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WP/22/029

The Political Economy of the Oil and Gas Sector in Emerging and Developing Countries

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The Political Economy of the Oil and Gas Sector in Emerging and Developing Countries**Simplice A. Asongu, Gerald Emmanuel Arhin, Abdul-Gafaru Abdulai & Justice Bawole****Abstract**

This chapter surveys the literature on the political-economy of oil and gas governance by focusing on the exploration, production and revenue sharing in the hydrocarbon sector. Emphasis is placed on the extent to which oil and gas governance is shaped by geopolitics and interparty-party politics. We argue that the interests and ideas relative to the power of key stakeholders, such as political actors, multinational companies, the citizens and the state are relevant to the understanding of the form and shape of the emergence and performance of the institutions governing the oil and gas sectors of emerging and developing countries.

Keywords: Political economy, oil and gas; development economies; inter-party politics; geopolitics; institutions; interests; ideas; power

JEL Classification: D72; H23; H77; P16; P48

1. Introduction

Recent talks among the United States, the International Energy Agency (IEA) and European nations to release Western strategic petroleum reserves of between 60 to 75 million barrels in order to hedge rising fuel price following the Russia-Ukraine war have ignited conversations around the political economy of oil production (Blas, 2022). The narrative also maintains that even if only about 50% of the Russian oil is affected by corporate decisions or official sanctions, more still has to be done in an attempt to mitigate rising oil prices. This brings to the fore how hydrocarbon resources can be weaponised and used as a means to an end. Consequently, it is important to further understand the role of geopolitics, inter-party politics and institutional

challenges in the management of oil and gas resources. Focusing on developing countries, the chapter seeks to survey the existing literature on the political-economy of hydrocarbon governance.

In so doing, three main strands are emphasised: (i) the political economy of oil and gas exploration; (ii) the political economy of gas production; and (iii) the political economy of revenue sharing from oil and gas exports. The review shows how the interests and ideas of the major actors in the oil and gas sector, including the state, political actors, multinational companies and the citizens relative to the power they wield shape the governance of the sector at all levels. These interests and power of the actors also influence the emergence and performance of the institutions governing the sector.

After this introductory section, the chapter proceeds in four successive sections. The next section focuses on the political-economy of oil and gas exploration. This is followed by a review on the political-economy of oil and gas production. The penultimate section, then surveys the literature on the political-economy of hydrocarbon revenues. Concluding the chapter is a summary of the review, implications and suggestions for future studies.

2. The political economy of oil and gas exploration

This section focuses on the political economy of “oil and gas exploration” prior to the production process, focusing particularly on local content issues in the legal frameworks of oil producing countries. Local content requirements (LCRs) are relevant for understanding the political economy of oil and gas exploration because the content of LCRs as well as the approach adopted to consolidate LCRs should be clarified to all parties in order to mitigate contractual mismatches and misalignments between international companies and governments that can lead to responses from party politics, challenge institutional building and influence geopolitics in the sector. For instance, while the first-two externalities are self-evident because of domestic responses, the third involving geopolitics is apparent in the ongoing Russian-Ukraine conflicts (Henn, 2022). Moreover, LCRs are also relevant because while LCR could engender positive externalities (e.g. securing jobs and improving the process of skills acquisition and technology transfer), such LCRs can also produce misalignments

between investors and governments, especially for countries where party politics are fundamental in clarifying and adjusting the legal framework underpinning LCRs and minimizing risks and disputes. With the above clarifications, this section is discussed in two main strands, notably: (i) drivers of LCRs in developing and emerging countries and (ii) governance and institutional challenges surrounding LCRs (Olawuyi 2019).

2.1 Drivers of LCRs in developing and emerging countries

Consistent with Olawuyi (2019), the drivers of LCRs are fivefold. The first relates to the desire of host governments to improve their domestic capability and competence levels with the unfolding of time. In essence, domestic governments usually desire that oil and gas exploration contracts should be tailored to enhance local skills, experience and capacity in the attendant and/or future petroleum operations.

The second driver of LCR is related to the desire for citizens and residents to be included in potential production processes as well as the need for home-based companies to also participate in the underlying process. These positions have been substantiated by Tagliapietra (2019) with respect to oil and gas producers in the Middle East and North Africa (MENA) and Adams et al. (2019) with respect of oil-rich developing countries more broadly.

