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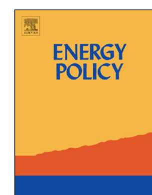

Why do leaders nationalize the oil industry? The politics of resource expropriation

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HIGHLIGHTS

- I model determinants of oil nationalizations for 65 producing countries 1945–2005.
- I offer a new measure of nationalization using the establishment of NOCs.
- Oil prices, political institutions, cross-country diffusion predict nationalization.
- Nationalization is also likely when revenue is perceived to be shared unfairly.
- Operator-led contract renegotiation can reduce likelihood of nationalization.

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ABSTRACT

Why do leaders nationalize the oil industry? In line with a general utility-maximizing theory, I argue that leaders nationalize to maximize state revenues while minimizing costs. The latter includes international retaliation and domestic political constraints. Using a novel longitudinal dataset on the establishment of national oil companies (NOCs), the empirical evidence presented in this paper lends support to four primary findings. States are most likely to establish NOCs (1) in periods of high oil prices, when the risks of expropriation are outweighed by the financial benefits; (2) in non-democratic systems, where executive constraints are limited; (3) in "waves", that is, after other countries have nationalized, reflecting reduced likelihood of international retaliation; and, though with weaker empirical support, (4) in political settings marked by resource nationalism. This last factor is proxied by OPEC membership in large-N analysis and, in a two-case comparison, by the difference in retained profits between the host and foreign governments. The theory and empirics presented here offer some clues for policy makers and multinational companies alike as to when to expect leaders to opt for nationalization.

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1. Introduction

As of 2012, between 73 and 95 percent of global oil reserves are controlled by national oil companies (NOCs).[1] The majority of these NOCs were established through nationalizations in the 1970s, though several states opted for NOCs in the 1930s and 1990s (see Fig. 1). Though these kinds of nationalization are rare events – occurring only 45 times since the 1930s – the impacts of state expropriation are game-changing in both international markets and the domestic political environment. Scholars working on the political resource curse – that is, the hypothesized relationship between oil and authoritarianism – point to the wave of nationalizations in the 1970s as a turning point for autocrats in gaining control over lucrative resource revenues (Aslaksen, 2010; Dunning, 2008; Haber and Menaldo, 2011; Ross, 2012). I provide insight on the determinants of these events; that is, I aim to answer the question, why do political leaders nationalize the oil industry?

Using both statistical analysis of historical nationalizations and a quantitative case comparison, I show that the decision to nationalize is motivated by state revenue maximization, risk of international retaliation, and resource nationalism. While researchers have put forth a handful of theories on why leaders expropriate the oil industry (see Victor, 2013 for a review), there exists no comprehensive assessment of political and economic factors of oil nationalization in the context of domestic perceptions and international risks. Some provide strong theoretical frameworks for the economic underpinnings of expropriation (Chang et al., 2010; Guriev et al., 2011), while others expound on domestic political factors in the

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[1] The variance in figures stems from how reserves are attributed to operating firms. The 95% figure is drawn from Ernst and Young (2013), *Global Oil and Gas Reserves Study*, which assumes that all reserves in a country with a nationalized sector belong to the NOC. The lower bound of 73% is drawn from Victor et al. (2012), who use the classification of reserves based on actual share of production from a given field (also known as "working interest").

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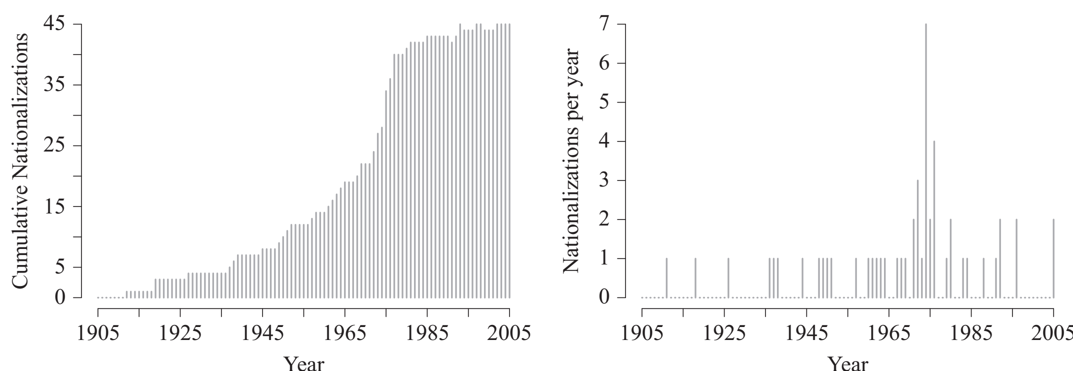

Fig. 1. Plotting cumulative and annual nationalizations for the period 1905–2005. Nationalization is measured as the establishment of a national oil company (NOC) in a given year. Sample includes 61 oil-producing countries.

formation of ownership structure in the oil sector (Luong and Weinthal, 2010; Warshaw, 2012). But current scholarly work has yet to incorporate a systematic discussion of the cost-benefit structure of nationalizations which takes into account resource nationalism and fears of foreign intervention.

