International Business, 14e

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about the AUTHOR

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Charles W. L. Hill is a Professor of Management in the Foster School of Business at the University of Washington. Professor Hill has taught in the MBA, Executive MBA, Technology Management MBA, and PhD programs at the University of Washington. His teaching responsibilities include strategic management, international business, and microeconomics. During his time at the University of Washington, he has received over 25 awards for teaching excellence, including the Charles E. Summer all faculty Outstanding Teaching Award.

A native of the United Kingdom, Professor Hill received his PhD from the University of Manchester, UK. In addition to the University of Washington, he has served on the faculties of the University of Manchester, Texas A&M University, and Michigan State University.

Professor Hill has published over 50 articles in top academic journals, including the *Academy of Management Journal, Academy of Management Review, Strategic Management Journal,* and *Organization Science.* Professor Hill has also published several textbooks, including *International Business* (McGraw-Hill) and *Global Business Today* (McGraw-Hill). His work is widely cited in international business and strategic management. A recent study that measured scholarly influence based on cumulative citations between 1996 and 2019 ranked Professor Hill in the top 1 percent of all scholars in the world across 22 major disciplines.

Professor Hill works on a private basis with a number of organizations. His clients have included Microsoft, where he taught in-house executive education courses for two decades. He has also consulted for a variety of other large companies (e.g., AT&T Wireless, Boeing, BF Goodrich, Group Health, Hexcel, Philips Healthcare, Philips Medical Systems, Seattle City Light, Swedish Health Services, Tacoma City Light, Thompson Financial Services, WRQ, and Wizards of the Coast). Additionally, Dr. Hill has served on the advisory board of several start-up companies.

For recreation, Professor Hill enjoys skiing and competitive sailing!

Letter to Instructors

It's now been thirty years since I started writing the first edition of *International Business: Competing in the Global Marketplace*. My original intention was to present international business content in an engaging, concise, and logical manner that would capture the attention of students and instructors alike. This turned out to be a winning formula, with the book quickly becoming the most widely used international business text in the world, a position it continues to hold today.

One of the fascinating things about international business content is that not only is it firmly grounded in academic theory; it's also profoundly influenced by real world current events. Over the last few years, multiple events have had a profound impact upon the environment within which international businesses operates. These include:

- The ongoing trade war between China and the United States and the growing geopolitical competition between the world's two largest economies.
- The exit of Britain from the European Union (Brexit) and its aftermath.
- The emergence and persistence of the Covid-19 global pandemic

These events have caused economic dislocation, major supply chain disruptions, and have challenged long held assumptions about the inevitability of globalization and the best strategies for international businesses to pursue. In this edition, I discuss these developments and many others, incorporating current events into multiple chapters through Opening Cases, Closing Cases, and extended in-chapter discussion. I hope that you and your students enjoy the results of this effort.

Finally, I would be remiss if I did not mention how important feedback from instructors (and students) has been over the years. Based on your feedback, content has been rewritten, new chapters have been added, and old chapters have been compressed or reorganized. Much of the feedback has been helpful and thought provoking, and it has undoubtedly helped me to improve the book. Please keep it coming!

Regards

Charles Hill

brief CONTENTS

THE PROVEN CHOICE FOR INTERNATIONAL BUSINESS

RELEVANT. PRACTICAL. INTEGRATED.

It is now more than a quarter of a century since work began on the first edition of *International Business: Competing in the Global Marketplace.* By the third edition the book was the most widely used international business text in the world. Since then its market share has only increased. The success of the book can be attributed to a number of unique features. Specifically, for the fourteenth edition we have developed a learning program that

- Is comprehensive, state of the art, and timely.
- Is theoretically sound and practically relevant.
- Focuses on applications of international business concepts.
- Maintains a tight integrated flow between chapters.
- Focuses on the implications of international business concepts for management practice.
- Makes important theories accessible and interesting to students.
- Incorporates ancillary resources that turbo-charge the text and make it easier to teach your course.

Over the years, and through now fourteen editions, I have worked hard to adhere to these goals. It has not always been easy. An enormous amount has happened over the last 25 years, both in the real world of economics, politics, and business, and in the academic world of theory and empirical research. Often I have had to significantly rewrite chapters, scrap old examples, bring in new ones, incorporate new theory and evidence into the book, and phase out older theories that are less relevant to the modern and dynamic world of international business. That process continues in the current edition. As noted later, there have been significant changes in this edition, and that will no doubt continue to be the case in the future. In deciding what changes to make, I have been guided not only by my own reading, teaching, and research, but also by the invaluable feedback I receive from professors and students around the world who use the book, from reviewers, and from the editorial staff at McGraw Hill. My thanks go out to all of them.

COMPREHENSIVE AND UP-TO-DATE

To be relevant and comprehensive, an international business package must

- Explain how and why the world's cultures, countries, and regions differ.
- Cover economics and politics of international trade and investment.
- Tackle international issues related to ethics, corporate social responsibility, and sustainability.
- Explain the functions and form of the global monetary system.
- Examine the strategies and structures of international businesses.
- Assess the special roles of the various functions of an international business.

Relevance and comprehensiveness also require coverage of the major theories. It has always been a goal to incorporate the insights gleaned from recent academic scholarship into the book. Consistent with this goal, insights from the following research, as a sample of theoretical streams used in the book, have been incorporated:

- New trade theory and strategic trade policy.
- The work of Nobel Prize–winning economist Amartya Sen on economic development.
- Samuel Huntington's influential thesis on the "clash of civilizations."
- Growth theory of economic development championed by Paul Romer and Gene Grossman.
- Empirical work by Jeffrey Sachs and others on the relationship between international trade and economic growth.
- Michael Porter's theory of the competitive advantage of nations.
- Robert Reich's work on national competitive advantage.
- The work of Nobel Prize–winner Douglass North and others on national institutional structures and the protection of property rights.

- The market imperfections approach to foreign direct investment that has grown out of Ronald Coase and Oliver Williamson's work on transaction cost economics.
- Bartlett and Ghoshal's research on the transnational corporation.
- The writings of C. K. Prahalad and Gary Hamel on core competencies, global competition, and global strategic alliances.
- Insights for international business strategy that can be derived from the resource-based view of the firm and complementary theories.
- Paul Samuelson's critique of free trade theory.
- Recent empirical work of multiple academics, including Paul Romer, Jeffrey Sachs, and David Autor, on the economic consequences of freer trade.
- Conceptual and empirical work on global supply chain management—logistics, purchasing (sourcing), operations, and marketing channels.

In addition to including leading-edge theory and empirical research, in light of the fast-changing nature of the international business environment, I have made every effort to ensure that this product is as up-to-date as possible. A significant amount has happened in the world since the first edition of this book. For much of the last 70 years, the world has moved toward a rules-based multinational order that has governed cross-border trade and investment. The goal has been to lower barriers to international trade and investment, allowing countries to benefit from the gains to trade. The result has been greater globalization and a fertile environment in which international businesses could thrive. Perhaps the high point of this movement was the establishment of the World Trade Organization (WTO) in 1995 and the decade that followed. Since 2016, however, the world has lurched away from this consensus. Most notably, under the leadership of President Donald Trump, America unilaterally raised trade barriers and entered into a trade war with China. President Biden seems to be charting a similar course to President Trump on trade with China. The fact that the two largest economies in the world, which together account for around 40 percent of global economic activity, are engaged in a significant and ongoing trade dispute, has created huge uncertainties for international businesses. The competitive environment has fundamentally changed. To compound matters, emergence in early 2020 of the SARS-CoV-2 virus that causes the COVID-19 disease has resulted in a global pandemic that has massively disrupted global supply chains and thrown the global economy into a deep recession. In this edition, I discuss the implications of these developments for the global economy and the practice of international business. The world has changed, and the text of the book reflects this reality.

What's New in the 14th Edition

The success of the first thirteen editions of *International Business* was based in part on the incorporation of leading-edge research into the text, the use of the up-to-date examples and statistics to illustrate global trends and enterprise strategy, and the discussion of current events within the context of the appropriate theory. Building on these strengths, our goals for the twelfth edition have focused on the following:

1. Incorporate new insights from scholarly research.
2. Make sure the content covers all appropriate issues.
3. Make sure the text is up-to-date with current events, statistics, and examples.
4. Add new and insightful opening and closing cases in most chapters.
5. Incorporate value-added globalEDGE™ features in every chapter.
6. Connect every chapter to a focus on managerial implications.
7. Provide 20 new integrated cases that can be used as additional cases for specific chapters but, more importantly, as learning vehicles across multiple chapters.
8. Add a new feature to the managerially focused chapters of the book (Chapters 13–20) that looks at how changes in the macro environment affect international business practice.

As part of the overall revision process, changes have been made to every chapter in the book. All statistics have been updated to incorporate the most recently available data. Important current events have been incorporated into the text and discussed at length. Within the book you will find comprehensive discussion of the ongoing trade war between America and China, Brexit and the outlook for Britain and the EU post-Brexit, the renegotiation of NAFTA and the ratification of its successor, the USMCA, and the economic and business implications of the COVID-19 pandemic. In addition, the *Focus on Managerial Implications* section that has always appeared at the end of each chapter that deals with the macro environment (Chapters 1–12) has been renamed, *360° View: Managerial Implications.* In the more managerially focused chapters (Chapters 13–20) I have added a new section, *360° View: Impact of the Macro Environment,* which explicitly discusses how ongoing changes in the macro environment (such as the U.S.–China trade conflict and the COVID-19 pandemic) affect management practice. I believe this is a very valuable addition to this edition.

In addition to updating all statistics, figures, and maps to incorporate most recently published data, and including reference to important current events in appropriate chapters (e.g., discussion of U.S.–China trade conflict, Brexit, COVID-19), a chapter-by-chapter selection of changes for the 14th edition also includes the following:

Chapter 1: Globalization

- New opening case: Trucklabs
- Updated statistics and figures to incorporate the most recent data on global trade flows and foreign direct investment
- Discussion of the implications of recent political trends (Brexit, trade disputes, the rise of China) and what this might mean for cross border trade and investment
- New closing case: Detroit Bikes

Chapter 2: National Differences in Political, Economic, and Legal Systems

- New opening case: Ireland's Economic Transformation
- Updated data on corruption
- New closing case: China's Mixed Economy

Chapter 3: National Differences in Economic Development

- New opening case: Economic Development in South Africa
- Updated maps, figures, and in-text statistics to reflect most recently available data
- Addition of demographic trends to the discussion of Political Economy and Economic Progress
- Updated discussion of the spread of democracy to reflect recent countertrends toward greater authoritarianism in several nations (e.g., Turkey)
- New closing case: What Ails Argentina?

Chapter 4: Differences in Culture

- New opening case: Doing Business in Brazil
- Inclusion of a discussion of patience across cultures
- Revised the foundation that most religions are now pro-business
- Revised discussion of the impact of Islam on national culture to note significant diversity in cultural practices between nations where Islam is the major religion
- New closing case: Russian Culture

Chapter 5: Ethics, Corporate Social Responsibility, and Sustainability

- New opening case: Gucci's Code of Ethics
- New closing case: Who Stitched Your Designer Jeans?

Chapter 6: International Trade Theory

- New opening case: Global Trade in Semiconductors
- Updated Country Focus on China and currency manipulation
- Added discussion of the impact of trade wars on business practice in 360° View: Managerial Implications
- New closing case: Trade in Services
- Updated balance of payments data in the Appendix to reflect 2020 data

Chapter 7: Government Policy and International Trade

- New opening case: The Jones Act
- Updated discussion of the world trading system to reflect recent developments, including Brexit and ongoing trade disputes between the United States, China, and others.
- New closing case: America and Kenya Negotiate a Trade Deal

Chapter 8: Foreign Direct Investment

- New opening case: Tesla's Direct Investment in China
- Updated statistics and figures on foreign direct investment in the world economy to incorporate the most recently available data
- New closing case: JCB in India

Chapter 9: Regional Economic Integration

- New opening case: Britain Post-Brexit
- Updated discussion of Brexit and its aftermath
- Added discussion of the renegotiation of NAFTA by the Trump administration and the ratification of NAFTA's replacement, the United States–Mexico–Canada Agreement (USMCA)

- Additional discussion of new free trade deals in Africa
- New closing case: RCEP: The World's Largest Trade Deal

Chapter 10: The Foreign Exchange Market

- New opening case: Hedging the Thai Baht
- Updated data throughout the chapter to reflect currency exchange rates in 2020
- New closing case: Exchange Rates and the Profitability of Korean Airlines

Chapter 11: The International Monetary System

- New opening case: The Future of the U.S. Dollar as the World's Reserve Currency
- Updated data and discussion of the floating exchange rate regime through till 2020
- New closing case: Did the IMF Help Egypt?