The third driver of LCRs pertains to the need to improve the socio-economic well-being of citizens via employment creation. This builds from the growing evidence that most oil-rich developing and emerging countries are characterized by high levels of unemployment (Musa & Basir, 2019; Cheratian et al., 2020; Uduji et al., 2019a, 2019b). For instance, there is growing evidence that with the influence of opposition parties and elections in many African countries, agreements surrounding Chinese oil-exploration are tailored such that there is a local proportion of employment clearly articulated in the corresponding oil contracts (Asongu, 2016; Asongu & Ssozi, 2016).

The fourth determinant of LCRs in oil-producing countries is the overall need to improve technological capacity at the national level and within this remit, there are requirements to give priority to locally manufactured consumables, machinery and equipment, especially when they are internationally competitive. This has been recently documented for countries such as Iran (Jahromi, 2021).

The fifth driver is the importance of mitigating socio-economic and political risks, especially as it pertains to the equitable distribution of the fruits of potential oil and gas production. This last

determinant is consistent with the growing body of literature on the importance of improving economic governance at the national level as well as promoting corporate social responsibility at the level of multinational oil companies (Uduji et al., 2021a, 2021b).

2.2 Governance challenges in LCRs

Consistent with Olawuyi (2019), there are obviously institutional challenges surrounding the nexus between governance and multinational oil companies, especially as it relates to procurement process.

While the concept and content of international best practices can be subject to debate and litigation in relation to compliance with LCRs, to limit and avoid such disputes, governments should be informed of standard practices on an annual basis. According to Olawuyi (2019), this is the case in countries such as Oman, Iran, Saudi Arabia and the United Arab Emirates (UAE). The narrative also maintains that some governments require such procurement plans to be submitted prior to oil and gas production (e.g. Iraq and Lebanon). In some countries like Egypt and Libya, beyond some financial limits, governments must take part in the procurement activities while in others such as Qatar, there is an advisory committee from the government. It is also important to clarify that while participation of the domestic government in the procurement process is a way to ensure transparency and ensure that the interest of the country is upheld, such can constitute delays due to bureaucracy and disagreements from opposition political parties. It is in this light that several oil-exporting countries have put in place mechanisms aimed at navigating institutional challenges surrounding LCRs (Olawuyi, 2019).

3. The political economy of oil and gas production

Beyond the drilling of petroleum, the processes characterizing the production of the discovered hydrocarbon cannot be detached from both political and economic reasoning (Hickey et al., 2020; Ngoasong, 2014). This section synthesizes the literature on how hydrocarbon production in developing countries can be understood through a political economy lens. In so doing, two main areas are emphasised. The first subsection highlights how the nature of a country's political context, particularly the nature of inter-party politics, shapes production sharing agreements and production contracts more broadly. It also briefly highlights the role of geopolitics in oil production on the global stage. The second focuses on local content policies (LCPs), at the stage of production. Emphasis is placed on how institutions are reformed to boost a state's share in oil and gas production through

LCPs and how IOCs in turn respond to these institutional framing. This is distinct from the review in the earlier section, where LCRs were discussed at the stage of exploration.

3.1 Understanding the politics of hydrocarbon production: the role of geopolitics, interparty and institutional bargain

Political actors through the use of different systems may influence decisions around hydrocarbon governance that serve their personal interest of retaining power (Clark & Lee, 2016; Lomasky, 2004; Brennan & Lomasky, 1993) at the expense of public interest. Prior studies (Smith, 2017; Bjorvatn et al., 2012; Briceno-Leon, 2006; Omgba, 2009; Watts, 2004) have documented several cases where oil and gas and political systems and actors have interplayed to influence the state of the economy. For instance, Watts (2004) documents evidence of how politics in the forms of chieftainship, ethnic minority and national politics influence the production of oil and gas in the Niger Delta of Nigeria.

The emergence of new hydrocarbon producers in sub-Saharan Africa, which was part of the ‘Africa rising’ narrative was deemed as an avenue for such countries to exert both political and economic control over the resources (Vivoda, 2009) and this included processes of negotiating production contracts (Tordo, 2011). Vernon (1971) emphasised the role of economic dynamics in oil and gas governance, driven mainly by price volatility of hydrocarbons. At the exploration stage, firms take greater risks, giving them an upper hand in the design of contracts whereas states may have greater control when it comes to production, especially in cases of price appreciation (Vernon, 1971). Wilson (2015) argues that the underlining conditions that shape oil governance, including at the production stage are political institutions.

