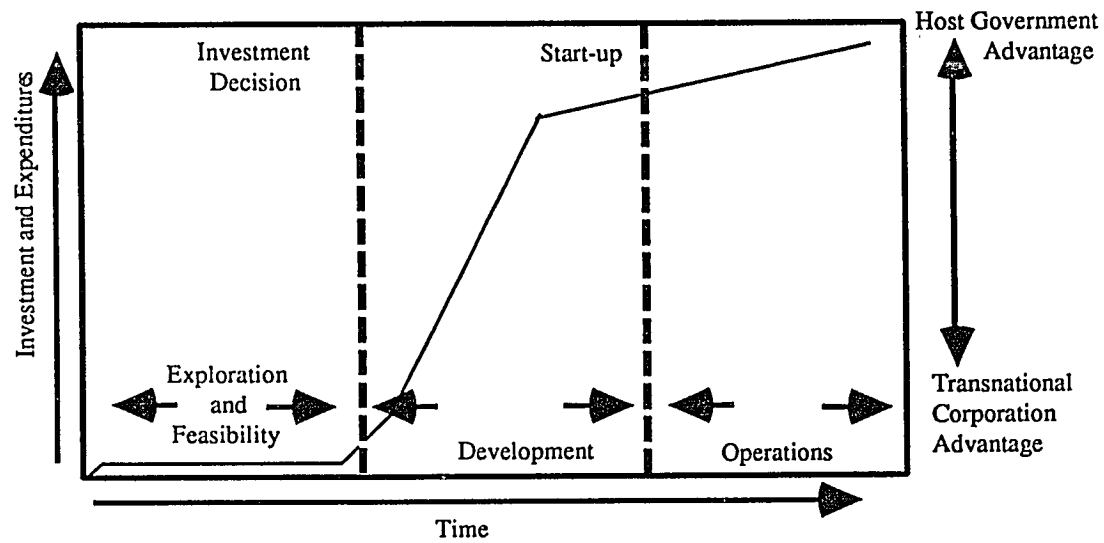
The bargaining process entails a continual revision of the "obsolescing bargain."²³ Initial agreements are reached under terms which subsequently become politically obsolete as the respective

bargaining strengths of the actors shift. "To argue that there should not be an ongoing process of adjustment...is to argue that agreements should be frozen on terms favorable to the foreign investors."²⁴ As much as TNCs would prefer the initial agreement to prevail throughout the lifetime of a project, host states are committed to revising agreements to reflect their enhanced bargaining position and further the state's interests.

"The reason that change is inevitable becomes apparent when one recalls the standards against which contracts are measured--what is needed to attract the investor or to hold onto him. The terms required to attract an investor are usually quite different from those required to retain him."²⁵ The terms hosts must accept to attract the investor bear little resemblance to the demands hosts impose on firms with commercial operations.

The general path of the bargaining relationship between host and TNC is illustrated in Figure V.I. In the early stages of the relationship, the firm is in a dominant position and is able to exact highly favorable terms from host leaders. "As raw material industries mature," however, "the most common pattern is a decline in the control that a particular foreign firm exercises."²⁶ The firm becomes less indispensable, while the state increasingly senses its ability to exercise influence over the TNC. Over time, with the company's investment fixed and immovable, the commercial viability of the project proven, and state leaders and nationals moving up the learning curve, the relative bargaining power of the state increases, while that of the firm ebbs. The result is greater bargaining leverage on

Figure V.1: Shift in the Relative Bargaining Positions of Host and TNC



Adapted from Bosson and Varon

the part of the state and the ability to impose changes upon the investment regime. Political risks are resident within those changes.

V.2 Domestic Demands and Supports and Leadership

The relative market and bargaining positions of host and TNC define the scope of opportunity available to the state and its capability to take advantage of such opportunity. Opportunities, however, are not always seized; capabilities are not necessarily translated into action. Domestic demands and supports and the style and ideology of leadership, mediate the relationship between the structure of foreign investment agreements and bargaining, on the one hand, and political risk events, on the other. These variables determine the willingness and/or political necessity of the host state to impose changes on TNCs.

Unrecognized opportunities have no impact on agreements. If leaders are not fully cognizant of their capabilities in dealing with TNCs or are permitted to be complacent in accepting the traditional investment relationship, changes are not going to occur. Action on the part of the host regime must be taken if the state's bargaining power is to be translated into new agreement terms. The shift in bargaining power detailed above gives the host the potential to exact changes from the TNC and leaves the TNC vulnerable to political risks. Changes and risks, however, become tangible only when the state acts upon its potential. Given opportunities created by the bargaining relationship, domestic demands and supports and leadership determine the timing and nature of policy changes imposed on TNCs.

The shift in bargaining power in and of itself does not automatically translate into new agreement terms or political risk events.

The rise in the host's power gives the state the potential to alter the terms of an investment relationship, but the state must take action if its potential is to be realized. In general, the most persistent demands for changes in investment agreements have come from those states with the most bargaining power and at those times when political and market conditions accentuate this power.²⁷ There is, however, a "possible separation between the potential capability of host governments to exercise greater negotiating strength in their relations with foreign investors and their political 'will' to do so."²⁸

Dependency theorists explain the failure of "will" in class terms, with a co-opted comprador class or bourgeoisie serving the interests of international capitalism.²⁹ This approach glosses over the innumerable instances in which host governments of all ideological stripes, from developed and developing countries alike, have challenged the TNCs. The interests of elites are very important to a host's willingness to push for changes in investment agreements, but this by no means necessarily implies that the failure of a state to press changes is evidence of a comprador mentality, nor that action on the part of the host to revise agreements is proof of an anti-capitalist, socially enlightened regime. In contrast to the dependency argument as to why the state may not assert its power against the TNC, moreover, other analysts have concluded that oil nationalist policies often are, at least in part, the product of class differences and are used as a substitute for class conflict.³⁰

"The will to control" the TNCs is a function of domestic politics³¹ and the bargaining process.³² Domestic political

processes include an "interplay of domestic groups trying to maximize their own particular interests as well as the larger national interest."³³ Different groups will have different policy preferences and influence in determining policy. Domestic political interests, moreover, are not summed-up simply in terms of the state's relationship with TNCs. Other concerns may take precedence over the issue of asserting greater control over the transnational firm. Moran, for example, argues that Saudi Arabia has not been aggressive in challenging the TNOCs in that country because the "operational code of advancing Saudi political priorities while minimizing hostile external and internal pressures upon the kingdom" have prevailed over the more narrowly defined interest of strict profit maximization.³⁴ Others also contend that "the object of economic growth, taken by itself, can not be expected to determine national policy."³⁵ This, however, may translate into intensified pressures upon the TNC, even at the expense of losses in national income.³⁶

To take advantage of its power, the state must be aware of it. If the host is ignorant of its capabilities, its potential will remain idle. The state can take advantage only of those opportunities it realizes. The state also must have the organizational resources to impose policy changes on the TNC.

The bargaining process itself also affects the government's will to control. By its nature, bargaining entails uncertainty and limited information.³⁷ Each party comes to the table with different perceptions of its respective power and needs.³⁸ The ability to manipulate the perceptions of the other actor(s) becomes particularly important under conditions of imperfect information. Bargaining,

moreover, is a multi-track, on-going process.³⁹ There are multiple issues, possible trade-offs, varying strategies, and different goals and pay-off scales. At the same time, the host/state relationship is a process along a continuum in which any one set of negotiations or terms is but part of the overall process.

The political motivation needed to prompt host leaders to challenge the investment relationship will vary with, among other things, the power of the state in confronting the TNCs. The more bargaining power the state has, the smaller the impetus must be to trigger leaders to push for new terms.⁴⁰ Conversely, the less powerful the host is, the greater the domestic political demands must be to move the government into a confrontation with the TNC.

Hodges has developed a series of propositions based on the conclusion that the likelihood of the host adversely reacting to foreign investment is a function of the state's capabilities and the salience or importance of the industry involved.⁴¹ Investment becomes an increasingly salient policy issue, he posits, (1) as government intervention in the economy increases, (2) as the level and distribution of foreign investment increases, (3) where the subsidiary lacks autonomy from the parent company, and (4) when government decision makers see foreign firms behaving differently than local ones.⁴² Assuming foreign investment is salient, Hodges continues, the crucial issue is whether decision makers see their goals threatened by foreign firms: if not, they are less likely to discriminate against TNCs.⁴³

The interests of host and firm, however, as we have previously determined, are inherently conflictual. The degree of conflict

increases as the host state tries to exercise control over domestic policy. Because national interests are threatened by corporate interests, the crucial issue, contrary to Hodges, is whether the host government perceives the salience of foreign investments in the natural resources sector.

The state or government, in reality, is an abstraction. Individuals, acting on behalf of the state, bargain and make decisions. Government leaders and strategic elites determine policy. First and foremost, it is the perceptions of these people that will determine whether and when the host state calls for better terms with the TNCs. "It is the perceptions, attitudes, expectations and demands of these elites--as they refer to foreign investment and multi-nationals--that primarily define the limits of corporate behavior within host countries."⁴⁴

The strength, skills, and coherence of elites, moreover, represent a crucial component in the bargaining power of the state.⁴⁵ The various elites--governments, business, scientific leaders, etc.--are always affected by the activities of foreign corporations.⁴⁶ Most likely, TNCs will bolster some elites and threaten others.⁴⁷ During the early phases of a state building process in developing countries, moreover, the TNCs typically were (and, in some instances, still are) very important to the power exercised by the government and elites. It is for this reason, as cited previously, that during the earliest stages of the investment relationship, when host leaders sought to solidify their power, that national elites did not challenge the position of the TNCs. After secured in power, national elites typically sought to enjoy the fruits of their efforts and developed

vast pockets of wealth. Elite support for TNCs rested primarily on economic grounds, with political and cultural concerns less important.⁴⁸ In contrast to this early support for TNCs by elites, the tension between host and firm is "partly, perhaps even mainly, a product of the defensive reactions of elite groups."⁴⁹

While leaders always have personal preferences and interests, the ability of TNCs to contribute to individual wealth and power carries less pull than in the past. Because of the fundamental conflict between the state and the TNC, as the state matures and strives to exercise its sovereignty, conflict between the two actors becomes increasingly frequent and intense. The crucial issue "often centers on the fundamental meaning and the nature and character of a desirable process of economic development."⁵⁰ This definition will determine how the impact of the firm is assessed. In every state, while the specific formula may vary, "a desirable process of economic development"⁵¹ is one which is controlled by the host state and maximizes the national interest. This means that the more elites define and are committed to economic development, the more they will conflict with TNCs. Even when TNCs promote the specific economic interests of elites, these elites exhibit disaffection toward and present challenges to TNCs. The commitment to industrialization and development and national sovereignty becomes increasingly important, and at a point, eclipses more narrowly based private interests.

Elites play a vital role in determining policy in all states. If elites seem more important to decision making in developing states it is because governments in these states tend to be less institutionalized and secure than regimes in the developed nations. At the same

time, for leaders in developing countries the relative gains from success in challenging the TNCs and costs of failure are greater than in developed states.⁵² For all modern countries, economic nationalism is the sine qua non of the state. Be it for purposes of political ideology, nationalism, or both, there is an almost universal preference for public rather than private enterprise.⁵³ To the extent private foreign investment is tolerated, it is with the explicit intent of having private capital serve public ends.

Nonetheless, elites can be more or less moderate (or strident) in asserting public, national interests against TNCs. Different leaders (and groups) exhibit different approaches and styles in dealing with foreign firms. While national elites no longer are the ally of TNCs, they are not homogeneous groups with identical responses to policy problems. As the people who make and implement policy decisions, differences in nuance, temperament, or style of elites can have significant ramifications for TNC exposure to political risk events resident in policy decisions.