Chapter 12: The Global Capital Market

- New opening case: Why do so many Israeli Companies List on American Stock Exchanges?
- Updated statistics and discussion to reflect most recently available data
- New closing case: Chinese IPOs in the United States

Chapter 13: The Strategy of International Business

- New opening case: Emirates Global Strategy
- New section: 360° View: Impact of the Macro Environment
- New closing case: Geely Holdings: China's First Global Car Company

Chapter 14: The Organization of International Business

- New opening case: Reorganizing Siemens to Compete Globally
- New Management Focus: IBM Moves Towards a Matrix Structure
- New section: 360° View: Impact of the Macro Environment
- New closing case: Philips: 120 years of Organization Change

Chapter 15: Entering Developed and Emerging Markets

- New opening case: Uber's Foreign Market Entry Strategy
- New section: 360° View: Impact of the Macro Environment
- New closing case: Vanguard in China

Chapter 16: Exporting, Importing, and Countertrade

- New opening case: Exporting to Egypt
- New section: 360° View: Impact of the Macro Environment
- New closing case: Maine Coast Company

Chapter 17: Global Production and Supply Chain Management

- New opening case: The Global Chip Shortage in the Auto Industry: Supply Chain Disruptions in the Age of COVID-19
- New section: 360° View: Impact of the Macro Environment
- New closing case: China: The World's Manufacturing Center in the Wake of Trade Wars and COVID-19

Chapter 18: Global Marketing and Business Analytics

- New opening case: Airbnb: Building a Global Brand by Emphasizing Local Experience
- New section: 360° View: Impact of the Macro Environment
- New closing case: Share a Coke

Chapter 19: Global Human Resource Management

- New opening case: Developing a Global Workforce at Colgate-Palmolive
- New section: 360° View: Impact of the Macro Environment
- New closing case: The Evolution of HR Strategy at IBM

Chapter 20: Accounting and Finance in the International Business

- New opening case: Google Ends its "Double Irish-Dutch Sandwich" Tax Minimization Scheme
- New section: 360° View: Impact of the Macro Environment
- New closing case: Microsoft's Acquisition of Skype

Integrated Cases

All of the 20 integrated cases are new for *International Business 14e.* Many of these cases build on previous opening and closing chapter cases that have been revised, updated, and oftentimes adopted a new angle or focus. A unique feature of the opening and closing cases for the chapters as well as the integrated cases at the back-end of the text is that we cover all continents of the world and we do so with regional or country issues and large, medium, and small company scenarios. This makes the 60 total cases that are included in *International Business 14e* remarkably wealthy as a learning program.

- How the iPhone is Made: Apple's Global Production System
- Kenya: An African Lion
- Poland: Eastern Europe's Economic Miracle
- Culture and Business in Saudi Arabia
- Microsoft Goes Carbon Neutral
- A Tale of Two Nations: Ghana and South Korea
- American Steel Tariffs
- Starbucks' Foreign Direct Investment
- The Cost of Brexit
- Managing Foreign Currency Exposure at 3M
- Pakistan Takes Another IMF Loan
- Saudi Aramco
- Red Bull
- Dow Chemical's Global Matrix Structure
- Walmart International
- IKEA Entering India, Finally!
- Higher Education Exporting and International Competitiveness
- Blockchain Technology and Global Supply Chains
- Marketing Sneakers
- Global Mobility at Shell

BEYOND UNCRITICAL PRESENTATION AND SHALLOW EXPLANATION

Many issues in international business are complex and thus necessitate considerations of pros and cons. To demonstrate this to students, I have always adopted a critical approach that presents the arguments for and against economic theories, government policies, business strategies, organizational structures, and so on.

Related to this, I have attempted to explain the complexities of the many theories and phenomena unique to international business so the student might fully comprehend the statements of a theory or the reasons a phenomenon is the way it is. These theories and phenomena are explained in more depth in this work than they are in competing texts. I have always believed that a shallow explanation is little better than no explanation at all. In international business, a little knowledge is indeed a dangerous thing.

PRACTICAL AND RICH APPLICATIONS

It is important to show students how the material covered in the text is relevant to the actual practice of international business. This is explicit in the later chapters of the book, which focus on the practice of international business, but it is not always obvious in the first half of the book, which considers macro topics. Accordingly, at the end of each of the first 12 chapters—where the primary focus is on the environment of international business, as opposed to particular firms—there is a section titled **360° View: Managerial Implications.** In this section, the managerial implications of the material discussed in the chapter are clearly explained. Additionally, most chapters have at least one **Management Focus box.** The purpose of these boxes is to illustrate the relevance of chapter material for the practice of international business. Finally, as noted already, in Chapters 13–20, where the focus in explicitly on management issues, a new section has been added, **360° View: Impact of the Macro Environment,** where we discuss how changes in the macro environment can affect the management of strategy and functional activities within an international business.

A **Did You Know?** feature challenges students to view the world around them through the lens of international business (e.g., Did you know that a Kit Kat bar is marketed very differently in different countries?). The author recorded short videos explaining the phenomena.

In addition, each chapter begins with an **opening case** that sets the stage for the chapter and ends with a **closing case** that illustrates the relevance of chapter material for the practice of international business.

To help students go a step further in expanding their application-level understanding of international business, each chapter incorporates two **globalEDGE™ research tasks.** The exercises dovetail with the content just covered.

INTEGRATED PROGRESSION OF TOPICS

A shortcoming of many texts is that they lack a tight, integrated flow of topics from chapter to chapter. This book explains to students in Chapter 1 how the book's topics are related to each other. Integration has been achieved by organizing the material so that each chapter builds on the material of the previous ones in a logical fashion.

Part One

Chapter 1 provides an overview of the key issues to be addressed and explains the plan of the book. Globalization of markets and globalization of production is the core focus.

Part Two

Chapters 2 through 4 focus on country differences in political economy and culture, and Chapter 5 on ethics, corporate social responsibility, and sustainability issues in international business. Most international business textbooks place this material at a later point, but we believe it is vital to discuss national differences first. After all, many of the central issues in international trade and investment, the global monetary system, international business strategy and structure, and international business functions arise out of national differences in political economy and culture.

Part Three

Chapters 6 through 9 investigate the political economy of global trade and investment. The purpose of this part is to describe and explain the trade and investment environment in which international business occurs.

Part Four

Chapters 10 through 12 describe and explain the global monetary system, laying out in detail the monetary framework in which international business transactions are conducted.

Part Five

In Chapters 13, 14 and 15 attention shifts from the environment to the firm. In other words, we move from a macro focus to a micro focus at this stage of the book. We examine strategies that firms adopt to compete effectively in the international business environment.

Part Six

In Chapters 16 through 20, the focus narrows further to investigate business functions and related operations. These chapters explain how firms can perform their key functions—exporting, importing, and countertrade; global production; global supply chain management; global marketing; global research and development (R&D); human resource management—to compete and succeed in the international business environment.

Throughout the book, the relationship of new material to topics discussed in earlier chapters is pointed out to the students to reinforce their understanding of how the material comprises an integrated whole. We deliberately bring a management focus to the macro chapters (Chapters 1 through 12). We also integrate macro themes in covering the micro chapters (Chapters 13 through 20).

ACCESSIBLE AND INTERESTING

The international business arena is fascinating and exciting, and we have tried to communicate our enthusiasm for it to the student. Learning is easier and better if the subject matter is communicated in an interesting, informative, and accessible manner. One technique we have used to achieve this is weaving interesting anecdotes into the narrative of the text, that is, stories that illustrate theory.

Most chapters also have a **Country Focus** box that provides background on the political, economic, social, or cultural aspects of countries grappling with an international business issue.

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2

LEARNING OBJECTIVES

After reading this chapter, you will be able to:

LO2-1 Understand how the political systems of countries differ.

LO2-2 Understand how the economic systems of countries differ.

LO2-3 Understand how the legal systems of countries differ.

LO2-4 Explain the implications for management practice of national differences in political economy.

David Creedon/Alamy Stock Photo

Ireland's Economic Transformation

OPENING CASE

Over the last 35 years, the Republic of Ireland has recorded one of the highest sustained economic growth rates among developed nations. Today, this country of 5 million has a Gross National Income (GNI) per capita of $64,000, similar to that of the United States and well above that of its neighbor, the United Kingdom, which has a GNI per capita of $42,220, or European economic powerhouse Germany, which has a GNI per capita of $48,580. However, it wasn't always this way.

After Ireland gained independence from the United Kingdom in 1922, in an attempt to stimulate economic growth, the country adopted protectionist policies, including high trade barriers and a policy of import substitution. This nationalistic policy didn't work. By the 1950s, while other European countries were enjoying fast economic growth, Ireland stagnated. The country's biggest export was its people, with 400,000 people leaving the country during the 1950s.

Ireland continued to stumble along until the 1980s. Marginal tax rates reached 60 percent of income for middle income workers, unemployment was close to 20 percent, one-third of the workforce was employed in the public sector, annual public sector deficits reached 15 percent of GDP, and emigration was around 1 percent of the population every year as the young and educated fled the nation for greener economic pastures in countries such as the United States or the United Kingdom.

In 1987, Fianna Fail, one of Ireland's two center-right political parties, was in power. In an acknowledgement that Ireland's economic policies had failed, Fianna Fail shifted course. Individual and corporate tax rates were reduced. Corporate tax rates are now at 12.5 percent, much lower than those in most developed nations. Business was deregulated, public spending was cut, the hold of the public sector over economic activity was curtailed, and private enterprise was actively encouraged.

These changes enabled Ireland to capitalize on two advantages that the country enjoyed: membership in the European Union (which it had joined in 1973) and a young well-educated work force. In 1989, the American semiconductor company, Intel, established operations in the country. Intel was followed by other technology companies, including Microsoft, Google, and Apple, all of which set up significant activities in the nation. Ireland also started to produce its own new enterprises, such as Ryanair, which was established after Ireland deregulated its own airline market.

The results were impressive. Between 1995 and 2002, private sector jobs increased by almost 60 percent. The high demand for educated labor drove up wage rates. Consumer spending, construction, and business investment all increased. Between 1995 and 2007, the country enjoyed a period of sustained economic growth that was the envy of most developed nations. Then in 2008, the great recession hit. It became clear that Ireland's property market had been in a bubble, with prices and new construction having been driven to unsustainable highs. To make matters worse, the banking system was in deep trouble after having financed so many speculative projects.

For three years, Ireland experienced negative economic growth. Unemployment soared, reaching 15 percent. The government was forced to seek help from the European Union and the IMF, which together loaned 68 billion euros to the country—equal to 40 percent of the value of the economy. The government responded by merging and shutting down illiquid banks, cutting public spending and public sector wages, and raising personal and property tax rates (but not corporate tax rates).

By the end of 2012, the Irish economy had started to improve. Economic growth turned positive again, unemployment began to fall, government debt was reduced, and inflation remained tame. The country exited from the IMF rescue plan ahead of schedule. In 2018, the economy grew by 8.3 percent. This was followed by 5.5 percent growth in 2019, while unemployment dropped to around 5 percent. Ireland seemed to be back on track. Then, the COVID-19 pandemic hit and the economy shrunk by almost 7 percent. However, the country seems well-positioned to rebound from its pandemic-induced slump and is projected to return to its growth path in 2021 and 2022.

Sources: "Ireland: From Tiger to Phoenix," *IMF,* August 2018; "Celtic Phoenix," *The Economist,* November 21, 2015; "A Model of Success," *The Economist,* October 16, 2004.

Introduction

International business is much more complicated than domestic business because countries differ in many ways. Countries have different political, economic, and legal systems. They vary significantly in their level of economic development and future economic growth trajectory. Cultural practices can vary dramatically, as can the education and skill levels of the population. All these differences can and do have major implications for the practice of international business. They have a profound impact on the benefits, costs, and risks associated with doing business in different countries; the way in which operations in different countries should be managed; and the strategy international firms should pursue in different countries. The main function of this chapter and the next two is to develop an awareness of and appreciation for the significance of country differences in political systems, economic systems, legal systems, economic development, and societal culture. Another function of the three chapters is to describe how the political, economic, legal, and cultural systems of many of the world's nation-states are evolving and to draw out the implications of these changes for the practice of international business.

