SAUDI ARABIAN OIL:
THE OBSOLESCING BARBGAINING MODEL

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ABSTRACT

While much has been written separately about the nationalization of Saudi oil, the obsolescing bargaining model (OBM), and the rentier effect, very little has been written about the interaction of these factors. This paper focuses on the OBM as an explanation for the shifting relationship between American multinational enterprises (MNE's) and the Saudi Arabian monarchy between 1933-1980. My work relies heavily on the original theory of OBM, which was theorized by Raymond Vernon in his 1971 book *Sovereignty at Bay*. I next looked to relate the OMB model to the current authoritarian regime in place. As a result of the nationalization of oil, I argue that the Saudi Monarchy has created a "rentier effect" that propagates its own power, allowing an authoritarian regime to exist even as Western forces push for a new wave of democratization.

DESCRIPTION

In 1933, the Saudi Arabian government granted an oil concession to Standard Oil Company of California (SOCAL) to search for oil in its Eastern provinces. At the time the agreement was signed, the Kingdom of Saudi Arabia was less than one-year-old. The young monarchy was in desperate need of a source of revenue outside taxing those who participated in the Hajj (annual pilgrimage to Mecca). As a result, King Abdulaziz Al Saud decided to grant an oil concession that greatly favored the interests of SOCAL. Despite the unfair terms of the concession agreement, the King reasoned that even meager financial returns were better than no returns at all. In addition, the King knew he was in no position to bargain for equitable terms, as his monarchy did not have the capital or technology needed to find oil reserves (Yamani, 381). As a result, the only way for the monarchy to make money through oil was to allow American multinational enterprises to control the discovery and subsequent production and distribution of oil.

By 1946, SOCAL had partnered with the Texas Oil Company, Jersey Standard, and Socony Vacuum to form the Arabian-American Oil Company (Aramco). These companies cooperated heavily with the United States government in a mutual relationship. The United States government relied on the oil companies to help them achieve key foreign policy objectives in the Middle East, and in return, the government exempt the companies from competition policies. In this way, "the US government facilitated the dominant role of the major oil companies in the Middle East by (a) forgoing antitrust investigation for foreign policy reasons; (b) allowing the companies to credit payments to the Middle East oil-producing sheikdoms against US corporate income tax…" (Church, 32). From the outside, it may have appeared that American oil companies were acting unilaterally in their deals with the Saudi government. In reality, however, the United States was using Aramco to further the nation's own foreign policy objective of creating a sphere of influence in the Middle East. In the minds of US politicians, the goals of the American oil companies and the government were intertwined.

Following World War II, global demand for oil increased astronomically, increasing the Saudi government's royalties from less than $5 million to more than $50 million in a four-year time span (Pearson). This increased revenue made King Abdulaziz realize the enormous potential wealth his Kingdom was sitting upon. As a result, in 1950, the King threatened to nationalize all of Aramco's oil fields with the hope of scaring American oil companies into a renegotiation of revenue shares. This tactic was directly influenced by Juan Pablo Perez Alfonso of Venezuela, who had managed to broker a 50-50 split of revenues between the Venezuelan government and New Jersey Standard Oil in 1946. The

American oil companies, pressured by the US government, agreed to a renegotiation of royalties. On December 30, 1950, the "50-50" Agreement was signed between Aramco and the Saudi government, which gave the Saudi's an equal share of oil income. In return for negotiating with the Saudi government and ensuring that Saudi oil was not nationalized, the Truman administration enacted the "Golden Gimmick", which gave American oil companies a tax break equivalent to 50% of their oil sales (Citino, 234).

In 1959, American oil companies cut the posted price of Saudi Arabian oil without consulting the monarchy, reducing their revenue. This led to the creation of the Organization of Petroleum Exporting Countries (OPEC) in 1960, which included Saudi Arabia, Iran, Iraq, Kuwait, and Venezuela. A founding tenant of OPEC was a resolution by member countries to "no longer remain indifferent to the attitude heretofore adopted by the oil companies in effecting price modifications" (Church, 35). The creation of OPEC began a dramatic shift in power from multinational oil corporations to the home countries where oil existed. Companies were forced to concede that they could no longer unilaterally impose prices of crude oil without consulting OPEC.

