



Global Business Today 6e

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by Charles W.L. Hill

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Chapter 2

National Differences in Political Economy

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Introduction

Question: What is the political economy of a country?

- A country's **political economy** refers to its political, economic, and legal systems
- These systems are interdependent, and interact and influence each other
- A country's political system has major implications for the practice of international business

Political Systems

- A **political system** is the system of government in a nation
- Political systems can be assessed
 - in terms of the degree to which they emphasize collectivism as opposed to individualism
 - in terms of the degree to which they are democratic or totalitarian

Classroom Performance System

The political, economic and legal systems of a country are called

- a) Political systems
- b) Economic systems
- c) Legal systems
- d) Political economy

Collectivism and Individualism

- **Collectivism** refers to a system that stresses the primacy of collective goals over individual goals
 - Collectivism can be traced to the ancient Greek philosopher Plato
 - Today, socialists support collectivism
- When collectivism is emphasized, the needs of the society as whole are generally viewed as being more important than individual freedoms

Collectivism and Individualism

Socialism

- Modern socialists trace their roots to Karl Marx who advocated state ownership of the basic means of production, distribution, and exchange
- The state then manages the enterprises for the benefit of society as whole

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Collectivism and Individualism

- In the early 20th century, socialism split into communists and social democrats
 - Communists generally believed that collectivism could only be achieved through revolution and totalitarian dictatorship, while social democrats worked to achieve the same goals by democratic means
- Many state-owned enterprises failed to succeed, and today, many nations are implementing privatization programs whereby state-owned enterprises to private investors

Collectivism and Individualism

Individualism

- Individualism is a political philosophy that suggests individuals should have freedom over their economic and political pursuits
 - It can be traced to Aristotle who argued that individual diversity and private ownership are desirable
- Individualism stresses
 - individual freedom and self-expression
 - letting people pursue their own self-interests to achieve the best overall good for society
 - democratic systems and free markets

Classroom Performance System

Individuals who believe socialism can be achieved only through revolutions and totalitarian dictatorship are called

- a) Social democrats
- b) Communists
- c) Individualists
- d) Representative democrats

Democracy and Totalitarianism

Question: What is the difference between a democracy and totalitarianism?

- **Democracy** is 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 opposing political parties are prohibited

Democracy and Totalitarianism

- Generally, democracy and individualism go hand in hand
- The most common form of democracy today is **representative democracy**, where elected representatives vote on behalf of constituents

Democracy and Totalitarianism

- Collectivism and totalitarianism generally go hand in hand
- In most totalitarian regimes
 - there is widespread political repression
 - there are no free and fair elections
 - media is censored
 - basic civil liberties are denied
 - challenges to the regime are prohibited

Democracy and Totalitarianism

There are four major forms of totalitarianism today:

1. **communist totalitarianism**: advocates achieving socialism through totalitarian dictatorship
2. **theocratic totalitarianism**: political power is monopolized by a party, group, or individual that governs according to religious principles
3. **tribal totalitarianism**: a political party that represents the interests of a particular tribe monopolizes power
4. **right wing totalitarianism**: individual economic freedom is allowed but individual political freedom is restricted in the belief that it could lead to communism

Classroom Performance System

Which system emphasizes individual freedom and self-expression?

- a) Individualism
- b) Collectivism
- c) Theocratic totalitarianism
- d) Tribal totalitarianism

Economic Systems

- Political ideology and economic systems are connected
- There are three types of economic systems: the market economy, the command economy, and the mixed economy
- A free market system is likely in countries where individual goals are given primacy over collective goals
- State-owned enterprises and restricted markets are common in countries where collective goals are dominant

Market Economy

- In a pure **market economy** the goods and services that a country produces, and the quantity in which they are produced is determined by supply and demand
- Consumers, through their purchases, determine what is produced and in what quantity
- The role of government is to encourage free and fair competition between private producers

Command Economy

- In a pure **command economy** the goods and services that a country produces, the quantity in which they are produced, and the price at which they are sold are all planned by the government
- All businesses are state owned, and so have little incentive to control costs and be efficient
- Because there is no private ownership, there is little incentive to better serve consumer needs

Mixed Economy

- A **mixed economy** includes some elements of a market economy and some elements of a command economy
- Governments tend to take over troubled firms that are considered to be vital to national interests
- The number of mixed economies in the world today is falling

Classroom Performance System

Which of the following is not one of the three broad types of economic systems?

- a) Market economy
- b) Command economy
- c) Mixed economy
- d) Free economy

Legal Systems

- The **legal system** of a country refers to the rules, or laws, that regulate behavior, along with the processes by which the laws of a country are enforced and through which redress for grievances is obtained
- A country's legal system is important because
 - laws regulate business practice
 - laws define the manner in which business transactions are to be executed
 - laws set down the rights and obligations of those involved in business transactions

Different Legal Systems

There are three main types of legal systems:

1. **Common law** (based on tradition, precedent, and custom)
 - found in most of Great Britain's former colonies, including the United States
2. **Civil law** (based on a very detailed set of laws organized into codes)
 - found in over 80 countries, including Germany, France, Japan, and Russia
3. **Theocratic law** (based on religious teachings)
 - Islamic law is the most widely practiced

Differences in Contract Law

Question: How do common law and civil differ?