This chapter focuses on how the political, economic, and legal systems of countries differ. Collectively, we refer to these systems as constituting the political economy of a country. We use the term **political economy** to stress that the political, economic, and legal systems of a country are interdependent; they interact with and influence each other, and in doing so, they affect the level of economic well-being. In Chapter 3, we build on the concepts discussed here to explore in detail how differences in political, economic, and legal systems influence the economic development of a nation-state and its likely future growth trajectory. In Chapter 4, we look at differences in societal culture and at how these differences influence the practice of international business. Moreover, as we will see in Chapter 4, societal culture has an influence on the political, economic, and legal systems in a nation and thus its level of economic well-being. We also discuss how the converse may occur: how political, economic, and legal systems may also shape societal culture.

The Opening Case illustrates some of the issues discussed in this chapter and the next in regard to Ireland's economy. As a result of its embrace of market-based policies, Ireland is now one of richest economies in the world.

As we will see in this chapter and the next, shifting toward more market-based economic policies seems to result in considerable economic growth.

globalEDGE GET INSIGHTS BY COUNTRY

The "Get Insights by Country" section of globalEDGE™ (globaledge.msu.edu/global-insights/by/country) is your source for information and statistical data for nearly every country around the world (more than 200 countries). As related to Chapter 2 of the text, globalEDGE™ has a wealth of information and data on national differences in political economy. These differences are available across a dozen menu categories in the country sections (e.g., economy, history, government, culture, risk). The "Executive Memos" on each country page are also great for abbreviated fingertip access to current information.

LO2-1
Understand how the political systems of countries differ.

Political Systems

The political system of a country shapes its economic and legal systems.[1] Thus, we need to understand the nature of different political systems before discussing economic and legal systems. By **political system**, we mean the system of government in a nation. Political systems can be assessed according to two dimensions. The first is the degree to which they emphasize collectivism as opposed to individualism. The second is the degree to which they are democratic or totalitarian. These dimensions are interrelated; systems that emphasize collectivism tend to lean toward totalitarianism, whereas those that place a high value on individualism tend to be democratic. However, a large gray area exists in the middle. It is possible to have democratic societies that emphasize a mix of collectivism and individualism. Similarly, it is possible to have totalitarian societies that are not collectivist.

COLLECTIVISM AND INDIVIDUALISM

Collectivism refers to a political system that stresses the primacy of collective goals over individual goals.[2] When collectivism is emphasized, the needs of society as a whole are generally viewed as being more important than individual freedoms. In such circumstances, an individual's right to do something may be restricted on the grounds that it runs counter to "the good of society" or to "the common good." Advocacy of collectivism can be traced to the ancient Greek philosopher Plato (427–347 B.C.), who, in *The Republic,* argued that individual rights should be sacrificed for the good of the majority and that property should be owned in common. Plato did not equate collectivism with equality; he believed that society should be stratified into classes, with those best suited to rule (which for Plato, naturally, were philosophers and soldiers) administering society for the benefit of all. In modern times, the collectivist mantle has been picked up by socialists.

Socialism

Modern **socialists** trace their intellectual roots to Karl Marx (1818–1883), although socialist thought clearly predates Marx (elements of it can be traced to Plato). Marx argued that the few benefit at the expense of the many in a capitalist society where individual freedoms are not restricted. While successful capitalists accumulate considerable wealth, Marx postulated that the wages earned by the majority of workers in a capitalist society would be forced down to subsistence levels. He argued that capitalists expropriate for their own use the value created by workers, while paying workers only subsistence wages in return. According to Marx, the pay of workers does not reflect the full value of their labor. To correct this perceived wrong, Marx advocated state ownership of the basic means of production, distribution, and exchange (i.e., businesses). His logic was that if the state owned the means of production, the state could ensure that workers were fully compensated for their labor. Thus, the idea is to manage state-owned enterprise to benefit society as a whole, rather than individual capitalists.[3]

In the early twentieth century, the socialist ideology split into two broad camps. The **communists** believed that socialism could be achieved only through violent revolution and totalitarian dictatorship, whereas the **social democrats** committed themselves to achieving socialism by democratic means, turning their backs on violent revolution and dictatorship. Both versions of socialism waxed and waned during the twentieth century.

The communist version of socialism reached its high point in the late 1970s, when the majority of the world's population lived in communist states. The countries under Communist Party rule at that time included the former Soviet Union; its eastern European client nations (e.g., Poland, Czechoslovakia, Hungary); China; the southeast Asian nations of Cambodia, Laos, and Vietnam; various African nations (e.g., Angola and Mozambique); and the Latin American nations of Cuba and Nicaragua. By the mid-1990s, however, communism was in retreat worldwide. The Soviet Union had collapsed and had been replaced by a collection of 15 republics, many of which were at least nominally structured as democracies. Communism was swept out of eastern Europe by the largely bloodless revolutions of 1989. Although China is still nominally a communist state with substantial limits to individual political freedom, in the economic sphere the country has moved away from strict adherence to communist ideology, despite China still having a significant state-owned sector. Old-style communism, with state control over all economic activity, hangs on in only a handful of small fringe states, most notably North Korea.

Social democracy also seems to have passed a high-water mark, although the ideology may prove to be more enduring than communism. Social democracy has had perhaps its greatest influence in a number of democratic Western nations, including Australia, Denmark, Finland, France, Germany, Great Britain, Norway, Spain, and Sweden, where social democratic parties have often held political power. Other countries where social democracy has had an important influence include India and Brazil. Consistent with their Marxist roots, after World War II social democratic governments in some nations nationalized some private companies, transforming them into state-owned enterprises to be run for the "public good rather than private profit." This trend was most apparent in Great Britain where, by the end of the 1970s, state-owned companies had a monopoly in the telecommunications, electricity, gas, coal, railway, and shipbuilding industries, as well as substantial interests in the oil, airline, auto, and steel industries.

However, experience demonstrated that state ownership of the means of production ran counter to the public interest. In many countries, state-owned companies performed poorly. Protected from competition by their monopoly position and guaranteed government financial support, many became increasingly inefficient. Individuals paid for the luxury of state ownership through higher prices and higher taxes. As a consequence, a number of Western democracies voted many social democratic parties out of office in the late 1970s and early 1980s. They were succeeded by political parties, such as Britain's Conservative Party and Germany's Christian Democratic Party, that were more committed to free market economics. These parties sold state-owned enterprises to private investors (a process referred to as **privatization**). Even where social democratic parties regained the levers of power, as in Great Britain in 1997 when the left-leaning Labor Party won control of the government, they too were now committed to continued private ownership.

Individualism

The opposite of collectivism, **individualism** refers to a philosophy that an individual should have freedom in his or her economic and political pursuits. In contrast to collectivism, individualism stresses that the interests of the individual should take precedence over the interests of the state. Like collectivism, individualism can be traced to an ancient Greek philosopher, in this case Plato's disciple Aristotle (384–322 B.C.). In contrast to Plato, Aristotle argued that individual diversity and private ownership are desirable. In a passage that might have been taken from a speech by contemporary politicians who adhere to a free market ideology, he argued that private property is more highly productive than communal property and will thus stimulate progress. According to Aristotle, communal property receives little care, whereas property that is owned by an individual will receive the greatest care and therefore be most productive.

Individualism was reborn as an influential political philosophy in the Protestant trading nations of England and the Netherlands during the sixteenth century. The philosophy was refined in the work of a number of British philosophers, including David Hume (1711–1776), Adam Smith (1723–1790), and John Stuart Mill (1806–1873). Individualism exercised a profound influence on those in the American colonies that sought independence from Great Britain. Indeed, the concept underlies the ideas expressed in the Declaration of Independence. In the twentieth century, several Nobel Prize–winning economists—including Milton Friedman, Friedrich von Hayek, and James Buchanan—championed the philosophy.

Individualism is built on two central tenets. The first is an emphasis on the importance of guaranteeing individual freedom and self-expression. The second tenet of individualism is that the welfare of society is best served by letting people pursue their own economic self-interest, as opposed to some collective body (such as government) dictating what is in society's best interest. Or, as Adam Smith put it in a famous passage from *The Wealth of Nations,* "an individual who intends his own gain is led by an invisible hand to promote an end that was no part of his intention. Nor is it always worse for the society that it was no part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it. This author has never known much good done by those who effect to trade for the public good."[4]

The central message of individualism, therefore, is that individual economic and political freedoms are the ground rules on which a society should be based. This puts individualism in conflict with collectivism. Collectivism asserts the primacy of the collective over the individual; individualism asserts the opposite. This underlying ideological conflict shaped much of the recent history of the world. The Cold War, for example, was in many respects a war between collectivism, championed by the former Soviet Union, and individualism, championed by the United States. From the late 1980s until about 2005, the waning of collectivism was matched by the ascendancy of individualism. Democratic ideals and market economics replaced socialism and communism in many states. Since 2005, there have been some signs of a swing back toward left-leaning socialist ideas in several countries, including several Latin America nations such as Venezuela, Bolivia, and Paraguay, along with Russia (see the Country Focus for details). In addition, the global financial crisis of 2008–2009 caused some reevaluation of the trends toward individualism, and it remains possible that the pendulum might tilt back the other way.

DEMOCRACY AND TOTALITARIANISM

Democracy and totalitarianism are at different ends of a political dimension. **Democracy** refers to a political system in which government is by the people, exercised either directly or through elected representatives. **Totalitarianism** is a form of government in which one person or political party exercises absolute control over all spheres of human life and prohibits opposing political parties. The democratic–totalitarian dimension is not independent of the individualism–collectivism dimension. Democracy and individualism go hand in hand, as do the communist version of collectivism and totalitarianism. However, gray areas exist; it is possible to have a democratic state in which collective values predominate, and it is possible to have a totalitarian state that is hostile to collectivism and in which some degree of individualism—particularly in the economic sphere—is encouraged. For example, China and Vietnam have seen a move toward greater individual freedom in the economic sphere, but those countries are stilled ruled by parties that have a monopoly on political power and constrain political freedom.

Democracy

The pure form of democracy, as originally practiced by several city-states in ancient Greece, is based on a belief that citizens should be directly involved in decision making. In complex, advanced societies with populations in the tens or hundreds of millions, this is impractical. Most modern democratic states practice **representative democracy**. The United States, for example, is a constitutional republic that operates as a representative democracy. In a representative democracy, citizens periodically elect individuals to represent them. These elected representatives then form a government whose function is to make decisions on behalf of the electorate. In a representative democracy, elected representatives who fail to perform this job adequately will be voted out of office at the next election.

To guarantee that elected representatives can be held accountable for their actions by the electorate, an ideal representative democracy has a number of safeguards that are typically enshrined in constitutional law. These include: (1) an individual's right to freedom of expression, opinion, and organization; (2) a free media; (3) regular elections in which all eligible citizens are allowed to vote; (4) universal adult suffrage; (5) limited terms for elected representatives; (6) a fair court system that is independent from the political system; (7) a nonpolitical state bureaucracy; (8) a nonpolitical police force and armed service; and (9) relatively free access to state information.[5]

Totalitarianism

In a totalitarian country, all the constitutional guarantees on which representative democracies are built—an individual's right to freedom of expression and organization, a free media, and regular elections—are denied to the citizens. In most totalitarian states,

COUNTRY FOCUS

Putin's Russia

The modern Russian state was born in 1991 after the dramatic collapse of the Soviet Union. Early in the post-Soviet era, Russia embraced ambitious policies designed to transform a communist dictatorship with a centrally planned economy into a democratic state with a market-based economic system. The policies, however, were imperfectly implemented. Political reform left Russia with a strong presidency that—in hindsight—had the ability to subvert the democratic process. On the economic front, the privatization of many state-owned enterprises was done in such a way as to leave large shareholdings in the hands of the politically connected, many of whom were party officials and factory managers under the old Soviet system. Corruption was also endemic, and organized crime was able to seize control of some newly privatized enterprises. In 1998, the poorly managed Russian economy went through a financial crisis that nearly bought the country to its knees.

Fast-forward to 2020, and Russia still is a long way from being a modern democracy with a functioning free market-based economic system. On the positive side, the economy grew at a healthy clip during the early 2000s, helped in large part by high prices for oil and gas, Russia's largest exports (in 2013, oil and gas accounted for 75 percent of all Russian exports). Between 2000 and 2013, Russia's gross domestic product (GDP) per capita more than doubled when measured by purchasing power parity. Today the country boasts the world's 12th-largest economy, just behind that of South Korea and ahead of Spain. Thanks to government oil revenues, public debt is also low by international standards—at just 12.5 percent of GDP in 2019 (in the United States, by comparison, public debt amounts to 80 percent of GDP). Indeed, Russia has run a healthy trade surplus on the back of strong oil and gas exports for the last decade.