The prevailing ideology, as expressed by elites, has an important, if at times subtle, impact on how states deal with TNCs. A regime is partially defined by its underlying political values and principles, which constrain and channel the purposes for which a state's energies and resources are spent.⁵⁴ The style and ideology of leadership will be reflected in how the government approaches problems, and approaches help shape outcomes. Investment conditions, for example, will be affected by the means the government uses to intervene in the economy, whether it works through the market or by direct controls.⁵⁵ Greater reliance on the public sector, a trend

evident in almost all natural resource exporters, predisposes a government to approach issues involving TNCs differently than a preference for free private enterprise. As an institution exercising private power, the TNC can be matched only by the public power of the host state. At the same time, tax receipts and government revenues and skill acquired from foreign investments in natural resources will strengthen the public sector, reinforcing the preference for and capability of public control.

According to some analysts, elites are all that matter. Popular ideology and issues are manufactured, reflecting the preferences only of elite groups. Public opinion, they argue, is manipulated and is an output of the policy process rather than an input.⁵⁶

While elites, by definition, occupy unique positions of influence and power in a society, denigrating the public as a by-product seems to be exaggerating the case. Elites are in part defined in terms of their position vis-à-vis the public. Without a "mass," there can be no elites. While elites may have and pursue their own interests and the public may often be docile, leaders seek to stay in power by satisfying others. Increasingly, satisfying the people requires an explicit ideology of economic nationalism, be it the official ideology of the dominant political party or a shouting match between competitive groups, each trying to prove itself to be the most nationalistic.⁵⁷ Elites remain disproportionately influential in all states, but they are increasingly under pressure to satisfy popular political demands, particularly in terms of the state's relationships with TNCs.⁵⁸ This trend is an ideology in itself, transcending political differences between states. Elites, if they

are to retain their privileged positions, must be at least partially responsive to the popular cry for challenging the TNCs.

Demands -- "expression(s) of opinion that an authoritative allocation with regard to a particular subject matter should or should not be made by those responsible for doing so"⁵⁹ -- and supports -- actions or attitudes favorable toward a political body⁶⁰ -- are basic inputs in all political systems. To survive, political systems must be adaptive.⁶¹ Demands must be satisfied to maintain the system's integrity and legitimacy. No system can long survive without support from below. Maintaining that support requires both a sense of material and psychic satisfaction among the people.

Asserting host state authority over TNCs can be very important to the government's ability to satisfy demands and retain supports. A regime which is insensitive to strong popular feelings about TNCs will alienate the people, stimulate opposition, and be seen as illegitimate. This will spawn opposition groups around nationalist, anti-TNC themes. To defuse such potential opposition and maintain a viable leadership role the host government will do better to channel discontent against the TNC.⁶² Challenging the TNC is "always politically popular."⁶³ Unchanneled hostility and frustration, moreover, would most likely rebound against the host government. Having directed popular antipathies and demands against the TNC the host state must be prepared to satisfy those demands.⁶⁴

At the same time that popular demands push host governments to assert control over TNCs, demands also strengthen the bargaining position of the state. The more the government is pressured by aggressively nationalist groups, for example, the more the TNC is

aware of the danger of such "extreme" groups coming to power.⁶⁵

Under such circumstances the TNC will most likely opt for the lesser of the two evils and make concessions to the current government. Similarly, if the government comes out with an explicit public stance regarding the TNCs it creates a position from which it cannot retreat without the loss of face in the eyes of the people. Such an unalterable commitment on the part of the government -- which leaders may purposefully adopt to pressure the TNCs -- reduces the negotiating room and strengthens the bargaining position of the state.⁶⁶

The bargaining relationship remains the fundamental key in determining the relationship between host and firm and the incidence of political risk. Policy, however, requires action. The timing and nature of policy changes will be influenced by the willingness and/or necessity of leaders to implement such changes. The proximate causes of this willingness and/or necessity are the nature and style of leaders and elites and the demands and supports of the people.

V.3 Bargaining Power

The foreign investment relationship involves an ongoing process of implicit and explicit bargaining. All interaction and negotiations between host and firm occur in a "bargaining situation."⁶⁷

Bargaining involves the exchange of values: the giving and withholding of positive values, or things which are wanted, and the withdrawing and applying of negative values, or things which are to be avoided. Theoretically, the more positive values one party has to give to (or withhold from) another and the more negative values it can inflict (or not inflict) upon another, the better its bargaining position.

The essence of bargaining is power.⁶⁸ It is the key to change and opposing change.⁶⁹ The concept of power traditionally has been reserved for discussions regarding the interactions of states in international politics or the interactions of companies in a market and not for comparisons between a state and a firm. The power of these two actors, it has been argued, are "of conceptually different dimensions, and cannot readily be compared."⁷⁰ While traditional notions of international political power or economic market power may be insufficient to analyze the bargaining relationship between the state and the TNC, dismissing their respective power as "different" begs the question.

Power is a relational concept which exists only between two actors or forces. An actor in a vacuum has no power and is, in a sense, "powerless." Power implies the ability to have power over someone or something. In this sense, TNC and state interact in terms of their respective power vis-à-vis each other. That is, each actor tries to influence the other and the international market in such a manner that its interests are maximized. The fact that the firm and the state may employ different resources or approaches in their bargaining only serves to make the bargaining relationship more unusual and the mixture of power more diversified.

Power is not a totally fungible commodity. One type of power is not necessarily interchangeable with another form of power. Power is issue and situation specific and varies across different issue areas.⁷¹ In any situation, however, power is essentially the ability of one party to move another through a range of outcomes.⁷² Regardless of differences between the state and the TNC, their

respective bargaining power can be operationally defined in terms of their relative ability to move each other through a range of outcomes.

Power can be conceptualized as the ability to constrain the "conduct options" of others⁷³ while retaining one's own options.⁷⁴ The bargaining power of "A" is a function of the ability of "A" to convince "B" that "A" controls resources, "B" needs those resources, and "A" is willing to use its resources against "B's" interest or withhold values wanted by "B."⁷⁵ A power relationship implies some measure of dependence -- to gain a positive value or avoid a negative value -- between two parties. The power of "A" and "B" can be expressed as a ratio of their sense of relative dependencies.⁷⁶

Perceptions are a key component in the power formula, as "A" and "B" respond to each other based on their respective perceptions of the power of themselves and their adversary. It is the "perceived power (of one party) to grant rewards or inflict penalties on the other"⁷⁷ that determines bargaining power. This perceived power between "A" and "B" will vary across different issues. The relative power of "A" and "B," as such, will vary across different issues.

Perceptions are particularly important in shaping negotiations between parties and structuring their initiatives and responses. While perceptions always remain important factors in shaping the interactions between parties, nonperceptual factors may contradict perceptions and determine outcomes, especially when words are replaced by deeds. Mossadegh, for example, clearly failed to perceive accurately the will and strength of Anglo-Iranian Oil Company (with the active support of the British and U.S. governments) and the

support of the other major oil firms. In the end, Mossadegh lost. Similarly, in 1967 the Arab states incorrectly assumed that an embargo and closure of the Suez Canal would hurt the TNOCs and the West. Instead, the Arab states were the ones to suffer, as liftings from Iran and Libya were increased and brought to market to replace Arab crude. Conversely, the Libyan concessionaires doubted the capability of the Qaddafi government to force price increases on them repeatedly in the early 1970s. When challenged, Qaddafi exercised his country's oil power by cutting production and nationalizing some companies. The companies' efforts to coordinate their resources in opposing threats of production cuts by Qaddafi and other host state leaders, as embodied in the Libyan Producer's Agreement (or "safety net agreement") and London Policy Group, also failed in the face of an "actual" exercise of state oil power in the form of nationalizations and the 1973/74 embargo.⁷⁸

There have been numerous efforts at listing the variables which determine bargaining power. Stoevers, for example, identifies twelve factors:

1. The power to command resources that the other wants
2. The ability to offer opportunities
3. Alternatives available
4. Negotiating experience
5. Knowledge of each's strengths and weaknesses
6. The ability to accommodate the other's needs and assuage fears
7. Precedents
8. External allies
9. Use of external devices, such as the media

10. The ability to persuade the other as to one's good intentions and desirability as a partner
11. The ability to demonstrate moral strength or rectitude
12. The ability to act unilaterally.⁷⁹

Moran sees bargaining position and a TNC's vulnerability to "nonrevolutionary economic nationalism" shaped by six variables:

1. The size of the fixed investment
2. The need to make lump versus incremental investments
3. Technological stability
4. Competition
5. The existence of a "choke point" downstream controlled by the TNCs
6. Reliance on bulk sales.

Regardless of the size of the fixed investment, the investment initially is a source of power for the TNC but subsequently becomes a point of vulnerability. The size of the investment, however, will determine the magnitude of power and vulnerability. The need for incremental investments leaves the firm with greater flexibility and ongoing negotiating power compared to lump-sum investment (although at the time immediately preceding such a lump-sum investment the company would enjoy an added advantage). The more stable the technology, the better off the host government's position. Similarly, the more competitive the industry, the better the host is able to exact concessions from TNCs. The existence of a downstream "choke point" will favor the companies. Finally, the reliance on bulk sales, rather than an extensive network of smaller sales, will favor the host state.⁸⁰

The host state, in contrast, Gladwin and Walter contend, will have its bargaining position enhanced by:

1. Large internal markets for the commodity and faster rate of growth of those markets
2. The more valuable its resources are to the TNC
3. The more stable and favorable domestic political conditions are to foreign investment
4. Lower economic and managerial costs of doing business
5. Healthier balance of payments
6. More stable external political relations
7. The more diverse the country's options are in obtaining the package of services offered by TNCs⁸¹

At the same time, the same authors see the TNC's bargaining leverage maximized by:

1. Greater packages of technological, marketing, and managerial inputs
2. Greater prospective contribution to national employment, income, balance of payments, economic development, and linkages
3. Greater coincidence between the firm's prospective economic contributions and national goals and plans
4. Larger number of and more relevant activities in other countries
5. Larger number of options available in alternative ventures⁸²

Ruffing sees the bargaining power of any owner of natural resources determined by:

1. The quality and importance of the resource

2. The availability of alternative sources or substitutes
3. The structure of the industry, i.e., degree of concentration
4. The position of a particular firm within that structure
5. The resource owner's ability to finance, develop, and market the resource
6. The resource owner's negotiating skills
7. The ability to inflict losses on the TNCs⁸³

While there is both convergence and divergence in the lists of power variables, each author would agree with the basic statement that the terms of an investment agreement will reflect the respective bargaining power commanded by the parties involved. Most of the above mentioned authors, however, seem to have gotten lost and confused in combining different levels of micro and macro level variables in attempting to explain bargaining power.

At the macro level, bargaining power is determined by:

1. The relative dependencies of the actors (the extent to which each has resources or positive values needed by the other and the extent of those needs)
2. The ability of each to exploit the dependencies of the other
3. The willingness/need of each to exploit the dependencies of the other

These macro level determinants of bargaining power actually are the mediating variables in our model explaining the incidence of political risks.

Virtually all of the variables identified by the other authors are micro level variables that fall within the first macro level variable identified above. At the micro level, relative dependencies

will include such variables as quality and quantity of resources (natural, labor, capital, and technological), the extent to which each needs resources controlled by the other, and alternative sources for those resources. These will be affected by industry structure and competition, the site of the investment, domestic demand, and other variables listed by the authors cited.