Limiting the institutional approach to understanding resource governance is the recent quest to understand why and how institutions emerge and perform the way they do (Hickey et al., 2020), and why similar institutions perform differently under different contexts (Rodrik, 2004). This has since seen several scholarships focusing on inter-elite bargaining, the power configuration underlining institutions and the role of path dependency in institutional emergence (Bebbington, 2013; Bebbington et al 2018; Karl, 2007; Portes, 2006; Poteete, 2009). The differences in countries’ political structures and the pursuance of different interest by actors relative to their bargaining strength, have since been well captured by Khan’s (2010) Political Settlement Analysis. Different

forms of political settlements generate different incentives for ruling elites, leading to different approaches in negotiating and developing production contracts. As an illustration of this point, we draw on the work of Hickey et al. (2020) on the analysis of the production contracts by Ghana and Uganda: two countries with similar sized hydrocarbon reserves but different political settlement dynamics.

Ghana's political settlement has been widely characterized as competitive clientelistic (Oduro et al., 2014; Abdulai and Hickey, 2016) because of the increasingly fierce inter-party electoral competition that plays out in a clientelist political environment and where ruling elites remain highly vulnerable due to the strength of both excluded elite factions and lower level factions within ruling coalitions. Though the country has experienced sustained economic growth, there has been little progress in achieving structural transformation in part because the nature of the country's political settlement undermines elite commitment towards long-term investments in the productive sectors of the economy (Whitfield, 2011). Uganda on the other hand, can best be described as a dominant party settlement (Golooba-Mutebi & Hickey, 2013) where Yoweri Museveni and his National Resistance Movement (NRM) have been in power since 1986.

These differences in the political settlement of the two countries greatly shaped the negotiation of its oil and gas production contracts (Hickey *et al.*, 2020). Whereas Ghana secured a profit share of 38-50 percent of its production share agreements with IOCs, Uganda managed 43.5-66 percent (Amoako-Tuffuor & Owusu-Ayim, 2010). Hickey *et al.* (2020) argue that in Ghana, the vulnerability of the ruling elites due to a strong excluded faction compelled the then ruling National Democratic Congress (NDC) party to hasten the pace of the negotiations in order to secure revenues for purposes of sustaining power. Museveni of Uganda, on the other hand, had less threat from opposition parties and did not fear losing power. This enabled him to be patient in negotiating a better deal for the country (Hickey *et al.*, 2020). This further emphasizes how the nature of a country's party politics shapes the negotiations around contracts on oil production. Deducing from the work of Hickey *et al.* (2020), a country with an intense party politics is likely to hasten the negotiation process, a tendency which may not yield the best deal for the country. In contrast, a country with weak or no opposition parties allows the ruling elites a longer time horizon, enabling them to have the patience to negotiate contractual terms that may better benefit the state in the long run (Hickey *et al.*, 2020).

3.2 Reforming institutions to strengthen Local Content Policies (LCPs) in Petroleum Production Agreements

The role of the state in reshaping and reforming institutions through LCPs and LCRs, as an avenue to maximise the state's benefits in petroleum production is a field that has seen wider coverage in extant literature (Auty, 2012; Kazzazi & Nouri, 2012; Klueh *et al.*, 2009). In recent times, oil-producing countries have engaged in institutional reforms around LCPs to regulate the activities of IOCs, a move that has come under international scrutiny (Ngoasong, 2014). Although LCPs are not novel, they gained renewed traction in petroleum production in developing countries through a revision of previous local content guidelines to boost domestic employment rate (Kazzazi & Nouri, 2014). Under these reformed LCPs, IOCs are required to prioritise locals in sourcing technical and human resources in petroleum production (Tracy *et al.*, 2011; Mendonca & de Oliveira, 2014).

Indeed, IOCs have long been under pressure to contribute to the economic and social development in the host country through the development of fiscal regimes, legal contracts and perhaps, more importantly, corporate social responsibility (CSR) (Dongkun & Na, 2010; Auty, 2012). Despite the positives associated with LCPs, some scholars have cautioned that they have the potential to turn a country's natural resource wealth into a 'curse' as stiff LCPs may circumscribe foreign direct investment (FDI) (Auty, 2012; Bakare, 2011; Dieck-Assad, 2006). This is against the backdrop that the form of some LCP/Rs has the potential of disrupting the operations of IOCs and even inhibiting their competitiveness (Ngoasong, 2014).