However, the Russian economy is overly dependent on commodities, particularly oil and gas. This was exposed in mid-2014 when the price of oil started to tumble as a result of rapidly increasing supply from the United States. Between mid-2014 and early 2016, the price of oil fell from $110 a barrel to a low of around $27 before rebounding to $50. This drove a freight train through Russia's public finances. Much of Russia's oil and gas production remains in the hands of enterprises in which the state still has a significant ownership stake. The government has a controlling ownership position in Gazprom and Rosneft, two of the country's largest oil and gas companies. The government used the rise in oil and gas revenues between 2004 and 2014 to increase public spending through state-led investment projects and increases in wages and pensions for government workers. While this boosted private consumption, there has been a dearth of private investment, and productivity growth remains low. This is particularly true among many state-owned enterprises that

political repression is widespread, free and fair elections are lacking, media are heavily censored, basic civil liberties are denied, and those who question the right of the rulers to rule find themselves imprisoned or worse.

Four major forms of totalitarianism exist in the world today. Until recently, the most widespread was **communist totalitarianism**. Communism, however, is in decline worldwide, and most of the Communist Party dictatorships have collapsed since 1989. Exceptions to this trend (so far) are China, Vietnam, Laos, North Korea, and Cuba, although most of these states exhibit clear signs that the Communist Party's monopoly on political power is eroding. In many respects, the governments of China, Vietnam, and Laos are communist in name only because those nations have adopted wide-ranging, market-based economic reforms. They remain, however, totalitarian states that deny many basic civil liberties to their populations. On the other hand, there are signs of a swing back toward communist totalitarian ideas in some states, such as Venezuela, where the government of the late Hugo Chávez displayed totalitarian tendencies. The same is true in Russia, where the government of Vladimir Putin has become increasingly totalitarian over time (see the Country Focus).

A second form of totalitarianism might be labeled **theocratic totalitarianism**. Theocratic totalitarianism is found in states where political power is monopolized by a collectively still account for about half of the Russian economy. Now with lower oil prices, Russia is having to issue more debt to finance public spending.

Russian private enterprises are also hamstrung by bureaucratic red tape and endemic corruption. Transparency International, which ranks countries by the extent of corruption, ranked Russia 137 out of 180 nations in 2019. The state and state-owned enterprises are famous for pushing work to private enterprises owned by political allies, which further subverts market-based processes.

On the political front, Russia is becoming less democratic with every passing year. Since 1999, Vladimir Putin has exerted increasingly tight control over Russian politics, either as president or as prime minister. Under Putin, potential opponents have been sidelined, civil liberties have been progressively reduced, and the freedom of the press has been diminished. For example, in response to opposition protests in 2011 and 2012, the Russian government passed laws increasing its control over the internet, dramatically raising fines for participating in "unsanctioned" street protests, and expanded the definition of treason to further limit opposition activities. Vocal opponents of the régime—from business executives who do not toe the state line to protest groups such as the punk rock protest band Pussy Riot—have found themselves jailed on dubious charges. To make matters worse, Putin has tightened his grip on the legal system. In late 2013, Russia's parliament, which is dominated by Putin supporters, gave the president more power to appoint and fire prosecutors, thereby diminishing the independence of the legal system.

Freedom House, which produces an annual ranking tracking freedom in the world, classifies Russia as "not free" and gives it very low scores for political and civil liberties. Freedom House notes that in the March 2012 presidential elections, Putin benefited from preferential treatment by state-owned media, numerous abuses of incumbency, and procedural "irregularities" during the vote count. Putin won 63.6 percent of the vote against a field of weak, hand-chosen opponents, led by Communist Party leader Gennadiy Zyuganove, with 17.2 percent of the vote. Under a Putin-inspired 2008 constitutional amendment, the term of the presidency was expanded from four years to six. Putin was elected to another six-year term in 2018 in an election that many observers thought was a sham.

In 2014, Putin burnished his growing reputation for authoritarianism when he took advantage of unrest in the neighboring country of Ukraine to annex the Crimea region and to support armed revolt by Russian-speaking separatists in eastern Ukraine. Western powers responded to this aggression by imposing economic sanctions on Russia. Taken together with the rapid fall in oil prices, this pushed the once-booming Russian economy into a recession. Despite economic weaknesses, there is no sign that Putin's hold on power has been diminished. In fact, quite the opposite seems to have occurred.

Sources: "Putin's Russia: Sochi or Bust," *The Economist,* February 1, 2014; "Russia's Economy: The S Word," *The Economist,* November 9, 2013; Freedom House, "Freedom in the World 2019: Russia," www.freedomhouse.org; K. Hille, "Putin Tightens Grip on Legal System," *Financial Times,* November 27, 2013; "A Fourth Term for Russia's Perpetual President," *The Economist,* March 19, 2018.

party, group, or individual that governs according to religious principles. The most common form of theocratic totalitarianism is based on Islam and is exemplified by states such as Iran and Saudi Arabia. These states limit freedom of political and religious expression with laws based on Islamic principles.

A third form of totalitarianism might be referred to as **tribal totalitarianism**. Tribal totalitarianism has arisen from time to time in African countries such as Zimbabwe, Tanzania, Uganda, and Kenya. The borders of most African states reflect the administrative boundaries drawn by the old European colonial powers rather than tribal realities. Consequently, the typical African country contains a number of tribes (e.g., in Kenya there are more than 40 tribes). Tribal totalitarianism occurs when a political party that represents the interests of a particular tribe (and not always the majority tribe) monopolizes power. In Kenya, for example, politicians from the Kikuyu tribe have long dominated the political system.

A fourth major form of totalitarianism might be described as **right-wing totalitarianism**. Right-wing totalitarianism generally permits some individual economic freedom but restricts individual political freedom, frequently on the grounds that it would lead to the rise of communism. A common feature of many right-wing dictatorships is an overt hostility to socialist or communist ideas. Many right-wing totalitarian governments are backed by the military, and in some cases, the government may be made up of military officers. The fascist regimes that ruled Germany and Italy in the 1930s and 1940s were right-wing totalitarian states. Until the early 1980s, right-wing dictatorships, many of which were military dictatorships, were common throughout Latin America (e.g., Brazil was ruled by a military dictatorship between 1964 and 1985). They were also found in several Asian countries, particularly South Korea, Taiwan, Singapore, Indonesia, and the Philippines. Since the early 1980s, however, this form of government has been in retreat. Most Latin American countries are now genuine multiparty democracies. Similarly, South Korea, Taiwan, and the Philippines have all become functioning democracies, as has Indonesia.

Pseudo-Democracies

Many of the world's nations are neither pure democracies nor iron-clad totalitarian states. Rather they lie between pure democracies and complete totalitarian systems of government. They might be described as imperfect or pseudo-democracies, where authoritarian elements have captured some or much of the machinery of state and use this in an attempt to deny basic political and civil liberties. In the Russia of Vladimir Putin, for example, elections are still held, people compete through the ballot box for political office, and the independent press does not always toe the official line. However, Putin has used his position to systematically limit the political and civil liberties of opposition groups. His control is not yet perfect, though. Voices opposing Putin are still heard in Russia, and in theory, elections are still contested. But in practice, it is becoming increasingly difficult to challenge a man and régime that have systematically extended their political, legal, and economic power over the past two decades (see the Country Focus).

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LO2-2

Understand how the economic systems of countries differ.

Economic Systems

It should be clear from the previous section that political ideology and economic systems are connected. In countries where individual goals are given primacy over collective goals, we are more likely to find market-based economic systems. In contrast, in countries where collective goals are given preeminence, the state may have taken control over many enterprises; markets in such countries are likely to be restricted rather than free. We can identify three broad types of economic systems: a market economy, a command economy, and a mixed economy.

MARKET ECONOMY

In the archetypal pure **market economy**, all productive activities are privately owned, as opposed to being owned by the state. The goods and services that a country produces are not planned by anyone. Production is determined by the interaction of supply and demand and signaled to producers through the price system. If demand for a product exceeds supply, prices will rise, signaling producers to produce more. If supply exceeds demand, prices will fall, signaling producers to produce less. In this system, consumers are sovereign. The purchasing patterns of consumers, as signaled to producers through the mechanism of the price system, determine what is produced and in what quantity.

For a market to work in this manner, supply must not be restricted. A supply restriction occurs when a single firm monopolizes a market. In such circumstances, rather than increase output in response to increased demand, a monopolist might restrict output and let prices rise. This allows the monopolist to take a greater profit margin on each unit it sells. Although this is good for the monopolist, it is bad for the consumer, who has to pay higher prices. It also is probably bad for the welfare of society. Because a monopolist has no competitors, it has no incentive to search for ways to lower production costs. Rather, it can simply pass on cost increases to consumers in the form of higher prices. The net result is that the monopolist is likely to become increasingly inefficient, producing high-priced, low-quality goods, and society suffers as a consequence.

Given the dangers inherent in monopoly, one role of government in a market economy is to encourage vigorous free and fair competition between private producers. Governments do this by banning restrictive business practices designed to monopolize a market (antitrust laws serve this function in the United States and European Union). Private ownership also encourages vigorous competition and economic efficiency. Private ownership ensures that entrepreneurs have a right to the profits generated by their own efforts. This gives entrepreneurs an incentive to search for better ways of serving consumer needs. That may be through introducing new products, by developing more efficient production processes, by pursuing better marketing and after-sale service, or simply through managing their businesses more efficiently than their competitors. In turn, the constant improvement in product and process that results from such an incentive has been argued to have a major positive impact on economic growth and development.[6]

COMMAND ECONOMY

In a pure **command economy**, the government plans the goods and services that a country produces, the quantity in which they are produced, and the prices at which they are sold. Consistent with the collectivist ideology, the objective of a command economy is for government to allocate resources for "the good of society." In addition, in a pure command economy, all businesses are state owned, the rationale being that the government can then direct them to make investments that are in the best interests of the nation as a whole rather than in the interests of private individuals. Historically, command economies were found in communist countries where collectivist goals were given priority over individual goals. Since the demise of communism in the late 1980s, the number of command economies has fallen dramatically. Some elements of a command economy were also evident in a number of democratic nations led by socialist-inclined governments. France and India both experimented with extensive government planning and state ownership, although government planning has fallen into disfavor in both countries.

North Korean leader Kim Jong-un visiting a factory.
AFP/Getty Images

While the objective of a command economy is to mobilize economic resources for the public good, the opposite often seems to have occurred. In a command economy, state-owned enterprises have little incentive to control costs and be efficient because they cannot go out of business. In addition, the abolition of private ownership means there is no incentive for individuals to look for better ways to serve consumer needs; hence, dynamism and innovation are absent from command economies. Instead of growing and becoming more prosperous, such economies tend to stagnate.

MIXED ECONOMY

Mixed economies can be found between market and command economies. In a mixed economy, certain sectors of the economy are left to private ownership and free market mechanisms, whereas other sectors have significant state ownership and government planning. Mixed economies were once common throughout much of the developed world, although they are becoming less so. Until the 1980s, Great Britain, Ireland, France, and Sweden were mixed economies, but extensive privatization has reduced state ownership of businesses in all these nations. A similar trend occurred in many other countries where there was once a large state-owned sector, such as Brazil, Italy, and India (although there are still state-owned enterprises in all of these nations). As a counterpoint, the involvement of the state in economic activity has been on the rise again in countries such as Russia and Venezuela, where authoritarian regimes have seized control of the political structure, typically by first winning power through democratic means and then subverting those same structures to maintain their grip on power.

In mixed economies, governments also tend to take into state ownership troubled firms whose continued operation is thought to be vital to national interests. For example, in 2008 the U.S. government took an 80 percent stake in AIG to stop that financial institution from collapsing, the theory being that if AIG did collapse, it would have very serious consequences for the entire financial system. The U.S. government usually prefers market-oriented solutions to economic problems, and in the AIG case, the intention was to sell the institution back to private investors as soon as possible. The United States also took similar action with respect to a number of other troubled private enterprises, including Citigroup and General Motors. In all these cases, the government stake was seen as nothing more than a short-term action designed to stave off economic collapse by injecting capital into troubled enterprises in highly unusual circumstances. As soon as it was able to, the government sold these stakes. In early 2010, for example, the U.S. government sold its stake in Citigroup. The government stake in AIG was sold off in 2012, and by 2014, it had also disposed of its stake in GM.