The ability to exploit dependencies reflects the perceptions and bargaining skills of the players. Having the resources needed by another actor is not enough. To exercise bargaining power the actor has to know what it has and what its opponent needs and how to translate its ability to satisfy the needs of the other into its own advantage.

Finally, exercising power requires will/need, the ingredient that turns the capability to act into the act. The will to act implies a positive direction undertaken by decision makers to attain specific goals. Acts also may stem from needs imposed upon decision makers by their constituents (stock holders or inhabitants of a country).

In general, the bargaining model posits that the initial bargaining advantage rests with the firm. The host will continuously strive to gain better terms for itself, but will be successful only to the extent it can wield more bargaining power. In general, such power will shift in favor of the state, reflecting the changing contributions to a project made by host and firm over time.

The dynamic of the host/firm relationship will continue to be determined by their respective bargaining power. While numerous variables can be listed which comprise the ingredients of power, the essence of bargaining power is the degree of relative dependency

between the two actors -- who needs more of what from whom -- and the ability and will/need of decision makers to exploit the dependencies of their opponents. This sense of dependency stems from both the power to reward and the power to punish. Needs are both for positive goods and to avoid negative "goods."

V.3.1 Bargaining Power: TNOC Ascendance

The initial bargaining power advantage of the TNOCs stemmed from a number of conditions. Traditionally, the TNOC approached the state with the advantages of a monopoly on markets, knowledge, and technology and a monopsony regarding the resources to buy concession privileges.⁸⁴ The companies had the capabilities and a variety of opportunities. There were plenty of unexplored and undeveloped resources. The companies enjoyed diversified sources of supply under their complete control, permitting them to allocate production to different sources and shift production from one country to another.

Economically, oil was the link between the Middle East and the world market. The demand centers for petroleum were in Europe and the U.S. (which had sufficient, albeit more costly, domestic petroleum reserves). This demand gave Middle Eastern oil its value. The local economies of the area had little use for the oil. Without the European and U.S. markets, the crude would have remained beneath the desert sands.

The relationship between consumer and producer countries institutionalized a flow of trade and a symbiotic relationship which netted inexpensive crude for the companies and previously undreamed of riches for the local rulers (and in exchange for a commodity which had no value other than for export). The international oil companies had

the technology, capital, skilled labor, and market outlets to develop Middle Eastern crude oil resources.

The host typically was in severe need of whatever economic inputs the TNOC could offer and usually lacked the institutional organization characteristic of the modern state.⁸⁵ Lacking the vital inputs necessary to produce oil, having virtually no domestic demand, and politically and economically unable to mount an effective challenge to the concession relationship, the Middle Eastern rulers had little negotiating strength in their dealings with the oil companies. "The large oil concessions, particularly in the Middle East, were granted under political and social conditions that were unfavorable for the producing countries, since most of them at the time did not exercise full sovereign rights over their territories or over their natural resources; moreover, the nationals of such countries lacked the knowledge and experience necessary for the proper evaluation of the real value of the oil rights granted."⁸⁶

The host countries were more spectators to than participants in early oil development. "Apart from the freedom the host governments had at the start to choose the original concession holders from a limited number of suitors," (and even this "freedom" was severely constrained) "they had no rights to a strategic role in the development of the resources in question, once the choice was made."⁸⁷

At the same time, the home governments were willing to engage in gunboat diplomacy in support of their TNOCs abroad. The political relationship behind the agreements was analogous to that of colony and colonizer, small territory and great power. The British, for example,

threatened not to pass the Iraqi constitution if the Turkish Petroleum Company concession was not signed.⁸⁸

Foreign investment in petroleum dates back to the close of the nineteenth century and is inseparable from the international politics of that time. European interests, particularly British and German concerns, were anxious to gain access to the promising oil reserves of the Middle East. As early as 1899 the Sheikh of Kuwait gave Britain exclusive access to and virtual control over the development of Kuwaiti lands.⁸⁹ The first petroleum concession, under which foreign firms had extensive and exclusive rights to exploit the natural resources of a specified area, was granted by the Shah of Persia to William D'Arcy in 1901. This concession was assumed by British Petroleum in 1909. The British also obtained exclusive rights in Bahrain in 1914 and Qatar in 1916.⁹⁰

The scramble by the European powers to win concessions in the Middle East was mirrored by U.S. companies in Mexico and Latin America, Russians in Rumania, Dutch efforts in the East Indies, and British firms in India and Burma. The First World War both interrupted the concession acquisition process and emphasized the strategic importance of petroleum. Following the close of the war, U.S. oil interests, supported by the U.S. Department of State, attempted to get a foothold in Middle East oil. Supported by the General Leasing Law enacted in 1920, which denied access to oil development on public lands to companies from states which discriminated against U.S. firms, U.S. TNOCs pushed their way into the Middle East concessions.⁹¹ France asserted its claim to the concession rights previously held by

Germany, which officially passed into French hands by virtue of the San Remo Agreement between Britain and France in April 1920.⁹²

The Arabian peninsula was more an amalgam of fiercely independent, divided sheikhdoms than a region of sovereign states. The dissolution of the remains of the Ottoman Empire in the course of the First World War ended the few vestiges of political coordination there were. After the war, political responsibility and control was assumed by the Europeans, particularly the British.

Industry structure supported the strong position of the firms: a small number of firms not bidding against each other⁹³ were able to exploit the ignorance of and differences between host governments.⁹⁴ The inter-war period saw many petroleum concessions granted, as virtually all of the known and suspected oil-rich areas of the world were divided into territorial assignments held by the international petroleum companies. Concessions covering Saudi Arabia, Iran, Iraq, Bahrain, Kuwait, Abu Dhabi, and Qatar were granted (or modified to accommodate different participants) during these years. The eight largest oil firms -- the international "majors" as they came to be known -- Exxon, Gulf, Texaco, Mobil, Standard of California (SoCal), British Petroleum (BP), Royal Dutch Shell, and Compagnie Franaise de Petroles (CFP) -- controlled between 95% and 100% of each of the Middle East holdings.⁹⁵ Through exclusive agreements regulating competition between themselves and restricting access to other companies these eight firms completely dominated oil developments in the Middle East. The companies engaged in a series of agreements among themselves to regulate and set standards for the industry, with scant regard for host interests. The position of the TNOCs was so

dominant that they could be arrogant, "confident that local governments would never evict them."⁹⁶

The legal relationship between the oil companies and the host governments in the oil countries was governed by the terms of the concession agreements. Under the traditional arrangements the concessionaires had exclusive and plenary rights covering all aspects of petroleum-related operations and activities. The general conditions were largely standardized and included terms which clearly favored the TNOCs. The concessions provided for:

- o extensive areas (the D'Arcy assignment covered 500,000 square miles, five sixths of modern day Iran) with no relinquishment requirements;
- o lengthy concession periods (the SoCal concession for Saudi Arabia was for 66 years; in Oman, Dubai, and Sharjah the term was 75 years);
- o 100% equity investments by the foreign firms, which had ownership rights to the petroleum produced;
- o initial cash payments (Ibn Saud got L50,000 in gold upon granting the Saudi concession) supplemented by fixed royalties based on volume at 4s. gold per ton (there were no income taxes); and
- o total managerial control over operations and planning was vested in the concessionaire.

The TNOCs' obligations under the concessions were left unspecified. The firms had no obligations with respect to expenditures, production rates, reinvestment, or use of local suppliers.⁹⁷ At the same time, while the concession agreements might call for the employment of nationals as far as practical the

TNOCs had the right to employ and import foreign personnel at their discretion.⁹⁸

The companies did have to pay for concession rights, but these were relatively inexpensive. Tonnage based royalties, although easier to administer and verify by the host government, meant the producer countries were not participating in any of the profits earned by the TNOCs.⁹⁹ It has been estimated that in the early 1930s 4s (gold) per ton, plus other payments to hosts, came to approximately one-half of TNOC profits; but when prices rose, company profits climbed without contributing to host revenues.¹⁰⁰ Payment, moreover, was not always made in gold and often left hosts vulnerable to adverse currency fluctuations. While Persia, Iraq, and Saudi Arabia received gold, for example, Kuwait, Bahrain, Qatar, Dubai, and Sharjah were paid in Indian rupees.¹⁰¹ As a result, royalty payments to Kuwait in the 1930s were worth approximately \$0.13 per barrel, compared to \$0.22 in those areas paid in gold.¹⁰² After Persia renegotiated its concession, furthermore, it received royalties based on the 1933 devaluation of the British pound, while the Saudis and Iraqis continued to be paid based on the higher valuation.¹⁰³

To a large extent, company payments were made into the personal coffers of host country leaders. Personal riches and power typically were of greater concern than any concept of social welfare, especially in the Middle East. Ibn Saud had a voracious appetite for money. While Saudi oil revenues climbed rapidly, he treated the funds as a royal allowance for personal expenses and even had to borrow money to cover his lavish expenditures.¹⁰⁴ Even in Bahrain, Qatar, and Kuwait, where the British actively interceded to avoid the Ibn Saud

model and worked to reserve a majority of oil revenues for development and reinvestment, the host rulers personally received one-third of the revenues.¹⁰⁵ The Iraqi monarchy was similarly predisposed towards cooperation with the IPC concessionaires, while Libyan King Idris, when his country saw its oil developed some two to three decades later, also looked upon the TNOCs as a source of personal riches.¹⁰⁶ Even in Latin America, where the states had a lengthy history of independence, there was a "general orthodoxy of the time (1920s) that foreign investment was a desirable and 'modernizing' force."¹⁰⁷ Dictators such as Juan Vincente Gomez (1908-35) in Venezuela looked to the TNOCs as an ally to be used to promote personal power rather than contribute to economic development or social welfare.¹⁰⁸

While the oil companies enjoyed superior bargaining strength, host governments were not totally passive. Nationalist opposition emerged first in Latin America, which already had a century of political independence by the early twentieth century.¹⁰⁹ The Latin American governments were the first to push for greater economic returns and more control over oil development by the state. As early as 1913, there was a dispute between the Peruvian government and the International Petroleum Company (IPC) regarding title to the La Brea y Parinas concession.¹¹⁰ First raised by the military government, the oil issue led to a showdown between the TNOCs and the ruling Civilista Party in 1918. The government, however, had no bargaining power, while the companies threatened to stop production and slow distribution within Peru and had the support of the U.S., British and Canadian governments.¹¹¹ The oil issue weakened the government, and in 1919 a right wing coup, partially financed by Shell, which was

hoping for a favorable concession,¹¹² brought August Leguia to power. The Leguia regime negotiated the Laudo of 1922, an agreement which was highly favorable to the companies.¹¹³

The government of Sanchez Cerro, which succeeded Leguia in 1930, promised to get tough with the TNOCs. Peruvian financial difficulties, however, forced the Cerro government to turn to IPC for loans.¹¹⁴ IPC influence in Peru was at its height during the 1930s. With three-quarters of production exported, the company realized large profits and incurred minimal taxes. For the 1935 through 1938 period, for example, the company earned a 100% return on investment annually.¹¹⁵ While the oil issue was not forgotten, the problem lingered throughout the 1940s and 1950s until the government got the upper hand in the 1960s.

V.3.2 Bargaining Power: Host State Ascendance

Over time the bargaining power of the TNOC ebbs, while that of the host state grows. For the most part, "the strength of the firm's bargaining position is a function of the usefulness of its proposed inputs to the host society in the immediate future."¹¹⁶ The usefulness of such inputs, however, tends to decline over time. As the state develops the skills necessary to the industry the "cost of nationalism" declines."¹¹⁷

As demand for petroleum grew and the technologies of exploration, development, and production became widespread, the industry experienced a general relaxation of the barriers to entry. Consequently, there was a substantial increase in the number of "independent" companies competing with the traditional transnational giants. Like new entrants into any industry, these companies initially competed in

terms of price, i.e., they paid host states more for concession privileges than the larger firms would. At the same time, the independents were less concerned about issues of control.¹¹⁸ The net effect of this increase in the number of companies that could handle the commercial development and operation of a natural resources project was to increase the options available to the host.¹¹⁹ This made the host state less dependent upon the TNOC.

