



Are oil and gas firms more likely to engage in unethical practices than other firms?



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ABSTRACT

In this study we investigate the unethical practices undertaken by the oil and gas firms vis-à-vis other firms. We find that oil and gas firms operating in non-competitive industries are more likely to engage in unethical practices. The results are particularly strong in countries that rank poorly in legal enforcement, regulations and institutional framework, and import less oil. Policy makers should consider undertaking steps to encourage competition in the industry to limit unethical practices. Further, the country-level enforcement laws, regulations, and institutional quality need to be reformed, especially in developing countries, to discourage firms from gaining undue benefits.

1. Introduction

The role of oil and gas firms engaged in unethical practices¹ to gain undue benefits remains controversial with a number of studies indicating that corruption is prevalent in the oil and gas industry. In an influential report published by OECD (Foreign Bribery Report),² more than 400 cases of bribery are investigated. Out of these cases extractive industries (19%) emerged a most corrupt industry. Similarly, a report published by Transparency International, a global advocate of the fight against corruption, found the oil and gas sector was third amongst the 19 bribery-prone sectors surveyed.³ Al-Kasim et al. (2013) conduct an in-depth interview with Norwegian specialists in oil regulation, while Ofori and Lujala (2015) study the Ghana market. Both the papers indicate that corruption is a concern in an oil and gas industry. However, as highlighted by Al-Kasim et al. (2013), empirical evidence into the relationships between oil and gas industries and corruption is limited to date.

The role of country-level determinants in discouraging oil and gas firms from engaging in unethical practices has been overlooked in the literature. For example, as per the resource curse phenomenon, resource boom leads to lower GDP (Robinson et al., 2006). Countries that are rich in natural resources can experience either positive or negative economic growth (Kolstad and Wiig, 2009; Al-Kasim et al., 2013; Leite and Weidmann, 1999). In fact, Mehlum et al., (2006a, 2006b) and Robinson et al. (2006) suggest that the relationship

between natural resources and growth of a country is conditional on the quality of institutions. Abundant natural resources and better institutional quality play a complementary role in increasing the economic growth. On the country, countries that have poor institutional quality have lower economic growth even if there is abundant supply of natural resources. Further Majbouri (2016) shows that resource-rich countries have a lower level of entrepreneurship as the focus turns from increasing productivity and efficiency to rent-seeking and patronage.

Additionally, there is a dearth of studies investigating the role of competition in driving firms to engage in unethical practices. This is highlighted by Al-Kasim et al. (2013), where the authors indicate competition levels and governance influence unethical practices. Similarly, Gupta (2016) shows that competition in an industry is a strong determinant of oil and gas stock returns.

We address this gap using a comprehensive dataset of 25,702 firm-year observations drawn from 53 countries spanning 2002–2012. We show that oil and gas firms are not more likely to engage in unethical practices as compared to other firms. However, the relationship between oil and gas firms and unethical practices is stronger and statistically significant when we condition our results on the competition level of the industry. We show that oil and gas firms operating in a non-competitive industry are more likely to engage in unethical practices.

Next, we examine the role of country-level determinants in

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¹ We include a range of misconducts, such as corruption, bribery, lobbying, money laundering etc. under the common term “unethical practices”.

² <http://www.oecd.org/corruption/oecd-foreign-bribery-report-9789264226616-en.htm>.

³ http://archive.transparency.org/publications/publications/bribe_payers_index_2011.

dissuading firms from engaging in unethical practices. We find the oil and gas firms operating in non-competitive industries are more likely to be involved in unethical practices and this is predominantly seen in countries that rank poorly in legal enforcement, regulations, and institutional quality. This suggests that a weak institutional framework may exacerbate corruption and potentially increases the firm's intention to engage in unethical practices. Additionally, we find the effect is stronger in oil-rich countries, i.e., countries that depend less on oil imports. Thus our results support the resource curse phenomenon where resource-rich countries suffer from rent-seeking, patronage and corruption primarily due to poor institutional quality.

This study contributes to the literature in a number of ways. First, prior studies mostly use case studies to highlight the corruption practices in the oil and gas industries. Although, these studies enhance our understanding of why firms engage in unethical practices, the empirical evidence that includes firm-level data from multiple countries is limited to date. To the best of our knowledge, this is the first study to test this link using a comprehensive firm-level data covering multiple countries.

Second, previous studies mostly undertake an analysis on a single country and therefore cross-country variation in regulations, laws and institutional quality are not properly explored. For instance, considerable evidence suggests that the tendency to undertake unethical practices is linked to the socioeconomic condition of the country, such as the resource curse phenomenon. This is also consistent with Jeong and Weiner (2012), where the authors note that country-level determinants play an important role in controlling the firm's intention to engage in unethical practices. Therefore, we complement the literature by empirically documenting that country-level determinants are important attributes in explaining the likelihood of firms engaging in unethical practices.