- The two systems approach **contract law** (the body of law that governs contract enforcement) in different ways
- 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
- In a common law state, contracts are very detailed with all contingencies spelled out
- In a civil law state, contracts are shorter and much less specific

Differences in Contract Law

Question: In a contract dispute, which country's laws should apply?

- The **United Nations Convention in Contracts for the International Sales of Goods (CIGS)** 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
- Countries that adopt CIGS signal to other nations that they will treat the Convention's rules as part of their law

Classroom Performance System

Which type of legal system is based on a very detailed set of laws organized into codes?

- a) Contract law
- b) Civil law
- c) Common law
- d) Theocratic law

Property Rights and Corruption

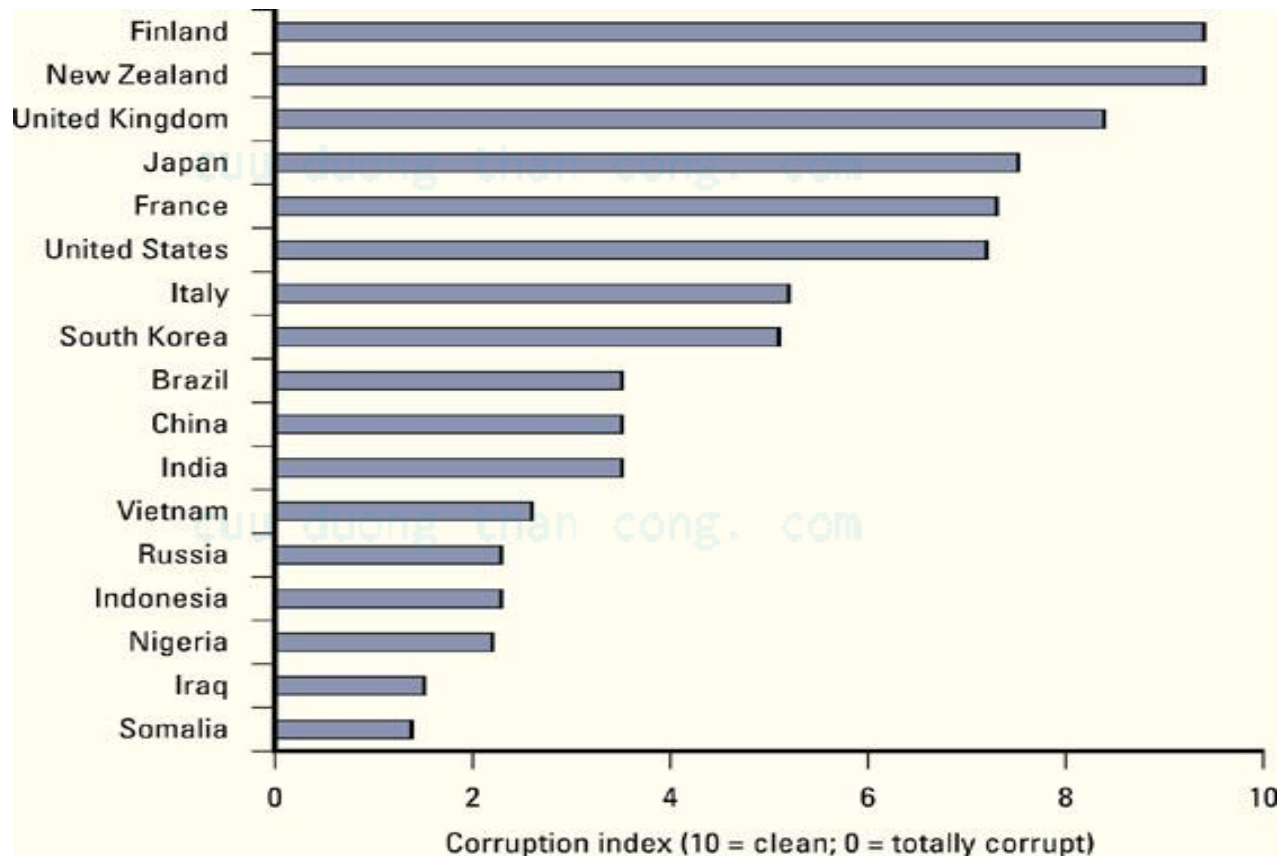
- **Property rights** (the legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource) are very important for the functioning of business
- Property rights can be violated
 - by **private action** (theft, piracy, blackmail, and the like by private individuals or groups)
 - by **public action** (when public officials extort income or resources from property holders using various legal mechanisms including excessive taxation, requiring expensive licenses or permits from property holders, or taking assets into state ownership without compensating the owners)

Property Rights and Corruption

- Corruption is present in all countries to some degree, however when a country has a high level of corruption
 - Foreign direct investment falls
 - International trade falls
 - Economic growth falls