At the same time, host governments and societies began ascending the learning curve. Nationals began to acquire the skills and know how of the industry, while host leaders began to understand the political economy of natural resources and the bargaining process. Again, "as the host country works itself up a learning curve, the accumulated domestic skills result in a decline in the perception of the relative value of the contribution of the foreign investors."¹²⁰ To the extent nationals can assume greater responsibility for technical and managerial work, the less the host state must rely on TNOCs. The more experienced and better educated host regime, moreover, no longer is negotiating from a position of ignorance. Rather, leaders have information about and understand the relative needs of host and TNOC, are aware of the non-bloc nature of the Western world, and are informed about practices and strategies used elsewhere.¹²¹ While TNOCs initially were able to act in harmony to exploit the differences between host governments, host leaders subsequently learned to coordinate their strategies to exploit the differences among TNOCs. This points to the importance of coalitions on the part of both host states and TNOCs.¹²²

The Latin American countries were the forerunner of the attitudes and policies developing countries have towards the TNOCs.¹²³ These states were the first mineral exporters to begin climbing the learning curve and using their new found sophistication to press changes upon the foreign companies. The bargaining position of the Latin American states was considerably stronger than the relative position of other oil exporters at this time.

Compared to other Third World nations, Latin America has always had a highly diversified economy. While oil revenues were important in Latin America, these states were never totally dependent on petroleum income. In Mexico, for example, because the economy was relatively diversified, oil accounted for only 12% of government revenues in 1937¹²⁴ (the year prior to nationalization), far less than the share of revenues petroleum represented in the Middle East. The chief bargaining strength of the TNOCs -- the spectre of "economic disaster for the [host] country if the oil revenues cease"¹²⁵ -- was diluted in Latin America. Having trained nationals, Argentina and Mexico were able to operate national oil companies and pursue active policies of state directed development of their petroleum resources. Because of their relatively diversified economies, moreover, the Latin American countries were oil consumers. Oil had value not only as an export, but as a commodity for internal consumption as well. By the time of the 1938 expropriation almost half of Mexico's oil output was consumed internally.¹²⁶ The larger domestic consumption grew, the less dependent the state was on the marketing networks controlled by the TNOCs.

Rising domestic oil consumption also nurtured the call for greater state control. The wisdom of an export oriented oil industry, and of an export oriented economy in general, was called into question in Latin America as early as World War I.¹²⁷ The preference was for an independent oil industry serving goals of national development. "Petroleum nationalists emphasized that (the country's) oil resources, if developed by a state monopoly, would enable the country to achieve sustained economic development without interference from the international oil companies or their home governments."¹²⁸ While the national oil companies were not without their problems, the Latin American countries proved that they could operate production and distribution operations and refineries and use a national oil company as a tool for implementing state policy.

The institutional ability to challenge the TNOCs also was unique to this region, where the concept of the state was relatively advanced and political independence was an entrenched tradition. While the Middle East was an area of nations in the early stages of the building of the state, Latin America had a regime of sovereign states with established laws and institutions.

The mediating variables also encouraged the Latin American states to challenge the TNOCs. The oil nationalist movements were popular and broad-based. In most instances, both the middle class and the military supported efforts to challenge the TNOCs.¹²⁹ Asserting control also was important to the leadership in the region. In Argentina, state control was an important component in consolidating the country and overcoming provincial pockets of power. In Mexico and Bolivia (following the latter's loss to Paraguay in the Chaco War),

the assertion of national sovereignty over oil was crucial to the continued legitimacy of the regimes.¹³⁰

While U.S. oil interests in Latin America have been said to have been "maneuvered, manacled, and mangled" in the 1930s,¹³¹ the losses TNOCs suffered at that time tend to be overstated. There were rumblings throughout the region, but the only expropriations occurred in Mexico and Bolivia. The Bolivian properties which were expropriated, moreover, were worth very little.¹³² The TNOCs continued to work oil properties, under fluctuating terms, in Argentina, Peru and Venezuela, where the major political risks would be encountered beginning the 1950s. The TNOCs also had geographically diverse sources of crude which permitted them to increase production in other areas to more than compensate for losses in any one area. In the opening part of the twentieth century, for example, the U.S. TNOCs began shifting incremental production from the U.S. to Mexico; in the period from the 1920s to the 1940s, when Mexico became a trouble spot, the firms allocated incremental production to Venezuela; and in the 1950s and 1960s, when Venezuela was in the forefront of the host state challenge to the TNOCs, production was shifted to the Middle East.¹³³

Mexico, with its relatively diversified economy, internal markets, and developed political institutions, was able to pursue nationalization and withstand the pressures exerted by the TNOCs (which also enjoyed the support of the U.S. Government). But Mexico's assertiveness was not without its costs: by the time of nationalization, Mexican oil exports were inconsequential to the market, as the TNCs boosted production elsewhere, and the Mexican oil fields were suffering from years of damaging practices on the part of

the companies.¹³⁴ While the Mexican government proved the power of the state to exert its authority through the implementation of policy decisions, the cost to Mexico could be measured in terms of the decades during which the country's evolution into a major oil producer was delayed.

While the Latin American states were challenging the TNOCs in their effort to forge a government directed oil policy, the Middle East was grappling with the problems of independence. Iran, with the oldest constitutional government among the oil exporters in the region, formed its first government in 1906, while Saudi Arabia attained independence in 1927 and Iraq in 1932. It is not surprising that "it was in the Middle East country that had self-government the longest and where the oil industry had its longest history in that region"¹³⁵ that the region saw its first host/firm confrontation.

Actually, the first concession "renegotiation" occurred in 1920. Under the original D'Arcy concession (1901), Iran (Persia) was to receive 16% of the net integrated profits of the Anglo-Persian Oil Company (APOC). As the company expanded its operations abroad, particularly in refining and marketing, it began to object to paying Iran for profits generated outside of that country.¹³⁶ APOC initiated discussions to exclude all operations other than production in Iran from the 16% levy. The British government firmly supported APOC. Since 1914, the British government had become the major owner of APOC and the company had a permanent contract to supply the British Admiralty (at below market prices).¹³⁷ During the 1920-21 "renegotiations" a British Treasury official represented the Iranian government. The Armitage-Smith "interpretive agreement" of 1921

effectively excluded all downstream and non-Iranian operations from the government levy. With company payments to the government being based exclusively on the value assigned to Iranian production and that value determined by APOC, the agreement opened the way for the company to employ "transfer pricing" to reduce payments to Iran.¹³⁸ (Being vertically integrated, the price at which a TNOC sells oil to itself is a "transfer price." This price can be manipulated to show profits at whatever point of operations a company prefers and permits the TNOC to move larger shares of profits downstream by under-charging themselves for crude.) During the ten year period from 1913/14 to 1923/24 Iran received only 13.7% of the non-consolidated revenues of APOC and an even smaller share of consolidated earnings.¹³⁹

Following the Armitage-Smith agreement, the Iranian government, headed by Reza Shah Pahlavi, regularly complained about the payments, accounting, and development practices of APOC.¹⁴⁰ Throughout the 1920s the regime expressed its dissatisfaction, but to no avail. The first real host/firm confrontation emerged in the early 1930s. Iranian government oil revenues fell sharply, more so than the decline in APOC profits or oil taxes collected by the British government.¹⁴¹ The dispute came to a head, and in November 1932 the government cancelled the APOC concession. The British government objected immediately and said it would protect British interests. In the shadow of the British navy a new agreement was concluded. The new terms included a fixed royalty (4 shillings/ton) and minimum royalty payments, rather than relying on a share of revenues, which the government was unable to measure.¹⁴² The concession area was reduced from 500,000 to 100,000 square miles, prices on domestic oil sales

were reduced, the share of nationals employed at all levels was to be increased, and the government was to have increased access to information and participate in APOC board meetings. The new concession was to run 60 years. While by today's standard the terms of the revised concession still seem particularly onerous to the host state, the new agreement included major gains for the state.

The principle of relinquishment actually was contained in the 1925 Iraqi concession held by the Turkish Petroleum Company (TPC). This agreement also recognized the right of state participation (up to 20%) and the specification of minimum investment expenditures. None of these terms, however, were enforceable by the Iraqis, and in the early 1930s the Iraqi Petroleum Company (IPC, which replaced TPC) openly ignored these requirements.¹⁴³

Similarly, the 1933 Aramco concession in Saudi Arabia had relinquishment provisions, although relinquishment was to be exercised at the discretion of the company regarding areas not being exploited.¹⁴⁴ When oil was discovered in Saudi Arabia (1938) the government pushed for a renegotiation in terms. The host got more money, the company got more land.¹⁴⁵ This type of arrangement satisfied both the personal interests of Ibn Saud and the interests of Aramco. It was not until 1948 that the company agreed to implement a relinquishment program.¹⁴⁶

By the late 1930s there was a general increase in demands among producers in the Middle East to provide for supplies to domestic markets and increase the use of local labor. For the most part, with Iran as perhaps the major exception, the TNOCs failed to comply with the call for increased reliance on nationals.¹⁴⁷ With local oil

demand weak, providing supplies for local markets was a relatively pain-free exercise for the firms. However, "while some moves were made to give the host country the appearance of influencing decisions, such as allowing government representatives on the boards of the operating companies, the companies were able to retain their control over the concession areas."¹⁴⁸

Aggressive host state demands for a greater share of oil revenues first appeared in the 1940s. While local leaders always wanted more personal payments, the cost of paying-off even the greediest of individuals was far less than the cost which would be incurred by sharing profits with the state. Satisfying the social welfare function is far more costly than satisfying the tastes of corrupt officials or extravagant dictators and kings.

Venezuela took the lead among oil exporters in systematically pushing the TNOCs to give the state a greater share of oil revenues. Under the corrupt regime of Vicente Gomez, during the period from July 1919 through June 1936 Venezuela's oil revenues for the concessions was equal to 7% of the gross receipts earned by the TNOCs.¹⁴⁹ While the subsequent government of Lopez Cantreras continued in the military and conservative traditions, there was a conscious effort to redirect the economy to serve national needs and cleanse the country of the earlier corruption. The new government's theme was "sow the petroleum" by using oil money to revitalize and diversify the economy, build public works, modernize the agricultural, transportation, and communications sectors, and improve health standards. The government planned to impose new taxes on the TNOCs and collect back taxes to generate the needed money.¹⁵⁰

The companies, not surprisingly, resisted. While Lopez Cantreras continued to pressure the TNOCs and the government brought suit against the oil companies, it was his chosen successor, Medina Angarita, that presided over the first major change in the financial terms between Venezuela and the TNOCs. The new regime committed itself to renegotiating the existing concessions.¹⁵¹ Under the Law of Hydrocarbons enacted in 1943 the government cancelled all concessions and subsequently issued new concessions to the same companies for almost the same areas.¹⁵² The revised concessions, however, reflected the stiffer requirements of the new law. The royalty was raised to 16.6% from the 7.5% to 11% range. Royalties, moreover, were to be based on the market value of oil.¹⁵³ This, in part, freed Venezuela from royalties linked to transfer prices. The expectation was that Venezuela would capture approximately half of the industry's profits.¹⁵⁴ The TNOCs were required to build a local refinery, and new conservation measures were enforced. The oil industry was declared a public utility which would revert to the state, without compensation, after the new concessions expired in 1983.¹⁵⁵

The Acción Democrática party opposed the 1943 law as not being sufficiently stern. Following the coup which brought the group to power in 1945, oil taxes were raised. In 1948 the government ushered in a "50/50" tax which equalized government oil revenues with the net income of the TNOCs.¹⁵⁶ Government revenues jumped to \$.86/barrel in 1948, up from \$.45 in 1945 and \$.31 in 1943.¹⁵⁷ Because of the importance of Venezuelan petroleum (in the midst and aftermath of World War II and with Middle East production yet to reach its

potential), however, U.S. oil investments in Venezuela almost tripled between 1943 and 1950 and were second in value only to U.S. oil interests in Canada.¹⁵⁸

By the late 1940s the host governments, in many instances, had begun to climb the learning curve in dealing with the TNOCs. The example set in one country became the aspiration of the others. Following the increased taxes levied in Venezuela the Middle East governments began to exert an upward pressure on oil taxes. When the Saudi-Kuwaiti Neutral Zone was opened for concession bidding the countries sold to the highest bidders, neither of which were among the eight majors which held all of the original concessions in the area. Aminoil got the Kuwaiti concession in the Neutral Zone in 1948, followed by the Pacific West Oil (Getty) concession on the Saudi side in 1949. These agreements provided the governments with a larger share of revenues than they received from the other concessions,¹⁵⁹ giving the hosts an example to emulate in their own back yard.