The next real change in power dynamics took place after the United States refused to stop resupplying armaments to Israel during the Yom Kippur War. This caused OPEC to implement the "oil weapon"- reducing oil production quotas (effectively increasing the price of oil) while simultaneously placing an embargo on the United States (Rieger, 108). The use of the "oil weapon" caused Saudi oil revenues to jump from $4.3 billion in 1973 to $22.6 billion in 1974 (Reiger, 109). With oil revenue increasing by more than four-fold, the Saudi Monarchy gained the capital needed to overpower the interests of the American oil companies. Between 1973 and 1980, the Monarchy used its increased cash flow to buy out shares from the four American oil companies. By 1980, the nationalization of the oil industry was complete, as the Saudi Arabia government owned 100% of Aramco shares.

CAUSES: THE OBSOLESCING BARGAINING MODEL

The best model of relations between multinational enterprises (MNE) and host country governments is the obsolescing bargain model (OBM). This model was first developed by Raymond Vernon in his 1971 novel, *Sovereignty at Bay.* The OBM model explains the shifting nature of bargaining between an MNE and a host country government, as each side looks to maximize its goals given its current resources (Vernon, 1971; Kobrin 1987; Eden 2004). Raymond Vernon originally formed the OBM to explain the widespread nationalization of MNE natural-resource subsidiaries in the 1970's (Eden 2004). The base assumption of the obsolescing bargain model is that the goals of the MNE and host country are conflicting (Eden 2004). The goal of the MNE is to exploit the resources in the host country to the largest extent possible. On the other hand, the host country, wants to gain as much revenue as possible (in the Saudi case through royalties) at the expense of the MNE.

Initially, relative bargaining power favors the MNE, as they have the capital and technology needed to exploit a valuable resource (Vernon, 1981). In the case of oil in Saudi Arabia, SOCAL had a lot of bargaining power at the very beginning of the process. Without the capital and technology of SOCAL, King Abdulaziz knew that any possible oil in his country would remain undiscovered. In addition, SOCAL had several different locations where they could have struck a deal to search for oil. Because of this, Saudi Arabia had to "offer locational incentives to attract FDI" (Eden, 2004). This meant that King Abdulaziz had to allow SOCAL to keep a majority of the revenue from any oil discovered. Otherwise, SOCAL would have invested in other countries on the Arabian Peninsula like Bahrain, Kuwait, or Oman.

Once the initial bargain is made, the OMB states that the bargain begins to obsolesce over time in favor of the host country (Vernon, 84). After SOCAL began establishing the infrastructure needed to successfully drill for oil, the risk of the Saudi government holding these investments hostage increased. When a country holds an investment hostage, it nationalizes physical capital inside its borders that is owned by an MNE. In 1950, King Abdulaziz did exactly this, when he threatened to nationalize Aramco unless an equitable profit-sharing agreement was reached. One of the largest reasons King Abdulaziz was able to threaten the nationalization of oil was because oil turned out to be much more profitable than either the Saudi government or the American MNE's initially realized. Because of this, "the benefit-cost ratio offered by the MNE fell" (Eden, 5). The MNE's involved in Aramco (which by this point included SOCAL, Texaco, Socony Vacuum, and Standard Oil of New Jersey) had little choice but to agree to revenue negotiations, as King Abdulaziz could have seized all of the infrastructure within his borders. While the American MNE's could have sued the Saudi government for this takeover, it would have been a long and most likely fruitless process. This led to the signing of the 50-50 between Aramco and the Saudi government on December 30, 1950. From this agreement, revenue was to be equally split between the MNE's and the Saudi government. At this stage, the obsolescing of power from the MNE to the host country was becoming apparent. From this point forward, the Saudi monarchy would dictate the involvement of the MNE's in Aramco.

When the OPEC oil embargo hit, power obsolesced further towards the Saudi Arabian government, as their oil revenues quadrupled to over 22 billion dollars (Reiger, 109). By this point, the American MNE oil companies had lost all the bargaining power they once had. The Saudi government no longer relied on them for capital and technological advantage to exploit their oil. The MNE's could no longer offer the Saudi government anything they didn't now have. Additionally, any involvement by the American oil companies simply diminished the amount of profit the Saudi government could be receiving from oil revenues. From 1973-1980, the Saudi government bought out shares from SOCAL, Texaco, Socony Vacuum, and Standard Oil of New Jersey, until they controlled 100% of Aramco. With this move, Saudi Arabia completed the process of obsolescing power from the MNE's to the host country.