This study offers three contributions to the extant literature. First, an often omitted factor in the empirical analysis of oil nationalization is the diffusion effect (Kobrin, 1985; Vernon, 1971). That is, the cost of nationalization in a given country is substantially reduced the more that other countries nationalize. Stephen Kobrin termed this phenomenon "the domino effect" of nationalization. While the theoretical implications of Kobrin's work have not been subjected to statistical analysis except by Kobrin himself – who was able to provide support for a "cumulative" or wave effect in the 1970–1984 period – other scholars have discussed the contagion effect of nationalizations (Adelman, 1993; Warshaw, 2012). Here, I extend this analysis to a broader time frame to confirm that diffusion is a strong predictor of nationalization. Based on these findings, I conclude that nationalization is substantially more likely to occur after a first-mover has reduced the risk of international retaliation and paved the way for further nationalizations – a phenomenon that occurred both in the early 1970s and the early 1990s.

Second, I hypothesize that a state's perceptions of "unfairness" in how profits are shared between host and operating countries influences the likelihood of nationalization. When a leader perceives that her share of oil profits is lower than the share taken home by the foreign operating company's government, this prompts government and public sentiments of resource nationalism and provides motivation for nationalization to eliminate the profit-sharing gap. These perceptions of unfairness are difficult to test cross-nationally due to data availability, so I show this effect both by employing a proxy variable in the longitudinal analysis and by analyzing a case comparison of Iran and Saudi Arabia. Whereas the ratio of profits shared between Iran and the UK was consistently in favor of the UK in early years of production (1930–1950), the profit-sharing ratio between Saudi Arabia and the US was nearly equal in the same period. Not surprisingly, Iran nationalized the oil industry in 1951, while Saudi Arabia waited until 1974 to nationalize and until 1980 to fully expropriate its oil sector (and was the last OPEC member to nationalize).[2] This explanation, I argue, helps to understand cases where current models get the prediction of nationalization wrong: Iran nationalized during a time of low oil prices and during an era with relatively (among non-democracies) high executive constraints, both of which are factors predicting a low probability of nationalization.

Third, I provide a methodological contribution to the existing literature on resource nationalization. Because the decision to nationalize is tested in the context of longitudinal data with a discrete outcome – a leader either nationalizes or not in a given country in a given year – researchers typically use either ordinary least squares or maximum likelihood regression techniques including unit fixed effects to account for country-specific potentially omitted factors. As I discuss in greater detail in the pages that follow, the application of conventional methods to these data is problematic. As such, I operate within a Bayesian estimation framework to mitigate these concerns. As this method requires specification of prior distributions for the parameters to be estimated, I combine expert interviews and previous scholarly findings to estimate informative priors for the analysis.

The findings of this study speak to the complexity of a state's decision to nationalize the oil sector. With many moving parts to this decision, it is difficult to pin down any one explanation for nationalization. My aim is to augment scholarly understanding of such events by providing evidence for two additional factors – resource nationalism and the diffusion effect – that help to improve the predictive accuracy of arguments for why leaders nationalize. In the sections that follow, I begin with a presentation of the puzzle in theoretical context. I then formulate hypotheses and discuss the methods and data I use to test them. The subsequent sections include empirical results from a statistical analysis and a case comparison of Iran and Saudi Arabia. I conclude with a discussion of policy implications based on these findings.

2. Methods

2.1. Theoretical determinants of nationalization

A leader's decision to nationalize the oil industry is inherently based on a delicate cost-benefit analysis.[3] A leader must maximize his expected utility from nationalization while considering the potential benefits to state ownership and avoiding the potential costs of expropriation.

The primary benefit to nationalization is a short- to medium-term increase in the state's take of revenues from the sale of oil (Victor et al., 2012; Victor, 2013; Wolf, 2009). Other benefits include direct oversight of operations and production decisions, and control over lucrative state-owned enterprise management positions to use as tools of patronage (Nolan and Thurber, 2010; Golden and Mahdavi, 2015). By expropriating foreign assets, the

[2] This excludes Gabon, which joined OPEC in 1975 and nationalized in 1979, and left OPEC in 1995.

[3] Though I use the term "leader" here referring to an individual political agent, the concept applies equally to consensus-based decisions to nationalize such as those by a parliament, junta, oligarchy, etc.

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