In 1949 the royalty to Iran was renegotiated to six shillings/ton. The next year Saudi Arabia and Aramco agreed on a 50/50 profit split, and 50/50 terms rapidly became the norm in the Middle East. The TNOCs did not oppose the 50/50 split because the taxes paid abroad were deducted from taxes owed at home. For the TNOCs, therefore, the higher taxes did not affect costs. The 50/50 split, moreover, was based on profits from production only and permitted deduction of both costs and royalties. This meant that the TNOCs still could use transfer pricing to minimize host revenues. It also meant that, with the exception of Venezuela, the oil exporters were not collecting their royalties, as royalties were treated as part

of the 50/50 tax regime: the net effect was that either the host received no royalty and a 50% tax or a 12.5% royalty and only a 43% tax.¹⁶⁰ For the first time, however, Middle East oil income was linked to the price (albeit a "posted" price) of crude oil.¹⁶¹

Iran, as mentioned earlier, was the most aggressive Middle East country in pushing for better terms from the TNOCs. In the latter half of the 1940s the government began pressing for increased revenues. Perhaps of even greater concern to the host than the question of profits was the failure of the oil industry to have a substantive impact on the national economy and standard of living.¹⁶² The industry was a classic enclave and had developed few linkages with the local economy.¹⁶³ In 1947 the Iranian Parliament enacted legislation requiring that the government rescind concessionary rights.¹⁶⁴ The companies were willing to pay more (hence the increased royalty in 1949) but were not willing to cede the advantages they enjoyed under the terms of the concessions.

At the same time, Iran objected to British dominance in the country. The British government was the majority owner of the Anglo-Iranian Oil Company (AIOC) and always supported the company in its dealings with the host state. The British Admiralty, AIOC's biggest customer, saved, in Iranian estimates, \$500 million on oil sold at below market value between 1914 and 1951.¹⁶⁵ The combination of economic dissatisfaction, the desire for increased revenues, and the demands for sovereignty culminated in 1951, when the government, under the nationalist leadership of Mohammed Mosadegh, nationalized AIOC.

Despite the relative sophistication of the Iranian government, however, the state simply lacked the bargaining power to enforce its

will. Supported by active intervention by the British government, which showed a military presence in the Gulf and declared its intention to seize any oil shipped from Iran as AIOC property, AIOC boycotted Iranian oil. None of the other majors would buy a drop of boycotted oil, as their interests were completely with AIOC. Independents were under heavy pressure not to buy Iranian oil either and could not afford the risk of having their cargo seized by the British navy. AIOC served notice it would take legal action against any firm buying Iranian oil, and the U.S. government "requested" that American oil companies honor the boycott.¹⁶⁶

Iran was unable to sell the oil which already had been lifted. There were some 12 million barrels stored at the Abadan refinery but there were no buyers.¹⁶⁷ Iranian oil production fell from 640,000 barrels per day in 1950 to a mere 20,000 barrels per day in 1952.¹⁶⁸ Iran was financially crippled by its inability to produce and sell oil. The oil fell in value by almost one-half, and the foreign exchange rate was frozen.¹⁶⁹

While Iran suffered, AIOC merely adjusted. Earnings dipped 27%.¹⁷⁰ The company was able to increase rapidly its liftings from Kuwait and Iraq and offset the shortfall from Iran. The biggest problem faced by AIOC was not in obtaining crude, but in making up for the refined products from Abadan. Increased liftings from other AIOC concessions and on the part of the other international majors more than offset the loss of Iranian output.

Iran was brought to its knees. While some analysts attribute the Iranian failure, at least in part, to misconceived national interests,¹⁷¹ the country simply lacked the bargaining power to

confront AIOC that directly. In 1954 the Shah granted the Iranian Consortium (40% BP, 14% Shell, 7% held each by Exxon, Gulf, Texaco, Mobil and SoCal, 6% CFP, and 5% shared by a group of U.S. independents) the concession to operate the nationalized AIOC concession. While Iran was "defeated," the country did gain some advantages. The nationalization law was never rescinded: technically the state owned all oil, although it was not able to exercise control over production and pricing, attributes typically associated with ownership. The Iranian operations remained nationalized in name, but not in effect. The nationalization also gave birth to the National Iranian Oil Company (NIOC), the first national oil company in the Middle East. NIOC would later become the primary instrument for the implementation of Iranian oil policy. NIOC had the right to receive production information and review all areas of operations. The government took control over all nonbasic associated activities, such as housing, medical needs, transportation, and industrial training.¹⁷² Following nationalization, moreover, Iran received as much oil income in one year as it had in the preceding 50.¹⁷³

Despite the oil companies' "victory" in Iran, the international oil industry was undergoing structural changes that steadily eroded the bargaining power of the TNOCs and, conversely, increased the bargaining power of the producer states. Following the close of the Second World War the near absolute control over the international industry exercised by the majors was steadily diluted by the emergence and aggressive growth of "independent" oil firms. During the 20 years from 1953 through 1972:¹⁷⁴

- o more than 330 private companies and over 50 government owned firms entered the oil industry or significantly expanded their petroleum operations;
- o the share of non-communist reserves controlled by the seven majors declined from 92% to 69% of total world reserves, while the share of concession acreage held by this group fell from 64% to 24%;
- o the share of non-communist crude oil production undertaken by the seven majors dropped from 87% to 74%;
- o sales of petroleum products to non-communist markets in the eastern hemisphere by the seven fell from 72% to 54%;
- o the share of refining capacity held by the majors declined from 73% to 50%; and
- o the tanker capacity owned or managed by the seven majors slipped from 29% to 19%.

By the late 1950s Libya, Algeria, and Nigeria became major exporters. At the same time, production was rising in Latin America, as well as the Far East, and Soviet oil was being exported to Western markets. There was a rapid proliferation in the number and mileage of oil pipelines by both private and government companies throughout the world.¹⁷⁵ Throughout the 1950s production climbed faster than demand and the excess supply of crude oil in the international markets exerted a steady downward pressure on prices.¹⁷⁶ The imposition of mandatory import quotas in the U.S. in March 1959 exacerbated the problem of over supply.

By the mid-1950s the majors were forced to sell their oil at discounts below the posted price. This cut directly into the

companies' profit margins, but did not affect the producer states (whose revenues were based on posted prices). Unable to bring production in line with demand the TNOCs felt that their only option was to cut posted prices. In February 1959 they lowered the posted prices by \$0.18 per barrel, followed by an additional cut of \$0.08 to \$0.10 in August 1960.¹⁷⁷

These price reductions directly affected the producer states. The two price cuts cost the oil exporting countries more than \$870 million.¹⁷⁸ Their interests adversely affected by decisions over which they had no control, the exporting states decided they needed to coordinate their pricing and petroleum policies. In September 1960 representatives of Iran, Kuwait, Saudi Arabia, Iraq, and Venezuela formed OPEC.

OPEC provided the producer states with a forum for collective action and bargaining with the TNOCs. While OPEC never has been a single coherent actor¹⁷⁹ and experienced only modest success during most of the 1960s, "the establishment of OPEC increased the bargaining power of the producers; it accelerated intergovernmental coordination and heightened the determination of governments to realize for themselves any tax advantages granted to any other producing country."¹⁸⁰ (Since the early 1950s most agreements incorporated "best-term" clauses providing the host states with the prerogative of demanding terms as favorable as those granted to other producer states.)¹⁸¹

OPEC was able to achieve some victories against the companies during the 1960s. In 1962 the organization challenged the companies on their deduction of a marketing expense allowance from taxable

revenues to cover marketing costs. Following two years of negotiations the allowable deduction was reduced from \$0.017 per barrel to \$0.005.¹⁸²

At the same time OPEC reached an accord with the TNOCs on the expensing of royalties. Since the adoption of the fifty-fifty standard and the introduction of income taxes on the TNOCs the companies treated royalties as taxes and counted royalty payments towards the 50% of net revenues owed to the host governments. The net effect was that the TNOCs really were not paying royalties or were paying a 12.5% royalty and only 43% in income taxes. The OPEC members wanted royalties to be treated as an operating cost before applying the 50% income tax. In exchange for a minor discount on heavy crude oils (which later was phased out) the companies agreed to the expensing of royalties.¹⁸³

OPEC was not able, however, to restore prices to their earlier levels, although further price reductions were avoided. In two separate attempts (1965-1966 and 1966-1967) the organization also failed in its efforts to coordinate production among its members.¹⁸⁴

OPEC's sixteenth conference, in Vienna in June 1968, by which time Qatar, Libya, Indonesia, and Abu Dhabi had become members, produced the program that served as the blueprint for the exporting nations' long-range strategy toward the oil companies. In the "Declaratory Statement of Petroleum Policy of Member Countries" OPEC outlined its intent to seek ownership and control over production and prices. Among the ten points in the declaratory statement was the recommendation that the producers endeavor "to explore for and develop their hydrocarbon resources directly," and at the minimum, "retain the

greatest measure possible of participation in and control over all aspects of operations."¹⁸⁵ Further points declared that, should changing events warrant it, concession agreements should be revised and governments should acquire ownership of producing companies. Under the Statement, prices would be set by host governments and could be adjusted to compensate for declining terms of trade. Although the Statement attracted little attention at the time, it served as a broad policy outline for OPEC members.

The buyers' market in oil that prevailed for most of the 1960s hindered the bargaining position of the producer states. But the market had been changing and Libya's 1970 confrontation with the TNOCs over prices was a decisive catalyst for change.

Following the rise to power of Colonel Qaddafi, the Libyan government began pressing the TNOCs to raise oil prices and curtail what Qaddafi considered to be the excessive lifting of Libyan crude. He demanded conservation measures, a \$0.40 per barrel increase in the price of Libyan oil, and an increase in the tax rate to 55%. When the companies refused, Qaddafi went on the offensive.