In some mixed economies, such as China, the state uses its control of state-owned enterprises to further its industrial policy, promoting the development of public *and* private sectors it believes to be important for the future economic development of the nation. For example, state-owned banks in China have made loans at below-market interest rates to private enterprises in the technology sector (such as the telecommunications equipment provider Huawei) as part of a strategy to turn China into a major provider of information technology. Advocates of market-based economic systems see this as a risky strategy. They believe government bureaucrats are ill-equipped to pick winners and losers. They argue that politicians lack the expertise to make industrial investment choices and are vulnerable to political considerations and lobbying efforts when doing so, which can distort market outcomes. Free market advocates believe that investment decisions are best left to the private sector. In contrast, those who advocate the state making investments in support of industrial policy point to the notable successes of the strategy as exemplified by Huawei in China and Airbus in Europe, both of which have received substantial state support (although state support for Airbus has declined significantly in recent decades). It must be said though, for every success there may be many failures.

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Legal Systems

LO2-3
Understand how the legal systems of countries differ.

The **legal system** of a country refers to the rules, or laws, that regulate behavior along with the processes by which the laws are enforced and through which redress for grievances is obtained. The legal system of a country is of immense importance to international business. A country's laws regulate business practice, define the manner in which business transactions are to be executed, and set down the rights and obligations of those involved in business transactions. The legal environments of countries differ in significant ways. As we shall see, differences in legal systems can affect the attractiveness of a country as an investment site or market.

Like the economic system of a country, the legal system is influenced by the prevailing political system (although it is also strongly influenced by historical tradition). The government of a country defines the legal framework within which firms do business, and often the laws that regulate business reflect the rulers' dominant political ideology. For example, collectivist-inclined totalitarian states tend to enact laws that severely restrict private enterprise, whereas the laws enacted by governments in democratic states where individualism is the dominant political philosophy tend to be pro-private enterprise and pro-consumer.

Here, we focus on several issues that illustrate how legal systems can vary—and how such variations can affect international business. First, we look at some basic differences in legal systems. Second, we look at contract law. Third, we look at the laws governing property rights with particular reference to patents, copyrights, and trademarks. Then we discuss protection of intellectual property. Finally, we look at laws covering product safety and product liability.

DIFFERENT LEGAL SYSTEMS

There are three main types of legal systems—or legal traditions—in use around the world: common law, civil law, and theocratic law.

Common Law

The common law system evolved in England over hundreds of years. It is now found in most of Great Britain's former colonies, including the United States. **Common law** is based on tradition, precedent, and custom. *Tradition* refers to a country's legal history, *precedent* to cases that have come before the courts in the past, and *custom* to the ways in which laws are applied in specific situations. When law courts interpret common law, they do so with regard to these characteristics. This gives a common law system a degree of flexibility that other systems lack. Judges in a common law system have the power to interpret the law so that it applies to the unique circumstances of an individual case. In turn, each new interpretation sets a precedent that may be followed in future cases. As new precedents arise, laws may be altered, clarified, or amended to deal with new situations.

Civil Law

A **civil law system** is based on a detailed set of laws organized into codes. When law courts interpret civil law, they do so with regard to these codes. More than 80 countries—including Germany, France, Japan, and Russia—operate with a civil law system. A civil law system tends to be less adversarial than a common law system because the judges rely on detailed legal codes rather than interpreting tradition, precedent, and custom. Judges under a civil law system have less flexibility than those under a common law system. Judges in a common law system have the power to interpret the law, whereas judges in a civil law system have the power only to apply the law.

Theocratic Law

A **theocratic law system** is one in which the law is based on religious teachings. Islamic law is the most widely practiced theocratic legal system in the modern world, although usage of both Hindu and Jewish law persisted into the twentieth century. Islamic law is primarily a moral rather than a commercial law and is intended to govern all aspects of life.[7] The foundation for Islamic law is the holy book of Islam, the Koran, along with the Sunnah, or decisions and sayings of the Prophet Muhammad, and the writings of Islamic scholars who have derived rules by analogy from the principles established in the Koran and the Sunnah. Because the Koran and Sunnah are holy documents, the basic foundations of Islamic law cannot be changed. However, in practice, Islamic jurists and scholars are constantly debating the application of Islamic law to the modern world. In reality, many Muslim countries have legal systems that are a blend of Islamic law and a common or civil law system.

Although Islamic law is primarily concerned with moral behavior, it has been extended to cover certain commercial activities. An example is the payment or receipt of interest, which is considered usury and outlawed by the Koran. To the devout Muslim, acceptance of interest payments is seen as a grave sin; the giver and the taker are equally damned. This is not just a matter of theology; in several Islamic states, it has also become a matter of law. In the 1990s, for example, Pakistan's Federal Shariat Court, the highest Islamic lawmaking body in the country, pronounced interest to be un-Islamic and therefore illegal and demanded that the government amend all financial laws accordingly. In 1999, Pakistan's Supreme Court ruled that Islamic banking methods should be used in the country after July 1, 2001.[8] By the late 2000s, there were some 500 Islamic financial institutions in the world, and as of 2016, they collectively managed more than $2 trillion in assets. In addition to Pakistan, Islamic financial institutions are found in many of the Gulf states, Egypt, Malaysia, and Iran.[9]

DIFFERENCES IN CONTRACT LAW

The difference between common law and civil law systems can be illustrated by the approach of each to contract law (remember, most theocratic legal systems also have elements of common or civil law). A **contract** is a document that specifies the conditions under which an exchange is to occur and details the rights and obligations of the parties involved. Some form of contract regulates many business transactions. **Contract law** is the body of law that governs contract enforcement. The parties to an agreement normally resort to contract law when one party feels the other has violated either the letter or the spirit of an agreement.

Because common law tends to be relatively ill specified, contracts drafted under a common law framework tend to be very detailed with all contingencies spelled out. In civil law systems, however, contracts tend to be much shorter and less specific because many of the issues are already covered in a civil code. Thus, it is more expensive to draw up contracts in a common law jurisdiction, and resolving contract disputes can be very adversarial in common law systems. But common law systems have the advantage of greater flexibility and allow judges to interpret a contract dispute in light of the prevailing situation. International businesses need to be sensitive to these differences; approaching a contract dispute in a state with a civil law system as if it had a common law system may backfire, and vice versa.

When contract disputes arise in international trade, there is always the question of which country's laws to apply. To resolve this issue, a number of countries, including the United States, have ratified the **United Nations Convention on Contracts for the International Sale of Goods (CISG)**. The CISG establishes a uniform set of rules governing certain aspects of the making and performance of everyday commercial contracts between sellers and buyers who have their places of business in different nations. By adopting the CISG, a nation signals to other adopters that it will treat the convention's rules as part of its law. The CISG applies automatically to all contracts for the sale of goods between different firms based in countries that have ratified the convention, unless the parties to the contract explicitly opt out. One problem with the CISG, however, is that as of 2020, only 93 nations had ratified the convention (the CISG went into effect in 1988).[10] Some of the world's important trading nations, including India and the United Kingdom, have not ratified the CISG.

When firms do not wish to accept the CISG, they often opt for arbitration by a recognized arbitration court to settle contract disputes. The most well known of these courts is the International Court of Arbitration of the International Chamber of Commerce in Paris, which handles more than 500 requests per year from more than 100 countries.[11]

PROPERTY RIGHTS AND CORRUPTION

In a legal sense, the term *property* refers to a resource over which an individual or business holds a legal title, that is, a resource that it owns. Resources include land, buildings, equipment, capital, mineral rights, businesses, and intellectual property (ideas, which are protected by patents, copyrights, and trademarks). **Property rights** refer to the legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.[12] Countries differ in the extent to which their legal systems define and protect property rights. Almost all countries now have laws on their books that protect property rights. Even China, still nominally a communist state despite its booming mixed economy, finally enacted a law to protect the rights of private property holders in 2007 (the law gives individuals the same legal protection for their property as the state has). The law was strengthened again in 2016 to offer further protection for land and intellectual property, in part because innovation is increasing in China and many local firms have argued that they need stronger property rights to protect their innovations.[13] However, in many countries these laws are not enforced by the authorities, and property rights are violated. Property rights can be violated in two ways: through private action and through public action.

Private Action

In terms of violating property rights, **private action** refers to theft, piracy, blackmail, and the like by private individuals or groups. Although theft occurs in all countries, a weak legal system allows a much higher level of criminal action. For example, in the chaotic period following the collapse of communism in Russia, an outdated legal system, coupled with a weak police force and judicial system, offered both domestic and foreign businesses scant protection from blackmail by the "Russian Mafia." Successful business owners in Russia often had to pay "protection money" to the Mafia or face violent retribution, including bombings and assassinations (about 500 contract killings of businessmen occurred per year in the 1990s).[14]

Russia is not alone in having organized crime problems (and the situation in Russia has improved since the 1990s). The Mafia has a long history in the United States (Chicago in the 1930s was similar to Moscow in the 1990s). In Japan, the local version of the Mafia, known as the *yakuza,* runs protection rackets, particularly in the food and entertainment industries.[15] However, there was a big difference between the magnitude of such activity in Russia in the 1990s and its limited impact in Japan and the United States. The difference arose because the legal enforcement apparatus, such as the police and court system, was weak in Russia following the collapse of communism. Many other countries from time to time have had problems similar to or even greater than those experienced by Russia.

Public Action and Corruption

Public action to violate property rights occurs when public officials, such as politicians and government bureaucrats, extort income, resources, or the property itself from property holders. This can be done through legal mechanisms such as levying excessive taxation, requiring expensive licenses or permits from property holders, taking assets into state ownership without compensating the owners, or redistributing assets without compensating the prior owners. It can also be done through illegal means, or corruption, by demanding bribes from businesses in return for the rights to operate in a country, industry, or location.[16]

Corruption has been well documented in every society, from the banks of the Congo River to the palace of the Dutch royal family, from Japanese politicians to Brazilian bankers, and from government officials in Zimbabwe to the New York City Police Department. The government of the late Ferdinand Marcos in the Philippines was famous for demanding bribes from foreign businesses wishing to set up operations in that country. The same was true of government officials in Indonesia under the rule of former President Suharto. No society is immune to corruption. However, there are systematic differences in the extent of corruption. In some countries, the rule of law minimizes corruption. Corruption is seen and treated as illegal, and when discovered, violators are punished by the full force of the law. In other countries, the rule of law is weak and corruption by bureaucrats and politicians is rife. Corruption is so endemic in some countries that politicians and bureaucrats regard it as a perk of office and openly flout laws against corruption. This seems to have been the case in Brazil until recently; the situation there may be evolving in a more positive direction.

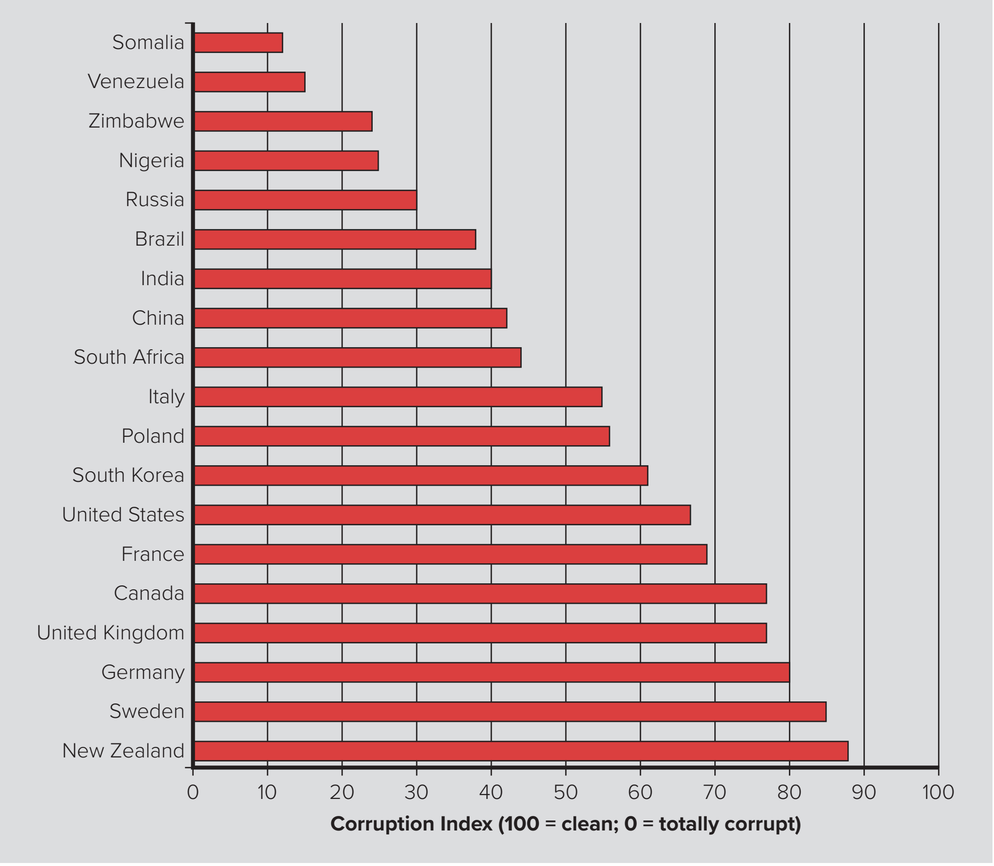
According to Transparency International, an independent nonprofit organization dedicated to exposing and fighting corruption, businesses and individuals spend some $400 billion a year worldwide on bribes related to government procurement contracts alone.[17] Transparency International has also measured the level of corruption among public officials in different countries.[18] As can be seen in Figure 2.1, the organization rated countries such as New Zealand and Sweden as clean; it rated others, such as Russia, Zimbabwe, and Venezuela, as corrupt. Somalia ranked last out of all 180 countries in the survey (the country is often described as a "failed state").