The state and IOCs are often the dominant actors in the political economy of oil production in developing countries (Ngoasong, 2014). It is therefore not uncommon for IOCs to negotiate with government, if the requirements of the LCPs are detrimental to their interest. For example, a letter signed by 47 IOCs in Kazakhstan to the president criticized the LCRs of the country to be extremely stiff and a barrier to foreign direct investment in the country's petroleum sector (Ritchie, 2004). Although the concerns of these IOCs did not yield the expected results, it highlights how the development institutions around certain regulations in favour of national interest could harm the activities of IOCs. Assessing the operations of five IOCs in seven different developing countries,

Ngoasong (2014) argues that the business activities adopted by IOCs in response to LCPs are a key determinant of socio-economic growth.

4. The political economy of revenue sharing from oil and gas exports

Extractive resource revenues are a key source of income for resource-rich countries (Chang, 2007). However, the slow pace of development in resource-rich countries, partly as a consequence of greater rent seeking on the part of political elites is regarded as a major manifestation of the resource curse thesis (Karl, 1997). The management and sharing of resource revenues, particularly, that of oil and gas have received substantial scholarly attention, mainly due to the material speciality of the resource: first, hydrocarbons are not infinite so it cannot be an everlasting source of revenue; second, prices of oil and gas fluctuate, exposing resource-rich countries to developmental fluctuations (Devlin and Titman, 2004); and third, petroleum resources are concentrated in specific geographical areas and are capital intensive (Chang, 2007b; Shao and Yang, 2014). The delicate nature of hydrocarbon revenues have therefore, necessitated the proposal of different mechanisms in sharing the revenues and the circumstances that shape such decision making (Acosta, 2012; Hadna, 2016; Hjort, 2006; Körinek, 2015; Lebdioui, 2020).

This section begins with a review of some of the proposed mechanisms of sharing petroleum revenues. The section focuses on the citizens' fund and subnational sharing mechanisms and discusses the circumstances that shape the decision to choose which. The section ends with a brief but important analysis of how interparty and interregional bargain, including the battle of ideas and interests shape the design of institutions purposed to guide oil and gas revenue sharing.

4.1 The Citizens' Fund

Some States operate the "citizens' Fund" where portions of the resource revenues are directly shared among citizens (Agustina et al., 2012). It is also referred to as direct distribution. Mongolia and Alaska are examples of states that have such mode of distribution. This method is intended to make citizens feel a direct impact of the resource revenues. It is also argued that such method may serve as an incentive for citizens to pay their taxes to foster development (Acosta, 2012; Lebdioui, 2020). Acosta (2012) and Hjort (2006) however argue that direct distribution is not an effective petroleum revenue sharing mechanism neither is it an effective way of eliminating poverty especially in

countries with weak institutions. Social amenities will remain undeveloped, public infrastructure will be uncompleted and instead of curing the illness of poverty, the country will only be treating the symptoms (Lebdioui, 2020).

Alaska from 1976 transfer 25 percent of their oil royalties into the Alaska Permanent fund (APF) and about half of the fund's dividend is transferred to citizens annually (Hjort, 2006) but there has always been budget deficits and unfinished public works (Acosta, 2012). Also, in Africa where majority of the people do not save in Banks, distributing such monies will be cumbersome. Direct distribution gives the individual a greater discretion in how to manage such revenues and there is always a possibility of mismanagement at the individual level. Direct distribution as a way of social policy is therefore just a way of treating the symptoms rather than eliminating poverty (Lebdioui, 2020).

4.2 Subnational Sharing of Petroleum Revenues

The mechanism of sharing hydrocarbon receipts to subnational levels and taking into consideration oil and gas producing regions is not uncommon. Nigeria, Indonesia and Peru are examples of countries that operate such a system (Körinek, 2015). In Nigeria for instance, the federal government is allocated 52.68 percent, states get 26.72 percent and 20.60 percent of oil revenues are disbursed to local governments (Acosta, 2012). Prior to 2012, Columbia distributed 80 percent of mineral revenues to the mineral-producing regions. Peru's resource revenues are distributed among the three levels of government: the central government; the regions and the local areas (Körinek, 2015).

Consistent with the subnational mechanism of sharing petroleum revenues, using Indonesia as case study, Hadna (2016) argues that a just system of sharing oil and gas revenues is the adoption of the rights-based approach (RBA). The RBA framework is one that takes into account international norms and standards of a human right system into development processes (Boesen and Martin, 2007). To this end, Hadna (2017) contends the relationship between duty bearers (government authorities) and right holders (the oil and gas producing regions) should be shaped by the RBA, where the indigens of the hydrocarbon producing areas will be regarded as the rightful owners of the resources and gain a commensurate share of the revenues.