A number of factors were working in Qaddafi's favor, giving him a bargaining advantage no producer state had ever had. Libya long had a policy of giving independents concessions as a means of avoiding dependence on the majors. By 1970 there were 21 oil companies operating in Libya, and independents accounted for more than 50% of Libyan output, compared to less than 15% for other OPEC countries.¹⁸⁶ Libya, as a result, was not heavily dependent on the major TNOCs and enjoyed the luxury of dealing with multiple independent firms, many of which were reliant on Libyan oil, instead of an integrated

consortium. Western dependence on imported oil climbed throughout the 1960s. Libyan oil was in particularly high demand because of its low sulphur content and easy proximity to European markets. At the time, Libyan crude accounted for one-quarter of Western Europe's oil consumption.¹⁸⁷

The closing of the Suez Canal in the wake of the 1967 Arab-Israeli War enhanced the Libyan position, which was further strengthened by the closing of the Tapline (Trans-Arabian Pipeline) in May 1970. Simultaneously, there was a super-tanker shortage and rising tanker rates; Nigerian production was interrupted by the war in Biafra; and the winter of 1970-71 was colder than normal. Libya's bargaining position was bolstered further by the country's financial condition: the state had foreign exchange reserves equal to three years worth of imports.¹⁸⁸

In June 1970, the Libyan government informed the Occidental Petroleum Company that its production would be reduced from 800,000 to 500,000 barrels per day. In August, Occidental's production was cut further to 440,000 b/d, or only 55% of its former production. Qaddafi chose Occidental because of its vulnerability to cutbacks: it depended on Libyan oil for almost one-third of its total earnings, had no other source of supply, and would be unable to meet its contractual commitment without suffering heavy losses. The seven majors refused to help Occidental and left it no choice but to capitulate. In September, Occidental agreed to raise the posted price by \$0.30 per barrel, rising to \$0.40 over the following five years, and also accepted a 5% increase in the tax rate, retroactive to 1965.¹⁸⁹

Qaddafi then turned to the Oasis group, a consortium of three independents (Amerada, Continental, and Marathon), and Royal Dutch/Shell. The independents were largely dependent on Libyan oil and yielded, but Royal Dutch/Shell refused to concede. In September 1970, Qaddafi suspended all of Shell's Libyan production. By this time, only the large majors were refusing Qaddafi's demands. Soon, however, Texaco and SoGal, followed by the other U.S. majors and lastly by Royal Dutch/Shell acceded to the price and tax increases. There was no alternative for the majors, who were faced with the possibility of nationalization and the takeover of their concessions by either a national oil company or by independents.¹⁹⁰

The market had changed. While in the past the TNOCs had the advantage of drawing on supplies totally under their control from multiple sources and could shift production from country to country, this no longer was the case. Most of the map, moreover, had been explored for potential oil resources. The prospect of exploring for and developing yet another huge oil producing area was remote. The TNOCs would have to make the best of what they had. Alaska and the North Sea could not replace the Middle East.

Libya was the turning point. Qaddafi had been able to pick-off the oil companies one at a time. The inability of the companies to compensate for the Libyan production cuts and to keep the lid on Libyan demands "signalled a fundamental shift in the balance of power in favor of the producing countries."¹⁹¹ Libya broke the twenty-year tradition of fifty/fifty and proved the bargaining power of the host states and the vulnerability of the TNOCs. Other producers soon followed suit in raising prices and adopting the 55% tax guideline.

In December 1970, at OPEC's twenty-first conference the organization called for a minimum income tax of 55%, an increase in posted prices, and the total elimination of both tax deductions for royalties and price deductions for marketing expenses. The group also decided to negotiate with the companies on a regional basis. If the TNOCs refused, member states agreed to take unilateral action.

The companies prepared themselves by deciding to negotiate collectively and develop a safety-net agreement to help any companies that were the target of production cutbacks during negotiations.¹⁹² The companies also wanted to negotiate with OPEC as a whole or at least conduct simultaneous negotiations with the Persian Gulf and Mediterranean groups. OPEC refused, and separate talks were scheduled for Teheran and Tripoli.

The Teheran negotiations opened on July 19, 1971. When the producer states presented their price demands and the companies refused, the states threatened to unilaterally raise prices and taxes. The TNOCs conceded. In exchange for the higher prices and acceptance of the 55% tax rate, the companies requested -- and received -- a promise that the Teheran terms would remain in force for five years. This "can be seen as a defensive effort to reestablish some measure of stability in a situation in which their (TNOC) control seemed to be ebbing."¹⁹³

Soon afterwards an agreement was reached in Tripoli. The Tripoli terms were even more favorable to the states and also gave the companies a five year guarantee.

Less than six months later the OPEC countries called the TNOCs to Geneva to protect against their loss in revenues as a result of the

floating and subsequent devaluation of the dollar. The companies readily acceded to increasing posted prices and linking prices to a basket of currencies. By this time, the host states were in control of oil prices.

Despite the five year "guarantees" the host states pressed for renegotiations in 1973. OPEC called for a doubling of prices. When the companies and their home governments rejected the increases, a unilateral increase of 70% (Saudi market crude went from \$3.01 to \$5.12) was imposed. At the same time, the outbreak of the Yom Kippur War prompted an OAPEC embargo against selected importer states. Production cutbacks during the fourth quarter of 1973 sent spot prices to \$20 per barrel. On January 1, 1974, OPEC states further asserted their control over prices and raised the cost of a barrel of Saudi market crude to \$11.65.

At the same time, OPEC was assuming a greater role in production, through either participation or nationalization. This brought the host states closer to their goal of direct management over the industry by their national oil companies. Following disputes with France, Algeria nationalized 51% of all French oil holdings and assets in February 1971. This, in effect, signalled the transfer of company control from the TNOCs to the states.

Venezuela began to call for 100% government ownership by 1983. At the September 1971 extraordinary conference OPEC members were urged to begin to "participate" in existing concessions on a basis moving toward full ownership and control.

Acting on behalf of Saudi Arabia, Kuwait, Qatar, and Abu Dhabi, Saudi oil minister Sheikh Ahmad Zaki Yamani began negotiations with

the TNOCs in January 1972 regarding participation. The companies were reluctant, and the four states threatened unilateral action. In October 1973 -- by which time Libya nationalized 51% of its BP concession and Iraq took 100% control over the Iraq Petroleum Company -- the TNOCs agreed to give the four states a 25% equity share in their concessions, to increase to 51% by 1982. Compensation for the companies was to be based on updated book value, and a supplementary agreement set the price and established the percentage of the governments' share of participation crude oil (also called bridging or buy-back oil), which would be sold to the companies so they could fulfill their contractual obligations. Provisions were also made for phase-in oil, whereby the governments had the option of selling to the companies those quantities the governments and their agents were not able to market themselves.

The OPEC nations were not long satisfied. Libya, which had nearly completed the 51% takeover of most fields by April 1974, was soon seeking 80% participation. Before the oil embargo was lifted in March 1974, Kuwait and Qatar became the first OPEC members to claim a 60% stake, and Kuwait, Saudi Arabia, and Venezuela announced their intention to reach 100% participation. By 1975, either through participation agreements or partial nationalization, control over production and exports rested in the producers' hands. Since then, their degree of ownership has continued to grow. By the end of 1980, Iran, Kuwait, Qatar, Saudi Arabia, and Bahrain had achieved 100% takeover, while Oman, Abu Dhabi, and Nigeria owned 60%.

The host states have continuously applied pressure to change the terms of agreements in their favor. The better their bargaining

position, the more successful they have been. "The fact that none of the concession agreements originally concluded with the producing countries has remained unchanged proves the compelling nature of circumstances rather than the accommodating attitudes of the concessionaires."¹⁹⁴

The shift in bargaining positions has occurred at both the project (micro) and global (macro) levels: at the project level individual host states have been able to exact better terms from the TNOs, while on the global level there has been a secular trend of continuous improvement in host terms.¹⁹⁵ This global trend is part and parcel of the emergence of the developing world and the call for a new international economic order. Third World states are less easily bullied than they once were. The threat of military intervention on behalf of corporate interests has lost most of its sting. The international political climate is not conducive to such activities, while the efficacy of such ventures is highly suspect.

While saber-rattling no longer is an effective means for home governments to support their TNCs, economic pressures are equally questionable. Despite a lengthy legislative history of laws on economic sanctions against host states which treat U.S. firms unfairly -- the Johnson-Bridges Amendment (1959), the Hickenlooper Amendment (1962), and the Gonzalez Amendment (1972) -- the U.S. has levied economic sanctions against other states very sparingly. Not only are such sanctions unlikely to be effective, but the potential backlash against U.S. interests has been considered unacceptable: the sanctioned country might follow the Cuban example and turn to the open arms of the Soviet Union.¹⁹⁶ To the extent that sanctions have been

used, moreover, one analyst has concluded that "if anything, formal aid sanctions have only strengthened nationalist hostility toward foreign investment."¹⁹⁷ The bottom line is that not only is the U.S. government reluctant to openly support American firms in their confrontations with host states, but that "like the U.S. government, the nation's businessmen confront greater turbulence abroad and wield less power than in the past."¹⁹⁸

V.4 Bargaining and Political Risk

Political risks are inherent, albeit latent, in the nature of foreign investment agreements. The increased bargaining power of the host is what translates host aspirations into realities, TNC concerns into political risk events. To the extent a host/firm relationship is stable, the two parties exist in relatively evenly balanced positions of power vis-à-vis one another. While some analysts contend that such a "harmonious" relationship would indicate the equity of the agreement¹⁹⁹ or degree of consensus between the parties,²⁰⁰ this is not the case. Outcomes are not determined by "fairness," "equity", or "logic" but by relative bargaining power.²⁰¹ While joint-maximization may sound like a genteel form of mutually beneficial interaction between comrades, it is, in effect, "a process of on-going mutual adjustments in which foreign investors act in accord with their best interest when they are in the strongest position and accede to necessity when they are weak and exposed, while host governments accede to necessity when they are weak and act in accord with their best interests as they gain strength."²⁰² Conflict, in short, "is continuous, and the outcome of the bargaining shifts with the relative bargaining strengths of the opponents."²⁰³

As mentioned earlier, the bargaining model posits that "the relative bargaining strength of each party changes over the cycle as their respective contributions to the project change"²⁰⁴ and that the shift is in favor of the host state. This greater bargaining power on behalf of the state enables the host to press its demands upon the TNC with greater success. The demands of the host regime will reflect the state's interests. As identified earlier, the state's interests are not consistent with the interests of the TNC and, moreover, the more the state realizes its interests, the less the firm will be successful in achieving its interests. In altering the terms of the relationship to reflect its greater bargaining power, the state is acting to the detriment of the TNC. In other words, the growing bargaining power of the host creates political risks for the TNC. As that power is translated into specific acts modifying the host/firm relationship, the TNC must endure political risk events.

The greater the TNC's leverage is relative to the host, the more likely it is that the firm will be able to resist the demands of the host and avoid political risk events.²⁰⁵ The firm's ability to withstand "the pressures of a host government depends, to a large extent, on how much the country needs what the firm has to offer and how many alternative sources for the firm's contribution exist,"²⁰⁶ i.e., the power which can be commanded by the TNC. Where the TNC's role is least vital the firm will be the most vulnerable to political risks. As the inputs of the TNC become less essential the cost of nationalism on the part of the state declines. It costs the host little to tighten the terms on a firm which grows increasingly dispensable. "As the bargaining power of the host grows, the firm is

exposed to an increased degree of political risk. The less vital a company is, the easier it is -- and the more likely -- for the government to escalate its demands."²⁰⁷

"Ceteris paribus, there is a tendency for the benefits of any foreign investment (i.e., resources transferred) to decline and the costs (i.e., constraints on national control) to increase over time."²⁰⁸ As the benefits brought by the TNC wane and the costs of the original agreement begin to bear upon the state, the host pushes for new terms. TNCs prefer stability and predictability in contractual terms²⁰⁹ and hail the sanctity of contract. As the initial terms in traditional agreements invariably reflected the superior bargaining position of the firm, this preference comes as no surprise.