Economic evidence suggests that high levels of corruption significantly reduce the foreign direct investment, level of international trade, and economic growth rate in a country.[19] By siphoning off profits, corrupt politicians and bureaucrats reduce the returns to business investment and, hence, reduce the incentive of both domestic and foreign businesses to invest in that country. The lower level of investment that results hurts economic growth. Thus, we would expect countries with high levels of corruption such as Indonesia, Nigeria, and Russia to have a lower rate of economic growth than might otherwise have been the case. A detailed example of the negative effect that corruption can have on economic development is given in the accompanying Country Focus, which looks at the impact of corruption on economic growth in Brazil.

FIGURE 2.1

Rankings of corruption by country, 2020.

Source: Constructed by the author from raw data from Transparency International, Corruption Perceptions Index 2020.



Corruption in Brazil

Brazil is the seventh-largest economy in the world with a gross domestic product of $2 trillion. The country has a democratic government and an economy characterized by moderately free markets, although the country's largest oil producer (Petrobras) and one of its top banks (Banco do Brazil) are both state owned. Many economists, however, have long felt that the country has never quite lived up to its considerable economic potential. A major reason for this has been an endemically high level of corruption that favors those with political connections and discourages investment by more ethical businesses.

Transparency International, a nongovernmental organization that evaluates countries based on perceptions of how corrupt they are, ranked Brazil 105th out of the 180 countries it looked at in its 2018 report. The problems it identifies in Brazil include public officials who demand bribes in return for awarding government contracts and "influence peddling," in which elected officials use their position in government to obtain favors or preferential treatment. Consistent with this, according to a study by the World Economic Forum, Brazil ranks 135th out of 144 countries in the proper use of public funds.

Over the last decade, several corruption scandals have come to light that serve to emphasize Brazil's corruption problem. In 2005, a scandal known as the *mensalao* (the monthly payoff scandal) broke. The scandal started when a midlevel postal official was caught on film pocketing a modest bribe in exchange for promises to favor certain businesses in landing government contracts. Further investigation uncovered a web of influence peddling in which fat monthly payments were given to lawmakers willing to back government initiatives in National Congress. After a lengthy investigation, in late 2012 some 25 politicians and business executives were found guilty of crimes that included bribery, money laundering, and corruption.

The public uproar surrounding the *mensalao* scandal was just starting to die down when in March 2014 another corruption scandal captured the attention of Brazilians. This time it involved the state-owned oil company, Petrobras. Under a scheme that seems to have been operating since 1997, construction firms wanting to do business with Petrobras agreed to pay bribes to the company's executives. Many of these executives were themselves political appointees. The executives would inflate the value of contracts they awarded, adding a 3 percent "fee," which was effectively a kickback. The 3 percent fee was shared among Petrobras executives, construction industry executives, and politicians. The construction companies established shell companies to make payments and launder the money. According to prosecutors investigating the case, the total value of bribes may have exceeded $3.7 billion.

Four former Petrobras officials and at least 23 construction company executives have been charged with crimes that include corruption and money laundering. In addition, Brazil's Supreme Court has given prosecutors the go-ahead to investigate 48 current or former members of Congress, including the former Brazilian President Fernando Collor de Mello. The Brazilian president, Dilma Rousseff, was also tainted by the scandal. In June 2016, she was suspended from the presidency pending an impeachment trial. She was chair of Petrobras during the time this was occurring. She is also a member of the governing Workers' Party, several members of which seem to have been among the major beneficiaries of the kickback scandal. Although there is no evidence that Rousseff knew of the bribes or profited from them, her ability to govern effectively was severely damaged by association. The scandal so rocked Brazil that it pushed the country close to a recession. In August 2016, Rousseff was impeached and removed from the presidency. Then in 2018 the former Brazilian president, Lula da Silva, was found guilty of corruption. Among the charges against Lula were that, when president, he was given a beach-front apartment by an engineering firm in return for his help in winning lucrative contracts for Petrobras. Lula was sentenced to 12 years in prison.

If there is a bright spot in all of this, it is that the scandals are coming to light. Backed by Supreme Court rulings and public outrage, corrupted politicians, government officials, and business executives are being prosecuted. In the past, that was far less likely to occur.

Sources: W. Conners and L. Magalhaes, "Brazil Cracks Open Vast Bribery Scandal," *The Wall Street Journal,* April 7, 2015; M. Margolis, "In Brazil's Trial of the Century, Lula's Reputation Is at Stake," *Newsweek,* July 27, 2012; "The Big Oily," *The Economist,* January 3, 2015; D. Bowater, "Brazil's Continuing Corruption Problem," *BBC News,* September 18, 2015; S. Romero, "Dilma Rousseff Is Ousted as Brazil's President in Impeachment Vote," *The New York Times,* August 31, 2016; "Brazilian Corruption Scandals: All You Need to Know," *BBC News,* April 8, 2018.

MANAGEMENT FOCUS

Did Walmart Violate the Foreign Corrupt Practices Act?

In the early 2000s, Walmart wanted to build a new store in San Juan Teotihuacan, Mexico, barely a mile from ancient pyramids that drew tourists from around the world. The owner of the land was happy to sell to Walmart, but one thing stood in the way of a deal: the city's new zoning laws. These prohibited commercial development in the historic area. Not to be denied, executives at the headquarters of Walmart de Mexico found a way around the problem: They paid a $52,000 bribe to a local official to redraw the zoning area so that the property Walmart wanted to purchase was placed *outside* the commercial-free zone. Walmart then went ahead and built the store, despite vigorous local opposition, opening it in late 2004.

A former lawyer for Walmart de Mexico subsequently contacted Walmart executives at the company's corporate headquarters in Bentonville, Arkansas. He told them that Walmart de Mexico routinely resorted to bribery, citing the altered zoning map as just one example. Alarmed, executives at Walmart started their own investigation. Faced with growing evidence of corruption in Mexico, top Walmart executives decided to engage in damage control, rather than coming clean. Walmart's top lawyer shipped the case files back to Mexico and handed over responsibility for the investigation to the general council of Walmart de Mexico. This was an interesting choice as the very same general council was alleged to have authorized bribes. The general council quickly exonerated fellow Mexican executives, and the internal investigation was closed in 2006.

For several years nothing more happened; then, in April 2012, *The New York Times* published an article detailing bribery by Walmart. The *Times* cited the changed zoning map and several other examples of bribery by Walmart. For example, eight bribes totaling $341,000 enabled Walmart to build a Sam's Club in one of Mexico City's most densely populated neighborhoods without a construction license, an environmental permit, an urban impact assessment, or even a traffic permit. Similarly, thanks to nine bribe payments totaling $765,000, Walmart built a vast refrigerated distribution center in an environmentally fragile flood basin north of Mexico City, in an area where electricity was so scarce that many smaller developers were turned away.

Walmart responded to *The New York Times* article by ramping up a second internal investigation into bribery that it had initiated in 2011. By mid-2015, there were reportedly more than 300 outside lawyers working on the investigation, and it had cost more than $612 million in fees. In addition, the U.S. Department of Justice and the Securities and Exchange Commission both announced that they had started investigations into Walmart's practices. In November 2012, Walmart reported that its own investigation into violations had extended beyond Mexico to include China and India. Among other things, it was looking into the allegations by the *Times* that top executives at Walmart, including former CEO Lee Scott Jr., had deliberately squashed earlier investigations. In late 2016, people familiar with the matter stated that the federal investigation had not uncovered evidence of widespread bribery. In November 2017, it was reported that Walmart had settled with the Justice Department and paid a $283 million fine, significantly less than had been expected.

Sources: D. Barstow, "Vast Mexican Bribery Case Hushed Up by Wal-Mart after Top Level Struggle," *The New York Times,* April 21, 2012; S. Clifford and D. Barstow, "Wal-Mart Inquiry Reflects Alarm on Corruption," *The New York Times,* November 15, 2012; N. Vardi, "Why Justice Department Could Hit Wal-Mart Hard over Mexican Bribery Allegations," *Forbes,* April 22, 2012; P. Wahba, "Walmart Bribery Probe by Feds Finds No Major Misconduct in Mexico," *Fortune,* October 18, 2015; T. Schoenberg and M. Robinson, "Wal-Mart Balks at Paying $600 Million in Bribery Case," *Bloomberg,* October 6, 2016; S. Reisinger, "Wal-Mart Reserves $283 million to Settle Mexico FCPA Case," *Corporate Counsel,* November 17, 2017.

Foreign Corrupt Practices Act

In the 1970s, the United States passed the **Foreign Corrupt Practices Act (FCPA)** following revelations that U.S. companies had bribed government officials in foreign countries in an attempt to win lucrative contracts. This law makes it illegal to bribe a foreign government official to obtain or maintain business over which that foreign official has authority, and it requires all publicly traded companies (whether or not they are involved in international trade) to keep detailed records that would reveal whether a violation of the act has occurred. In 2012, evidence emerged that in its eagerness to expand in Mexico, Walmart may have run afoul of the FCPA (for details, see the Management Focus feature).

In 1997, trade and finance ministers from the member states of the Organisation for Economic Co-operation and Development (OECD), an association of 34 major economies including most Western economies (but not Russia, India or China), adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.[20] The convention obliges member states to make the bribery of foreign public officials a criminal offense.

Both the U.S. law and OECD convention include language that allows exceptions known as facilitating or expediting payments (also called *grease payments* or *speed money*), the purpose of which is to expedite or to secure the performance of a routine governmental action.[21] For example, they allow small payments made to speed up the issuance of permits or licenses, process paperwork, or just get vegetables off the dock and on their way to market. The explanation for this exception to general antibribery provisions is that while grease payments are, technically, bribes, they are distinguishable from (and, apparently, less offensive than) bribes used to obtain or maintain business because they merely facilitate performance of duties that the recipients are already obligated to perform.

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THE PROTECTION OF INTELLECTUAL PROPERTY

Intellectual property refers to property that is the product of intellectual activity, such as computer software, a screenplay, a music score, or the chemical formula for a new drug. Patents, copyrights, and trademarks establish ownership rights over intellectual property. A **patent** grants the inventor of a new product or process exclusive rights for a defined period to the manufacture, use, or sale of that invention. **Copyrights** are the exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit. **Trademarks** are designs and names, officially registered, by which merchants or manufacturers can differentiate their products (e.g., Christian Dior clothes). In the high-technology "knowledge" economy of the twenty-first century, intellectual property has become an increasingly important source of economic value for businesses. Protecting intellectual property has also become increasingly problematic, particularly if it can be rendered in a digital form and then copied and distributed at very low cost over the internet (e.g., computer software, music, and video recordings).[22]

The philosophy behind intellectual property laws is to reward the originator of a new invention, book, musical record, clothes design, restaurant chain, and the like for his or her idea and effort. Such laws stimulate innovation and creative work. They provide an incentive for people to search for novel ways of doing things, and they reward creativity. For example, consider innovation in the pharmaceutical industry. A patent will grant the inventor of a new drug a 20-year monopoly in production of that drug. This gives pharmaceutical firms an incentive to undertake the expensive, difficult, and time-consuming basic research required to generate new drugs (it can cost $1 billion in R&D and take 12 years to get a new drug on the market). Without the guarantees provided by patents, companies would be unlikely to commit themselves to extensive basic research.[23]

The protection of intellectual property rights differs greatly from country to country. Although many countries have stringent intellectual property regulations on their books, the enforcement of these regulations has often been lax. This has been the case even among many of the 192 countries that are now members of the **World Intellectual Property Organization**, all of which have signed international treaties designed to protect intellectual property, including the oldest such treaty, the **Paris Convention for the Protection of Industrial Property**, which dates to 1883 and has been signed by more than 170 nations. Weak enforcement encourages the piracy (theft) of intellectual property. China and Thailand have often been among the worst offenders in Asia. Pirated computer software is widely available in China. Similarly, the streets of Bangkok, Thailand's capital, are lined with stands selling pirated copies of Rolex watches, Levi's jeans, DVDs, and computer software.