Third, considerable evidence indicates that product market competition influences corporate decision-making. For instance, Shleifer and Vishny (1997 p.738) claim that product market competition is “the most powerful force toward economic efficiency in the world”. In the context of oil and gas firms, Gupta (2016) show that the stock returns and oil price shocks are different for the firms operating in a competitive vis-à-vis non-competitive industry. In this paper, we show that the competition level is also an important factor that influences a firm's tendency to engage in unethical practices.

The results from this paper may be of particular interest to policy makers, regulators and market participants. Extractive industries, such as oil and gas, have a significant impact on the economy of the country through revenue generation, tax collection and export. One of the prime challenges is to control rent-seeking, patronage and corruption and to develop strong institutional framework that encourages productivity, efficiency and innovation (Kolstad and Søreide, 2009). The results from this study suggest that low competition in the oil and gas industry increases the likelihood of firms engaging in unethical practices. Therefore, policy makers should consider undertaking steps to encourage competition in the industry. Encouraging competition will increase efficiency, productivity, and cost control and at the same time limit the ill effects of rent-seeking and patronage. The results also suggest that country-level enforcement laws, regulations and institutional quality need to be reformed, especially in developing countries, to discourage firms from gaining undue benefits.

Extractive Industries Transparency Initiative (EITI) and other initiatives are undertaken to encourage countries and firms to be more transparent in disclosing revenues. However, becoming a member of EITI is although an important step, but not the only way to limit unethical practices in the extractive industries. Following Kolstad and Søreide (2009), policy makers should focus more on curbing rent-seeking, patronage and corruption problems than macroeconomic management.

The rest of this paper is organised as follows: The literature is reviewed in Section 2. Data and Methodology is presented in Section 3.

In Section 4, we present empirical results and their implications. Finally, Section 5 summarises research findings and concludes.

2. Background literature

The issue of corruption and its negative effect on the business environment has been well documented in literature. The focus of the literature is on the resource curse phenomenon and this arises mainly from rent-seeking, patronage, poor institutional quality and corruption (Al-Kasim et al., 2013; Kolstad and Søreide, 2009). Rent-seeking occurs when individuals are more interested in obtaining economic benefits from society through manipulation of the social and political environment. Patronage refers to a situation where government attempts to stay in power by providing economic and other incentives to its supporters. Consistent with this, Frynas (2010) alleges that the incentives to engage in unethical practices are higher in the oil and gas industry as it has great political power. Resource curse phenomenon is primarily seen in resource-rich countries with poor institutional quality, but is not limited to these countries. For instance, evidence suggests that energy firms deliberately reported lower prices than the actual market price in order to pay a lower royalty cost (New York Times, 1/23/2006).⁴

Several theoretical models are developed to explain why firms are engaged in unethical practices. For instance, Harstad and Svensson (2011) present a theoretical model and illustrates that firms can either comply, bribe or lobby in order to extract favourable regulations. Similarly, Fredriksson et al. (2004) present a theoretical model and show that an increase in corruption leads to a less stringent energy policy.

Another strand of literature highlights the nexus between unethical practices, regulation and lobbying. Bjertnæs and Fæhn (2008) document that energy-dependent industries are often exempt from paying taxes in many countries. The possible reason for this favourable treatment is likely to be attributed to powerful lobby groups. They also add that the likelihood of engaging in corruption increases significantly in the oil and gas industry as the sector involves high-value investment and interaction with government officials. Schweitzer (2010) allege that oil companies are likelier to spend a significant amount of money on lobbying to promote their self-interest. Further, Slack (2012) documents that firms are more interested in window dressing socially responsible practices and this is prevalent in developing countries.

Literature also suggests that group lobbying can influence regulation. For instance, four major oil companies (BP, Caltex, Mobil and Shell) in Australia successfully lobbied against the Australian Government to remove the regulation of unleaded petrol prices (Valadkhani, 2013). Similarly, Marques et al. (2010) states that oil and gas companies lobby against alternative energy to protect their self-interest. This finding is supported by Huang et al. (2007) and Sovacool (2009) who note that strong lobbying from traditional energy sources results in a delay of alternative energy usage. Collectively, the evidence suggests that firms engage in unethical practices in order to extract favourable regulation and to generate positive perception through lobbying and other activities.

Several studies show that in addition to firm-level determinants, country-level determinants also drive incentive to engage in unethical practices. For instance, Jeong and Weiner (2012) find that country-level determinants play an important role in controlling the firm's intention to engage in unethical practices. The authors note that firms are likelier to engage in unethical practices in countries that have poor legal enforcement and regulations. Similarly, Baughn et al. (2010) indicate that the chances of firms engaging in corruption are likely to be greater in countries where corruption is tolerated. In a different context, Voyer and Beamish (2004) show that the flow of Foreign

⁴ <http://faculty.washington.edu/mturn/NYT1-27-06Oilprofits.pdf>.

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