Rules, however, are situation specific, and in any situation the strongest actors determine the rules. If conditions change, i.e., power shifts, the old rules lose their application and must be replaced with new rules.²¹⁰ The new rules defining the relationship between players will reflect the new distribution of power. "When there is great incongruity in an issue area between the distribution of power in the underlying structure, and its distribution in current use, there will be pressures for a regime change."²¹¹ The terms of agreement are not immutable. To the contrary, they are fluid and shift, over time, in accordance with changes in bargaining power. The longer the life of an agreement, the more likely it is to undergo changes reflecting shifts in the relative bargaining power of host and state. While TNCs have repetitively appealed to the law of contracts, "whatever the law has been thought to be, the practice is clear:

concession contracts have been constantly altered. Economic, political, and social factors have become more potent than legal factors in determining the viability and shape of concession arrangements."²¹²

As a result of the shift in bargaining power, TNCs see their agreements subject to "political obsolescence," "the deterioration in profitability of an investment because of political rather than other reasons."²¹³ The clearest example of this is in the allocation of economic rents. "It is, in fact, precisely the question of how any possible rent is to be divided that is at the heart of most resource project negotiations."²¹⁴ Rent refers to the surplus generated by a factor of production above the minimum earnings required to induce that factor to do its work.²¹⁵ "The objective of mineral economics, is to capture all rents while letting the investor make the return necessary to induce him to invest."²¹⁶ The economic bargaining range can be plotted between total rents and zero rents.²¹⁷ In a competitive industry, the concessionaire or TNC would earn only "normal" profits, that is the minimum amount needed to induce and continue an investment.²¹⁸ In each investment relationship, however, "the allocation of rents...reflects the bargaining positions of the claimants."²¹⁹

Mineral economists have identified five types of rents:

1. Scarcity rent, which is determined by consumption relative to reserves
2. Differential rent owing to the quality of the resource
3. Monopolistic rents exacted by virtue of market control
4. Quasi rent from superior knowledge or control of individual

expertise

5. Windfall rent realized from sudden demand increases with low supply elasticity²²⁰ or sudden supply decreases with low demand elasticity.

Royalties, the traditional means by which host states received revenues from natural resource projects, captured only scarcity rents.²²¹ As the bargaining position of the hosts improved, they introduced various types of taxes to increase their earnings at the expense of the TNCs (and, in some instances, consumers). The purpose of taxation, in fact, is to capture for the state all economic rents, while permitting the firm to earn the minimum return necessary to maintain an investment.²²² The introduction, and subsequent increases in, income, surface, production, export, labor, reinvestment, excess profit, and other types of taxes have been aimed at maximizing host revenues both in absolute terms and relative terms. Host states not only earn more from these taxes, but they also earn a greater share of the rents associated with a project.

Figure V.2 plots the relative share of rents captured by the OPEC states and the TNOCs during the past 70 years, illustrating the increasing share of revenues that has been taken by the host. As its share of the pie, the host state has boosted its take from less than 20% to more than 90%.

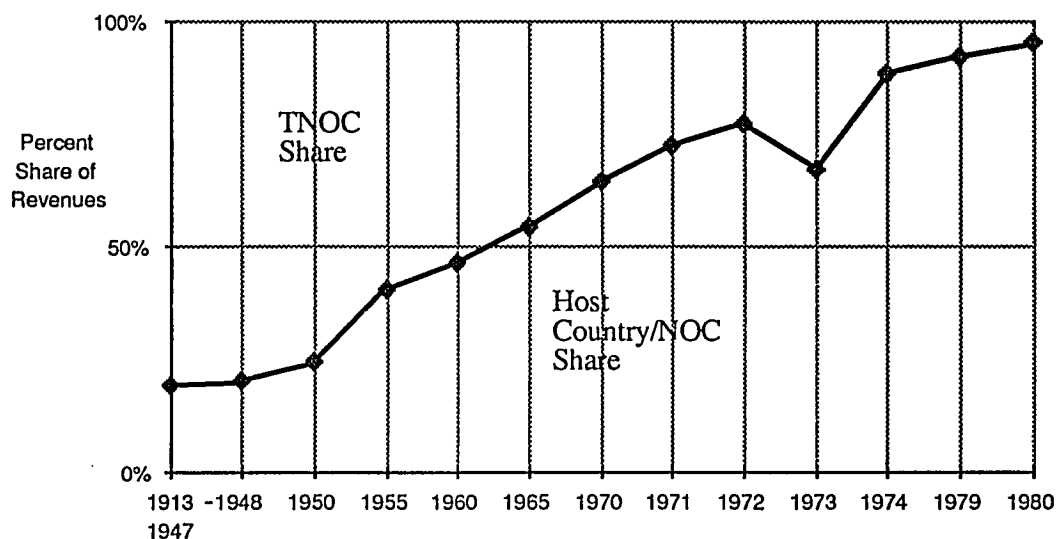
During the same period, the amount of oil revenues grew tremendously. As Figure V.3 shows, the twelve year period from 1960 to 1972 saw net revenues from OPEC oil climb from \$3 billion to \$12 billion. By 1980, the total would eclipse \$200 billion.²²³ TNOC net revenues, Figure V.3 illustrates, continued to climb during a period

when the OPEC states increased their share of the net pie from 46% to 77%. While company earnings increased by a not insignificant measure, however, host state earnings jumped almost 600%.

In addition to a "normal" return on investment, the only type of rent which TNCs are still able to extract is quasi rent. Primarily this reflects the technological and managerial know-how of the firm. Technology, in fact, is the key bargaining chip of the TNC. States want the technology, while the companies have a vested interest in controlling technology as a vital input and bargaining point. Because technology eventually becomes diffused, moreover, the TNCs always have a motive to push new technological frontiers.²²⁴ Over time, however, the host's "ability to produce the mineral product could grow to such a point that the 'rent of ability' claimed by the foreign company would wither away."²²⁵ At that point, the TNC has become little more than a general contractor bidding to perform explicit services on behalf of the host.

It is the bargaining power of the host which explains the state's ability to force TNCs to give up the traditional notion of a concession with full ownership and accept increasingly onerous terms.²²⁶ The TNC, of course, is not a passive observer in this process. Although the efficacy of such actions is far from certain, TNCs have tried to protect themselves from risk with strategies "that raise the cost of irresponsible nationalism."²²⁷ Depending on the situation the TNC is not without some potentially effective bargaining tools of its own. When it is time for the TNC to decide whether or not to reinvest profits and depreciation allowances or

Figure V.2: TNOC and OPEC* Host State Share of Petroleum Revenue from OPEC Oil Operations (% Revenues)



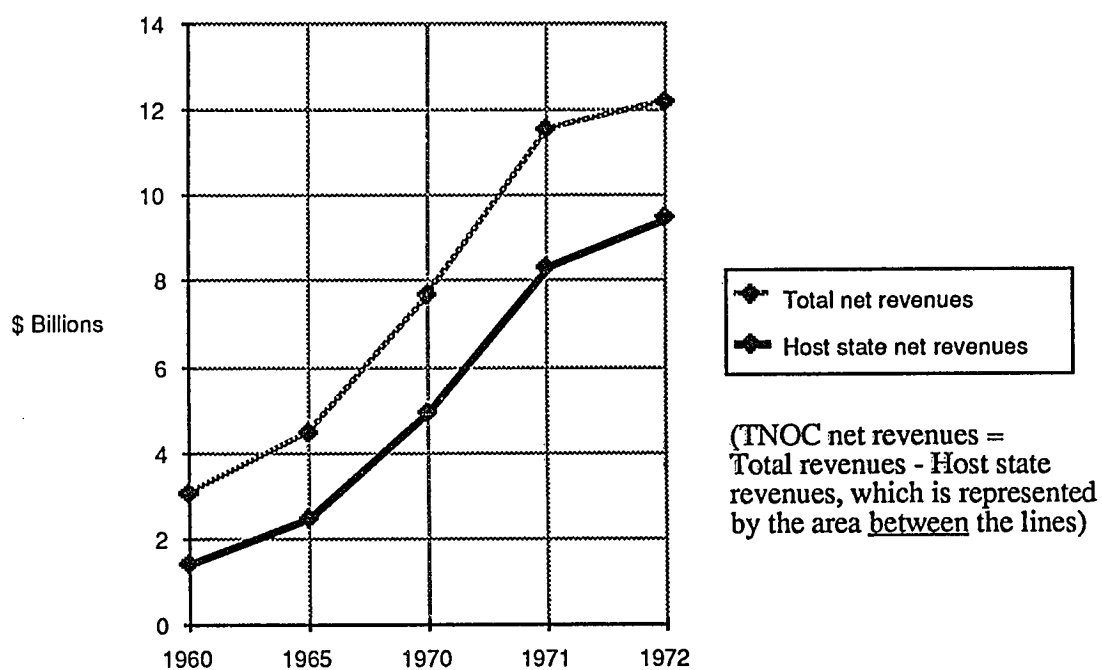
*Data for 1913-1960 excludes Venezuela, whose share went from 26% to 69% during that period.

Sources: (1) 1913-1960 data: Charles Issawi and Mohammed Yeganeh. The Economy of Middle Eastern Oil (New York: Praeger, 1962)

(2) 1965-1972 data: Dankwart A. Rustow and John F. Mugno. OPEC: Success and Prospects (New York: Council on Foreign Relations and NYU Press, 1976)

(3) 1973-1980 data: Estimated

**Figure V.3: Net Revenues From OPEC Oil Operations
(\$ Billions)**



Source: Dankwart A. Rustow and John F. Mugno. OPEC: Success and Prospects (New York: Council on Foreign Relations and NYU Press, 1976)

bring in new capital, for example, the TNC enjoys significantly enhanced bargaining power.²²⁸

Rather than the smooth curve portrayed in Exhibit V.1, the shift in favor of the host state "is likely to proceed along a more discontinuous path, with each innovative state action being answered with innovative responses by transnational corporations."²²⁹ The growing ability of the state to improve its terms with the TNC, moreover, does not mean that the TNC is unable to impose additional costs on the state²³⁰ or is lacking in resources wanted by the host government. These rejoinders notwithstanding, our framework sees the relative bargaining power of the host state vis-à-vis the TNC growing over time, and political risks are the result of the state exercising its bargaining power against the TNC.

Notes to Chapter V

- ¹Mikdash, International Politics, p.162.
- ²Leonard, p.482.
- ³Prast and Lax, "Political Risk," pp.10-16.
- ⁴Kindleberger, Power and Money, p.334.
- ⁵Cobbe, p.334.
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- ⁷Widyono, p.12.
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- ⁹Smith and Wells, pp.3-4.
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- ¹³Moran, Multinational Corporations, p.159.
- ¹⁴Smith and Wells, p.19.
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- ²¹Mikesell, Foreign Investment, p.38.
- ²²Moran, Multinational Corporations, p.160.
- ²³Vernon, Sovereignty, p.46.

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³⁰Philip, pp.315, 320-321.

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³²Keohane and Nye, Power, p.19.

³³Moran, "Theory," p.164.

³⁴Theodore H. Moran, "Modeling OPEC Behavior," International Organization, 35 (1981), p.253.

³⁵Vernon, Economic and Political, p.32.

³⁶Philip, p.313.

³⁷Cobbe, p.81.

³⁸Bacharach and Lawler, pp.49-50.

³⁹Cobbe, pp.151-152.

⁴⁰Stoeever, Renegotiations, p.312.

⁴¹Hodges, p.294.

⁴²Hodges, p.13.

⁴³Hodges, p.296.

⁴⁴La Palombara and Blank, p.71.