The computer software industry is an example of an industry that suffers from lax enforcement of intellectual property rights. A study published in 2012 suggested that violations of intellectual property rights cost personal computer software firms revenues equal to $63 billion a year.[24] According to the study's sponsor, the Business Software Alliance, a software industry association, some 42 percent of all software applications used in the world were pirated. One of the worst large countries was China, where the piracy rate ran at 77 percent and cost the industry more than $9.8 billion in lost sales, up from $444 million in 1995. The piracy rate in the United States was much lower at 19 percent; however, the value of sales lost was significant because of the size of the U.S. market.[25]

International businesses have a number of possible responses to violations of their intellectual property. They can lobby their respective governments to push for international agreements to ensure that intellectual property rights are protected and that the law is enforced. Partly as a result of such actions, international laws are being strengthened. As we shall see in Chapter 7, the most recent world trade agreement, signed in 1994, for the first time extends the scope of the General Agreement on Tariffs and Trade to cover intellectual property. Under the new agreement, known as the Trade-Related Aspects of Intellectual Property Rights (TRIPS), as of 1995 a council of the World Trade Organization is overseeing enforcement of much stricter intellectual property regulations. These regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years after the death of the author. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years of grace, and the very poorest have 10 years.[26] (For further details of the TRIPS agreement, see Chapter 7.)

In addition to lobbying governments, firms can file lawsuits on their own behalf. Firms may also choose to stay out of countries where intellectual property laws are lax, rather than risk having their ideas stolen by local entrepreneurs. Firms also need to be on the alert to ensure that pirated copies of their products produced in countries with weak intellectual property laws don't turn up in their home market or in third countries. For example, a few years ago U.S. computer software giant Microsoft discovered that pirated Microsoft software, produced illegally in Thailand, was being sold worldwide as the real thing.

PRODUCT SAFETY AND PRODUCT LIABILITY

Product safety laws set certain safety standards to which a product must adhere. **Product liability** involves holding a firm and its officers responsible when a product causes injury, death, or damage. Product liability can be much greater if a product does not conform to required safety standards. Both civil and criminal product liability laws exist. Civil laws call for payment and monetary damages. Criminal liability laws result in fines or imprisonment. Both civil and criminal liability laws are probably more extensive in the United States than in any other country, although many other Western nations also have comprehensive liability laws. Liability laws are typically the least extensive in less developed nations. A boom in product liability suits and awards in the United States resulted in a dramatic increase in the cost of liability insurance. Many business executives argue that the high costs of liability insurance make American businesses less competitive in the global marketplace.

In addition to the competitiveness issue, country differences in product safety and liability laws raise an important ethical issue for firms doing business abroad. When product safety laws are tougher in a firm's home country than in a foreign country or when liability laws are more lax, should a firm doing business in that foreign country follow the more relaxed local standards or should it adhere to the standards of its home country? While the ethical thing to do is undoubtedly to adhere to home-country standards, firms have been known to take advantage of lax safety and liability laws to do business in a manner that would not be allowed at home.

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360° View: Managerial Implications

LO2-4

Explain the implications for management practice of national differences in political economy.

THE MACRO ENVIRONMENT INFLUENCES MARKET ATTRACTIVENESS

The material discussed in this chapter has two broad implications for international business. First, the political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business. For example, what ethical implications are associated with doing business in totalitarian countries where citizens are denied basic human rights, corruption is rampant, and bribes are necessary to gain permission to do business? Is it right to operate in such a setting? A full discussion of the ethical implications of country differences in political economy is reserved for Chapter 5, where we explore ethics in international business in much greater depth.

Second, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. The benefits, costs, and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. The overall attractiveness of a country as a market or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Because this chapter is the first of two dealing with issues of political economy, we will delay a detailed discussion of how political economy impacts the benefits, costs, and risks of doing business in different nation-states until the end of the next chapter, when we have a full grasp of all the relevant variables that are important for assessing benefits, costs, and risks.

For now, other things being equal, a nation with democratic political institutions, a market-based economic system, and strong legal system that protects property rights and limits corruption is clearly more attractive as a place in which to do business than a nation that lacks democratic institutions, where economic activity is heavily regulated by the state, and where corruption is rampant and the rule of law is not respected. On this basis, for example, a country like Canada is a better place in which to do business than the Russia of Vladimir Putin (see the Country Focus: Putin's Russia). That being said, the reality is often more nuanced and complex. For example, China lacks democratic institutions; corruption is widespread; property rights are not always respected; and even though the country has embraced many market-based economic reforms, there are still large numbers of state-owned enterprises—yet many Western businesses feel that they must invest in China. They do so despite the risks because the market is large, the nation is moving toward a market-based system, economic growth has been strong (although growth rates there have slowed down significantly since 2015), legal protection of property rights has been improving, and China is already the second-largest economy in the world and could ultimately replace the United States as the world's largest. Thus, China is becoming increasingly attractive as a place in which to do business, and given the future growth trajectory, significant opportunities may be lost by not investing in the country. We will explore how changes in political economy affect the attractiveness of a nation as a place in which to do business in Chapter 3.

Key Terms

SUMMARY

This chapter has reviewed how the political, economic, and legal systems of countries vary. The potential benefits, costs, and risks of doing business in a country are a function of its political, economic, and legal systems. The chapter made the following points:

1. Political systems can be assessed according to two dimensions: the degree to which they emphasize collectivism as opposed to individualism, and the degree to which they are democratic or totalitarian.
2. Collectivism is an ideology that views the needs of society as being more important than the needs of the individual. Collectivism translates into an advocacy for state intervention in economic activity and, in the case of communism, a totalitarian dictatorship.
3. Individualism is an ideology that is built on an emphasis of the primacy of the individual's freedoms in the political, economic, and cultural realms. Individualism translates into an advocacy for democratic ideals and free market economics.
4. Democracy and totalitarianism are at different ends of the political spectrum. In a representative democracy, citizens periodically elect individuals to represent them, and political freedoms are guaranteed by a constitution. In a totalitarian state, political power is monopolized by a party, group, or individual, and basic political freedoms are denied to citizens of the state.
5. There are three broad types of economic systems: a market economy, a command economy, and a mixed economy. In a market economy, prices are free of controls, and private ownership is predominant. In a command economy, prices are set by central planners, productive assets are owned by the state, and private ownership is forbidden. A mixed economy has elements of both a market economy and a command economy.
6. Differences in the structure of law between countries can have important implications for the practice of international business. The degree to which property rights are protected can vary dramatically from country to country, as can product safety and product liability legislation and the nature of contract law.

Critical Thinking and Discussion Questions

1. Free market economies stimulate greater economic growth, whereas state-directed economies stifle growth. Discuss.
2. A democratic political system is an essential condition for sustained economic progress. Discuss.
3. What is the relationship between corruption in a country (i.e., government officials taking bribes) and economic growth? Is corruption always bad?
4. You are the CEO of a company that has to choose between making a $100 million investment in Russia or Poland. Both investments promise the same long-run return, so your choice is driven by risk considerations. Assess the various risks of doing business in each of these nations. Which investment would you favor and why?
5. Read the Management Focus, "Did Walmart Violate the Foreign Corrupt Practices Act?" What is your opinion? If you think it did, what do you think the consequences will be for Walmart?

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1. The definition of words and political ideas can have different meanings in different contexts worldwide. In fact, the *Freedom in the World* survey published by Freedom House evaluates the state of political rights and civil liberties around the world. Provide a description of this survey and a ranking (in terms of "freedom") of the world's country leaders and laggards. What factors are taken into consideration in this survey?
2. As the chapter discusses, differences in political, economic, and legal systems have considerable impact on the benefits, costs, and risks of doing business in various countries. The World Bank's "Doing Business Indicators" measure the extent of business regulations in countries around the world. Compare Brazil, Ghana, India, New Zealand, the United States, Sweden, and Turkey in terms of how easily contracts are enforced, how property can be registered, and how investors can be protected. Identify in which area you see the greatest variation from one country to the next.

CLOSING CASE

China's Mixed Economy

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Back in the 1950s, China was a one-party state ruled by the Communist Party. Private enterprise was banned, economic activity was dictated by central planning, and state-owned enterprises played a dominant role in the country's industrialization. This Marxist model failed to deliver economic gains and, beginning in the late 1970s, the communist government gradually began to launch market-oriented reforms. These reforms accelerated throughout the 1980s and 1990s. They included the removal of price controls, the privatization or liquidation of many smaller state-owned enterprises, the growth of the private sector, the development of stock markets, and the opening up of the economy to international trade and inward investment by foreign multinationals. The reforms helped to make China one of the fastest-growing economies in the world, with gross domestic product (GDP) increasing more than tenfold between 1978 and 2018. By 2020, China was the world's second-largest economy behind the United States, measured by nominal GDP, and the world's largest measured by GDP on a purchasing power parity basis.

Today, China remains a one-party state ruled by the Communist Party, but it now operates with what is essentially a mixed economy, comprised of a vibrant private sector and a significant state-owned sector. The Chinese refer to this as a "socialist market economy." Major multinational tech companies such as Alibaba, Tencent, Baidu, and Huawei have come to symbolize the country's private sector. However, the country still has a significant number of large state-owned enterprises. According to a study by the World Bank, in 2017 state-owned enterprises accounted for 27.5 percent of the country's GDP. State-owned enterprises are concentrated in certain sectors. In banking, they account for an estimated 88 percent of value added, in transportation and postal services 77 percent, in construction 38 percent, in wholesale and retail activates 37 percent, and in manufacturing industry around 21 percent. On the other hand, state-owned enterprises account for less than 10 percent of value added in information technology, hotel and catering, and agriculture, among other sectors.

China has used its state-owned enterprises in a strategic manner to help drive economic growth, combining the invisible hand of the market with the visible hand of the state. This is most evident in areas such as infrastructure, where state-owned enterprises have been at the forefront of building the country's rail and road networks, its shipping ports and airports, and its high-speed wireless networks. It is also an obvious factor in heavy industries such as steel, where three of the largest five producers are state owned, or automobiles, where the top four companies are state owned.

Less obviously, the state has also helped foster the development of private enterprises in certain sectors. For example, research by *The Wall Street Journal* suggests that Huawei, a private company and China's largest vendor of telecommunications equipment, may have received as much as $75 billion in state support in the form of grants, cheap land, credit facilities, low-interest rate loans, and tax breaks since 1995. China's large state-owned banks have been a major conduit through which the state has funneled supported to Huawei. China Development Bank and the Export-Import Bank of China, both state-owned banks, have reportedly made available more than $30 billion in credit lines for Huawei's customers since 2000. All of this support has helped Huawei offer generous financing terms to its customers, undercutting the prices of its rivals by as much as 30 percent and powering Huawei to the top rank of global telecommunications companies. For comparison, Huawei's largest competitor, Cisco Systems, received $44.5 million in state and federal subsidies, loans, guarantees, grants, and assistance since 2000.

The proactive role of the state in China's enterprises has certainly created some problems. Numerous studies have shown that China's state-owned enterprises are less productive than private-sector business, no matter how much support they receive from the state. China's subsidization of both state-owned enterprises, such as the steel companies, and private companies such as Huawei, have also created tensions with the country's major trading partners, and most notably the United States. The Obama administration argued that the state-subsidized steel sector was dumping excess steel production on world markets and slapped punitive tariffs on Chinese steel imports. The Trump administration took this approach further, launching an all-out trade war with China and imposing limits on the ability of companies like Huawei (which the administration feared is an arm of the Chinese state) from doing business in the United States. There are signs this confrontational approach is starting to bite. China's economic growth rate has slowed significantly in the last 8 years from around 10 percent to 6.1 percent in 2019. To date though, there are few signs that the Chinese government is willing to pull back from its state-directed mixed private-/state-owned economic model.

Case Discussion Questions

1. How would you describe China's economy prior to the market-based reforms of the 1980s and 1990s. This system failed to deliver rising living standards to the bulk of China's population. Why?
2. How would you describe China's current economic system? What are the benefits of this system? What are the potential drawbacks?
3. Would China be better or worse off, economically, if it privatized more of its substantial state-owned sector?
4. Do you think the Chinese enterprises that received substantial funds at below-market interest rates from state-owned banks, such as Huawei, should be allowed to compete in international markets against private companies that received no such assistance? What policy remedies, if any, would you suggest here?