Such distribution has the purpose of making the resource producing areas benefit from what they produce. It is also intended to compensate such regions for the environmental destruction that comes

with natural resource extraction. Acosta (2012) however argues that such mode of distribution brings about unequal development. Some regions of the country will receive more revenues for development at the expense of others. Again, subnational governments may not have the requisite technical know-how in the management of such funds. The result therefore is poor investments, embezzlement, corruption and misappropriation. Even with the justification of compensating for environmental pollution, it is difficult to determine areas or regions that are environmentally affected by the extractive activities. For instance, some neighbouring towns may be directly or indirectly affected by the extraction of natural resources but will not be considered as the concession region and as such will not benefit from such developments (Acosta, 2012).

4.3 The political economy of hydrocarbon revenue sharing

The decision to opt for a particular form of revenue sharing is shaped by the political dynamics of a country, underpinned by both formal and informal structures, the interest and ideas held by the key stakeholders relative to their bargaining strength (Agustina et al., 2012; Asante, 2016; Bebbington, 2013). The externalities associated with the exploitation of extractives, such as petroleum spark intense struggles between different social and political groups, which in turn shape the development of institutions and the subsequent sharing of the acquired revenues (Bebbington, 2013). The local dynamics of power is therefore crucial in shaping the decisions of national elites in the design of petroleum revenue sharing mechanisms (Asante, 2016).

As part of the local dynamics, spatial inequality is a key factor in negotiating the mechanisms guiding the distribution of petroleum revenues (Ewetan, 2012). This inequality could be either as a result of the deplorable nature of resource rich regions or inadequate fiscal injection into non-resource rich countries or both (Vande, 2021). The agitations and arguments by the people of the Delta region and northern sphere of Nigeria reflect the inter-regional bargain of petroleum revenue sharing, underscored by different reasons. As the main region for hydrocarbon production, people of the Niger Delta claim custody of the resources and contend that they should be the greater beneficiaries of the revenues (Ukpong & Obok, 2018). The northern regions, on the other hand believe the resources should be viewed as wealth of the whole country and as such, the revenues should be shared equally to benefit every Nigerian (Nzemeke, 2001). Similarly, interest of groups and individuals are vital in

bargaining how much and how hydrocarbon revenues are shared. Thus, both political and economic reasoning shape the sharing of oil and gas revenues (Vande, 2021).

The discovery of oil and gas and the sharing of its revenues can be instrumentalized to gain political popularity and capture political power (Asante, 2016). For instance, in the run up to Ghana's 2008 presidential elections, the National Democratic Congress (NDC), which was the main opposition party, leveraged on the country's commercial discovery of hydrocarbons to promise 10 percent perpetual allocation of the petroleum revenues to the Western region (Essel, 2008). The Western region, which harbours the country's petroleum resources is seen as a swing voting region. Hence, winning the region boosts a party's victory in general elections. However, on winning power, the NDC did not fulfil its promise due to both political and economic reasons coupled with the idea of national unity and political stability. The NDC later resorted to informal means of compensating the region with the intention of repelling the wrath of the region (Asante, 2016).

The brief review of the literature and analysis in this section shows that developing countries resort to different forms of sharing petroleum revenues. The decision to settle on any form, however, depends on the social, economic and political dimensions of the country. The discovery of oil and gas leads to the generation of different ideas and interests on its governance. Different strategies are therefore, pursued by different actors, from the people in the region of oil and gas to political elites on how the revenues should be shared. The development and outcome of the institutional design guiding the sharing of these revenues, are hence, shaped by the interests of these actors relative to their bargaining strength.

5. Conclusion and future research directions

This chapter has surveyed existing literature on the political economy of the oil and gas sector in emerging and developing countries. The chapter has provided insights into understanding the politics of hydrocarbon production especially as it pertains to the role of interparty and institutional bargain and how the differential politics of countries differently shape the decision-making process in the production of hydrocarbons. These insights have been complemented with documented perspectives on reforming institutions to strengthen LCPs in petroleum production agreements. Relying on the

Citizens Fund and subnational sharing of revenues as examples, the review explored the rationale underpinning the decision to adopt a certain mechanism of sharing oil and gas revenues. As argued above, the bargaining power of the relevant stakeholders cannot be downplayed in how hydrocarbon revenues are shared. For instance, it is not uncommon for political actors to instrumentalise the sharing of hydrocarbon revenues to achieve their political and clientelist interest and ideas. Progressing on this review, future studies can focus on assessing how insights provided in this chapter are relevant to achieving the sustainable development goals (SDGs) especially given the importance of natural resource wealth in funding the socio-economic development of resource-rich developing and emerging economies.

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