⁴⁵Stepan, pp.238-239.

⁴⁶Vernon, Economic and Political, p.166.

⁴⁷Vernon, Sovereignty, p.194.

⁴⁸Ajami, p.90.

- ⁴⁹Vernon, Sovereignty, p.196.
- ⁵⁰Leonard, p.455.
- ⁵¹Leonard, p.481.
- ⁵²Moran, Multinational Corporations, p.166.
- ⁵³Johnson, p.2.
- ⁵⁴David Easton, A Systems Analysis of Political Life, (New York: Wiley, 1965), p.194.
- ⁵⁵Committee for Economic Development, p.26.
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- ⁵⁷Johnson, p.6.
- ⁵⁸Moran, Multinational Corporations, p.190; See also Miles Kahler, "Political Regimes and Economic Actors: The Response of Firms to the End of Colonial Rules," World Politics, xxxiii (1981).
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- ⁶¹Easton, p.21.
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- ⁶³Sigmund, p.261.
- ⁶⁴Penrose, Growth, p.155.
- ⁶⁵Penrose, Large International Firm, p.199.
- ⁶⁶Kapoor, in Kapoor and Grub, p.376.
- ⁶⁷Widyono, p.11.
- ⁶⁸See Bacharach and Lawler.
- ⁶⁹Galtung, p.119.
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- ⁷³Robert Smith, p.418.

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- ⁹⁸Torrens, pp.83-84.
- ⁹⁹Mikdashi, Financial, p.63.
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- ¹¹¹Pinelo, pp.34-42.
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- ¹¹³Krasner, p.236.
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- ¹³²Philip, p.57.
- ¹³³Girvan, pp.17-18.
- ¹³⁴Philip, p.210.
- ¹³⁵Wilkins, p.219.
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- ¹³⁷Mikdash, Financial Analysis, p.31.
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- ¹⁴¹Fesharaki, p.4.
- ¹⁴²Danielsen, p.117.
- ¹⁴³Al-Chalabi, pp.8-9.
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- 164 Danielsen, p.144.
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VI. CONCLUSION

Political risks are not the result of the irrationality of nationalist Third World leaders. Nor are such risks the unexpected catastrophe that befalls TNCs when unstable and misled developing states erupt in a nationalistic frenzy.

What confront TNCs as political risks are the products of policy decisions implemented by states in the pursuit of the interests of the state. These decisions are rational, goal-oriented efforts to maximize (or, at least, promote) the state's interests.

Policy decisions are the proximate cause of political risks. The underlying or ultimate cause is the natural conflict of interests between the TNC and the state. The nature, orientation, and ultimate interests of these two entities are inherently different.

These structurally rooted conflicts of interests are mediated by the bargaining and market relationship between the actors, as well as domestic demands and supports, and the style and ideology of host state leadership. Differences in interests, therefore, often are overshadowed by political and economic realities. These constrain otherwise antagonistic forms of behavior, forcing the parties involved to deal with each other as necessary to meet each's short term needs and interests. If neither party can be totally dominant to the virtual exclusion and elimination of the other, they have no choice but to establish some type of modus vivendi for their interaction.

The dialectic of host/firm relations creates an ever changing modus vivendi. The dynamics of reality, in the form of the bargaining relationship, are ever changing. These changes are reflected in the

level of cooperation and conflict apparent in the relationship between host states and TNCs.

The inherent relationship between host state and TNOC has remained the same for some nine decades. During this period of time, however, the bargaining relationship and other mediating variables have changed dramatically. This has been reflected in the interaction between host and firm and in their day-to-day relationships.

Foreign investment agreements are a process that change over time in response to prevailing political and economic conditions. At any point in time the agreements in force between a host state and TNC reflect the relative bargaining positions of the two actors. As those bargaining positions change, the terms of agreements are modified to keep pace with the bargaining relationship. The host state effects changes by means of policies. These changes are the proximate cause of political risks. The traditional concept of sanctity of contract, to which the oil companies attempted to cling as each renegotiation eroded their dominance, has little application in the foreign investment process.

Historically, the TNOCs enjoyed a preponderance of bargaining power relative to the host states. Unable to challenge the position of the companies, which enjoyed a cartel-like arrangement and at times overt support from the colonial powers that were their home states, host states accepted the dominant position of the TNOCs.

As is the case with any industry with high barriers to entry at the point of production, "the balance of power between foreign investors and domestic governments begins very much tilted in favor of the foreign" companies.¹ During the early years of the industry,

"in comparison with the companies, the producers were powerless; they depended, almost exclusively, on the oil companies for their regular budgets and for other governmental expenses."² The companies were able to "mobilize financial resources far in excess of host government capabilities,"³ monopolize the technical and managerial skills to explore, find, lift, refine, and transport petroleum, and dominate the markets for the sale of crude and products. Bolstered by a dominant bargaining position compared to the host states, the TNOCs were relatively safe from political risks.

Over time, however, as the financial alternatives of the state improve, technical and managerial skills become available from other sources and are acquired by host state nationals, and alternative markets are developed, the bargaining strengths of the TNOCs begin to wane and the bargaining position of the state begins to improve. In the oil industry the emergence of the independents and the aggressive positions adopted by ENI and the Soviets in the 1950s and 1960s contributed to the increase of host state bargaining power by diluting the absolute control formerly exercised by the major TNOCs. "The most important fact about the 1960s was not the continuing decline in oil prices... [but] the shift of power from companies to governments."⁴ This power shift gives the state the new found capability to impose changes on the TNOCs and revise investment terms. Sparked by the will and/or need to change the investment relationship, this capability results in political risks.

The companies retained the upper hand. At the same time, however, they had to make concessions to the host states. Those hosts that enjoyed the strongest bargaining positions, be it because of the

degree of institutionalization in the state, the diversity of the national economy, or a particular weakness on the part of the TNOCs, were the first to press their demands and went the farthest in those demands. These demands, which constituted political risk events for the TNOCs, were acceded to by the firms on the basis of necessity: if the bargaining power of the state was sufficient, the TNOc gave in.

While the pendulum has swung in favor of the host states, they still need and rely on the TNOCs. Despite the preferences of both actors, neither can do without the other. This mutual need on a daily basis creates an immediate sense of shared concerns in such areas as price, production, transportation, etc. While these concerns are totally dependent upon market conditions and represent a type of collaboration of necessity, they are nonetheless real. To paint this relationship as cooperative, however, is to misunderstand the fundamental differences between the two actors and the temporal nature of their collaboration. Host and firm deal with and cooperate with each other out of necessity.

While policy changes are the immediate source of political risk events which confront TNOCs, political risks are rooted in the structural differences and conflicting interests of host and firm. Though the inherent differences are not resolvable, on the surface of the relationship the differences are managed as a by-product of the bargaining relationship, by which each actor's ability to pursue its interests to the exclusion of the other are constrained. The TNOCs have little motive to share host goals and interests "except insofar as the bargaining leverage of the host government has forced the firms to address their attention to these issues."⁵

Both the state and the company want to capture all of the values created by an investment project,⁶ and each wants to use those values to promote its own (conflictual) interests. The allocation of the values between the parties is a function of the bargaining relationship. As the bargaining relationship evolves the hosts become increasingly capable of imposing their interests on the TNOCs and taking a larger share of the values created by an investment agreement. The increased capability of the host to impose such changes on the firms is accentuated by a reduced capability on the part of the companies to withstand those changes and a greater vulnerability to political risk.

The host states, through their NOCs, have displaced the TNOCs as owners of the world's oil and have steadily increased their control over operations. The process of host ascendancy has been "in inverse ratio to the decline of the position of the concessionary companies and in direct ratio to the rise in the position of the producing countries."⁷ Over time, industry structure takes shape as "both a reflection of and a determinant of the bargaining relationship between host and firm. As the bargaining strengths of host governments have waxed and those of the oil companies have waned, the structure of the industry has responded to the distribution of market power. Simultaneously, the changing market structure, on the whole, has promoted the bargaining leverage of the oil-producing countries."⁸

Historically, host states typically have begun penetrating TNOC operations at those points where the barriers to entry are lowest, the necessary skills are easiest to acquire, and the host bargaining position is strongest. This usually means beginning with gaining

control over the local market: first handling local distribution and marketing, then moving into refining for local needs (which entails operating smaller, less sophisticated refineries), and local transportation. Once the national market is under local control, the host seeks to move both upstream, and play a larger role in production and management, and downstream, where it becomes involved in refining for international markets and transportation and marketing abroad.

The long-term goal of oil producing states is clear: they want to increase their scope of control, while steadily reducing the role of the TNOCs to the point where they either perform specific services for a fee or disappear. "If these companies survive into the future it will be because they can perform important economic functions more efficiently than governments, state companies or commercial competitors. If they cannot do this, they will become extinct like all unfit organisms."⁹ If the host can do everything as well and as economically efficiently as the TNOCs--including search for, develop, extract, transport, refine, and market petroleum--the host would have no reason to use the oil companies for any functions.

Differences within OPEC the past few years and weak market conditions -- a reflection of intra-OPEC squabbling and inability to regain control over supplies, as well as conservation and the use of alternative fuels in the consuming countries -- have weakened OPEC's control over the international oil industry. This, in turn, appears to have at least temporarily alleviated the pressures exerted upon the TNOCs by oil exporting states.

The companies, for their part, are enjoying a respite from the constant pressures that were exerted upon them by host states for most

of the past 15 years. The TNOCs are enjoying what is, in effect, a buyer's market. As buyers of crude oil with very limited entitlements on an equity basis, the TNOCs are feeling the advantages of being a buyer in a period of over-supply and weak prices.

Despite favorable short-term deals on prices, which are reflected in spot market prices as much as direct TNOC purchases from the producer states, the fundamental relationship between TNOC and host remains unchanged. Control of production still rests with the state. Taxes and royalties are not being rolled-back. Expropriated assets are not being returned. The market may be slack and OPEC may be struggling to regain its position of control, but the host state's interests in controlling its oil for the pursuit of state policy goals remain unchanged.

While TNOC activities may be increasingly circumscribed by government policies, especially if OPEC proves able to regain its hold on the market, these firms will continue to perform essential functions. In particular, TNOCs continue to hold a major technological edge on the industry. While labor, capital, and managerial skills are widely available, technology is more tightly controlled. Technological skills are particularly important in exploration and development, particularly off-shore, and in such areas as enhanced recovery and sophisticated refinery operations. These activities also are the riskiest economically. Producer states want access to state-of-the-art technology, but the companies recognize that "demands for increased state participation in the major producing countries appear to be limited only by the level of technical expertise available to the host country."¹⁰

Technology is an expensive, elusive component. Along with their control over major market outlets, technology is the primary bargaining advantage still held by the oil companies. This gives the TNOCs a vested interest in continuing to control the latest technology and always pushing on to new technological frontiers. Only by means of their ability to control some valuable inputs into the investment relationship will TNOCs avoid the ultimate political risk of extinction.

Notes to Chapter VI

¹Moran, Multinational Corporations and the Politics of Dependence, p.8.

²Benjamin Shwadran, Middle East Oil Issues and Problems (Cambridge, MA: Schenkman, 1977), p.76.

³Turner, p.90.

⁴M.A. Adelman, cited in Petroleum Intelligence Weekly, "Oil Firms Losing Power to Set Sales Price, Adelman Says," 28 Dec. 1970, p.171.

⁵Lax, Political Risk, p.25.

⁶This position is a variation on that found in Penrose, Growth, pp.152-154.

⁷Schwadran, p.26.

⁸Lax, Political Risk, p.48.

⁹Turner, p.115.

¹⁰Sahakian, p.66.

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