Sources: H. Fan, "The Long March to the Mixed Economy in China," *East Asia Forum,* February 9, 2015; Y. Huang, "China Has a Big Economic Problem, and It Isn't the Trade War," *The New York Times,* January 17, 2020; C. Yap, "State Support Helped Fuel Huawei's Global Rise," *The Wall Street Journal,* December 25, 2019; C. Zang, "How Much Do State Owned Enterprises Contribute to China's GDP and Employment?" *World Bank,* July 15, 2019.

Endnotes

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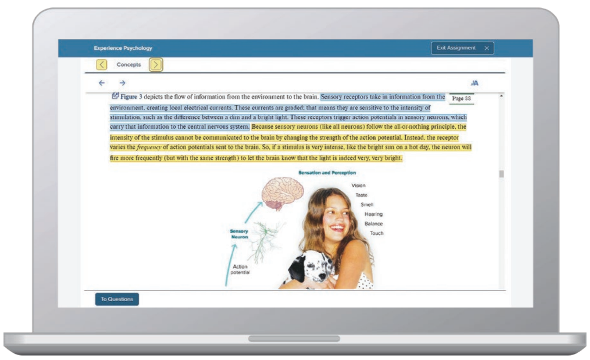

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Education For All

Affordability & Outcomes

Education For All

“The meaning of access has evolved...**it includes not just getting on a path, but staying on that path** and achieving success, including graduation and economic mobility.”

Everyone deserves support on their path to an education of value.

An education that opens doors, expands possibilities, and helps propel us all forward.

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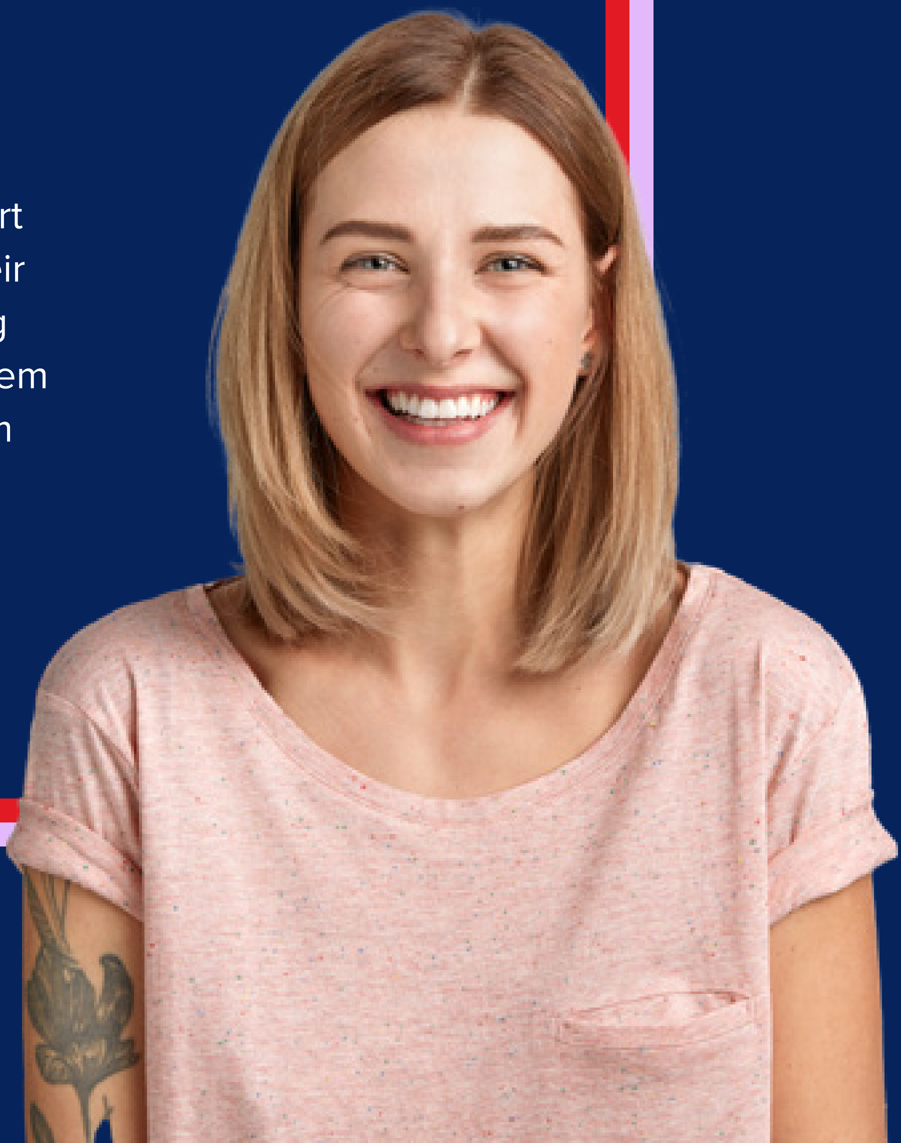
We've been working hard to change that, to make real progress. But our job is not done yet. We need to support every person throughout their educational journey, creating equitable paths that meet them where they are, and set them up to succeed.



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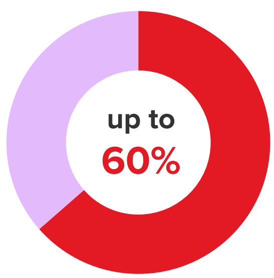
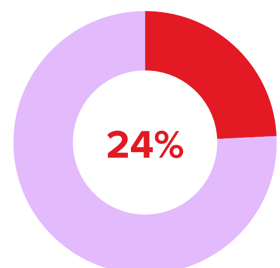
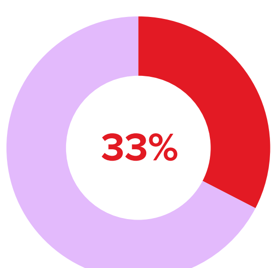


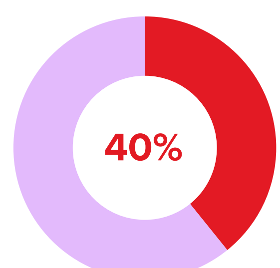
There is a 24% gap in the completion of a college-level credential by African American and indigenous students compared to White students.



The probability of first-generation students dropping out of school within 3 years is 33%, compared to students whose parents have a bachelor's degree – 14%.



40% of undergraduate students with disabilities graduated with a bachelor's degree within 6 years, compared to 57% of students without disabilities.



We strive for education that is within reach for everyone — an education that works for everyone.

Education for all — at McGraw Hill, we're all in.

Clearing paths so learners can move forward. Ensuring that learning fits the unique needs of every student so each can achieve success.

That's why we haven't stopped advocating for over 130 years...

For trusted, high-quality content created with world- class authors. For learning that is affordable without compromise. For evidence-based tools, creating better outcomes in and out of the classroom.

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When we all advocate for an education of value, we make education valuable for all.

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Here's how we're working on it:

Trusted and vetted content
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Affordable choices
Variety of affordable content formats and platforms that offer instructors flexibility, and keep students engaged.

Inclusive Access
Delivering digital learning resources to students, at a significantly reduced cost, on day 1 of classes.

Best-in-class technology
Secure, easy-to-use, integrated technology that allows educators to save their time and enhance their impact.

Inclusive Access

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McGraw Hill's Inclusive Access is in place at over 1,400 institutions, resulting in over $500M in student savings.

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Equity for Each

Together, we can work towards leveling the playing field.

Here's how we're working on it:

Personalized learning platforms
Create individual paths and address different learner preparedness levels.

Accessibility features
Help meet the needs of all learners with various assistive technologies.

Analytics, data, and insights
Help educators track individual student progress and provide targeted support.

Commitment to diversity, equity and inclusion
Reflected in our content, products, marketing and culture.

Our products support all learners

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Resources, engagement tools, and assessments that help instructors build their courses in a way that works for them.

Integrated personalized reading experience focusing on learning gaps and ensuring that the time spent studying, is time well-spent.

McGraw Hill ALEKS®

Constructive learning paths for each student to provide equitable support and structure.

McGraw Hill ALEKS® PPL

Adaptive placement assessment with a personalized remediation tool for students.

Working Together

We support you every step of the way, bringing together a community to help you work towards your goals.

Here's how we're working on it:

Course-building support
Customized training, course design, and implementation consultation to support instructors at every step.

Peer-to-peer support
Network of Digital Faculty Consultants and Online Learning Consortium certified instructors to provide peer-to-peer support.

24/7 product support
Customer service and self-serve support for educators and students offering the right guidance, right when they need it.

Professional development resources
Resources, articles, and thought leadership that support instructors with best practices, inspiration, and experiences from the community.

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What drives us, like you, is to help deliver an education that works for the real world – an education that makes you proud.

Here's how we're working on it:

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Content and assessment formats that help develop student success skills such as critical thinking and effective communication.

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Platforms and content that have improved student performance, retention rates, and graduation rates.

After using Connect at The College of Health Care Professions, student retention rates rose between 2015–2017 from:

60% to 85%

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67% to 74%

The graduation and job placement rate for the same time frame rose from:

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Remote proctoring and browser locking capabilities seamlessly integrate within Connect to offer more control over the integrity of online assessments. Instructors can enable security options that restrict browser activity, monitor student behavior, and verify the identity of each student. Instant and detailed reporting gives instructors an at-a-glance view of potential academic integrity concerns, supported by evidence.

PACKAGES & PRICING

BASIC

Free

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- Video proctoring
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PLUS

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OPTIONS	BASIC FREE	PLUS $15
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Control level – Lenient	✓	✓
Control level – Moderate	✓	✓
Prevent the use of other monitors	✓	✓
Control level – Strict	✓	✓
30 seconds	✓	✓
15 seconds		✓
0 seconds		✓
Control content import or export		
Disable Clipboard	✓	✓
Disable Right-Click	✓	✓
Disable Printing	✓	✓
Block Downloads		✓
Prevent tampering		
Disable Other Browser Extensions		✓
REMOTE PROCTORING		
Record Video	✓	✓
Record Audio		✓
Record Screen		✓
Record Web Traffic		✓
Environment Scan		
Only at Start		✓
Intelligent		✓
VERIFICATION OPTIONS		
Verify Video		✓
Verify Audio		✓
Verify Desktop		✓
ID Verification (auto)		✓
Integrity Agreement		✓
TOOLS		
Calculator		✓
Whiteboard		✓

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Easy Set-Up Within Connect

Proctorio is easy to turn on within McGraw-Hill Connect® through the policy settings when creating an assessment. Instructors denote which level of proctoring and features to enable for students, and students will receive instructions upon entering the assessment. After the student finishes the proctored assessment, reporting will be available along with any settings the instructor enabled.

BROWSER LOCKING CAPABILITIES

Browser locking capabilities allow the instructor to control the assessment environment to increase the security during the assessment.

CONTROL ACCESS TO OTHER APPS AND WEBSITES
Controls whether students can access other tabs or programs

DISABLE CLIPBOARD
Blocks students from using copy, cut, and paste

DISABLE PRINTING
Prevents students from printing the assessment via keyboard shortcut or right-click and print

DISABLE EXTENSIONS
Prevents students from using other browser extensions

PREVENT THE USE OF OTHER MONITORS
Prevents students from having multiple monitors

DISABLE RIGHT-CLICK
Prevents students from right-clicking within the assessment window

BLOCK DOWNLOADS
Prevents students from downloading anything during the assessment

REMOTE PROCTORING

Recording Options settings control the information that is recorded during the exam, allowing the instructor to control the assessment environment.

RECORD VIDEO
Records video from the student's webcam

RECORD SCREEN
Records the student's screen

ENVIRONMENT SCAN
Records the student's environment

RECORD AUDIO
Records audio from the student's microphone

RECORD WEB TRAFFIC
Records the web pages the student visits

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Remote Proctoring & Verification

VERIFICATION OPTIONS

Verification options include settings that help ensure students are who they say they are, their hardware is working, and they are reminded of academic integrity policies.

VERIFY CAMERA
Ensures the webcam is properly working and the student's face is visible

VERIFY SCREEN
Ensures the student's screen is being correctly recorded

INTEGRITY AGREEMENT
Has the student digitally sign an integrity agreement before the assessment

VERIFY AUDIO
Ensures the student's audio is working

ID VERIFICATION
Aids the instructor to help authenticate the student's identity by having the student show an ID card that is automatically captured and stored

TOOLS

Tools that students can use during the assessment.

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