RESULTS

After 1980, the Saudi Arabian government was able to derive almost all of its revenue from Aramco (which was renamed Saudi Aramco in 1988), which became the largest oil producing company in the world. Saudi Aramco generates more than a billion dollars a day worth of revenue, and the company has an initial public offering evaluation of over two trillion dollars. From this, the monarchy earns annual revenue in the hundreds of billions of dollars, solidifying itself as one of the top rentier states in the world. A rentier state is one that derives a substantial portion of its revenue from natural resource wealth (Mahdavy, 17). This requires that the "government (or their agencies) be the direct recipients of these rent" (Losman, 2). Saudi Arabia is easily classified as a rentier state, as oil revenues account for 87 percent of government revenues, and 55 percent of the country's GDP (Saudi Aramco). Since 1980—when the Saudi Kingdom nationalized Saudi Aramco—the Saudi Arabian government has been in direct control of all oil production that takes place within its borders. Saudi Aramco has both the world's largest crude oil reserves and largest daily oil production, bringing in an excess of $300 billion dollars of revenue per year (Saudi Aramco). All of this revenue flows back to the coffers of the government, which is an authoritarian monarchy.

The abundance of revenue created from rent allowed the Saudi monarchy to implement large social welfare programs, while simultaneously eliminating taxes for its citizens. The Monarchy is able to purchase political acquiescence by providing cradle-to-grave welfare programs to all of its citizens. In addition, about three million of Saudi Arabia's 5.5 million people workforce works for the government. By providing exorbitant welfare subsidies and employing a majority of the working age population, the Monarchy ensures that it rules unopposed. Another important consequence of rent wealth is that the Monarchy does have to tax its citizens. This has created a "Rentier Effect", whereby citizens trade not having to pay taxes in return for no say in the operation of their government. As Michael Ross suggests, a lack of taxation leads to an apathetic general public that is unlikely to "demand accountability from—and representation in—their government" (Ross, 332). Since Saudi Arabians do not demand any representation in the government, the Saudi monarchy can easily resist democratization efforts by the West.

Another mechanism that can help explain the link between oil revenue and authoritarian regimes is the "Repression Effect." This effect does not assume that citizens are apathetic toward authoritarian rule. In fact, it assumes that citizens in rentier states want democracy just as much as citizens elsewhere. The reason why the county does not democratize then, is because rent wealth obtained by oil allows authoritarian governments to "spend more on internal security and so block the population's democratic aspirations" (Ross, 335). Any uprising that takes place against the authoritarian regime would be quickly put down by both the state military and police. Both the "Rentier Effect" and "Repression Effect" are important causal mechanisms that help explain persistent authoritarian regimes in the Middle East, despite a very successful third wave of democratization.

The causal link between rentier states and authoritarian regimes has been well established in the literature, making the nationalization of oil companies a very important aspect in determining a country's chance of democratization (Losman, 2010; Schwarz, 2008; Ross, 2001; Steffen, 2011). If the al-Saud family had not nationalized Saudi Aramco in 1980, the trajectory of the monarchy would most likely look vastly different today, with its very existence being in question. By nationalizing the largest oil company in the world, the Monarchy ensured the continuation of their militant authoritarian regime, even as the West pressed other authoritarian regimes throughout the world to democratize.

CONCLUSION

In 1973, the Saudi Arabian Monarchy began buying Aramco shares from SOCAL, Texaco, Socony Vacuum, and Standard Oil of New Jersey. The gradual shift in power from the multinational enterprises to the Saudi government between the years of 1933-1980 perfectly followed the path developed by the obsolescing bargaining model (OBM). At first, the American multinational enterprises had the upper hand when bargaining due to a monopoly on capital and technology. Over time, however, the bargaining power obsolesced to the Monarchy as they held the oil drilling infrastructure hostage. By 1980, Aramco was completely nationalized, with all revenues going to the government. With the Monarchy receiving hundreds of billions of dollars a year in rent wealth, it could create a large cradle-to-grave welfare system. At the same time the welfare system was put into place, the Monarchy simultaneously eliminated taxes for all of its citizens. The Monarchy could now effectively buy out the support of its civilians. Even if members of Saudi Arabia wish for democracy, they do not mobilize and remain apathetic in order to maintain their quality of life. While much of the world has been pressured to democratize by Western powers, rent wealth explains why an authoritarian regime persists in Saudi Arabia.

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