Property Rights and Corruption

Rankings of Corruption by Country 2007



Foreign Corrupt Practices Act

- To limit corruption in the U.S., the **Foreign Corrupt Practices Act** was passed
- The Act makes it a violation of the United States' law to bribe a foreign government official in order to obtain or maintain business over which the foreign official has authority, and requires all publicly traded countries to keep detailed records so that it is clear whether a violation of the act has occurred
- The Act does allow facilitating or expediting payments for secure the performance of routine government actions

The Protection of Intellectual Property

- Intellectual property is property, such as computer software, a screenplay, or the chemical formula for a new drug, that is the product of intellectual activity

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The Protection of Intellectual Property

Intellectual property rights include

- **patents** (documents giving the inventor of a new product or process exclusive rights to the manufacture, use, or sale of that invention)
- **copyrights** (exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and dispose of their work as they see fit)
- **trademarks** (designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products)

The Protection of Intellectual Property

- The protection of intellectual property rights differs greatly from country to country
 - The Paris Convention for the Protection of Industrial Property is an agreement signed by 96 countries to protect intellectual property rights
 - The Trade Related Aspects of Intellectual Property Rights (TRIPS) requires WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years

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
 - Liability laws are usually least extensive in less developed countries
- Firms must decide whether to adhere to the standards of the home country or the standards of the host country

The Determinants of Economic Development

- A country's level of economic development affects its attractiveness as a possible market or production location for firms

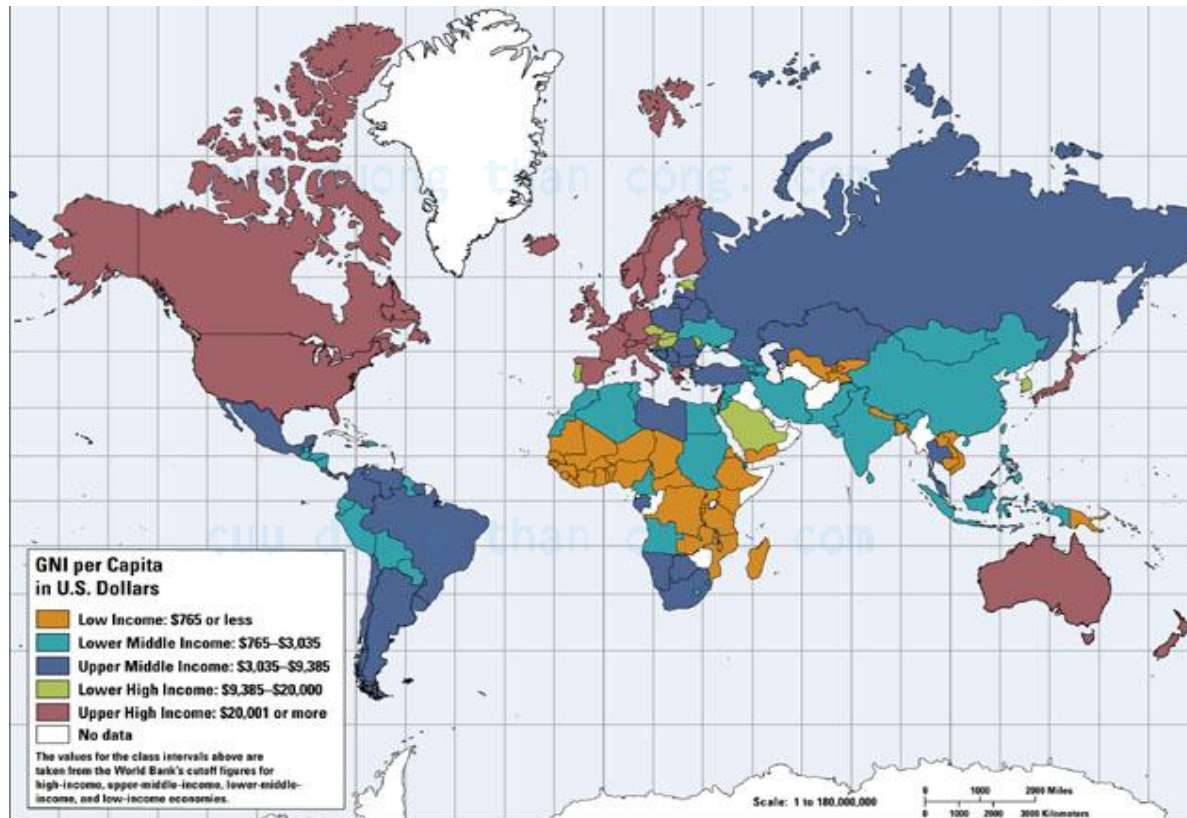
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Differences in Economic Development

- One common measure of economic development is a country's gross national income (GNI) per head of population
- A purchasing power parity (PPP) adjustment allows for a more direct comparison of living standards in different countries
- Because both GNI and PPP data only provide a static picture of development, it is also important to consider growth rates

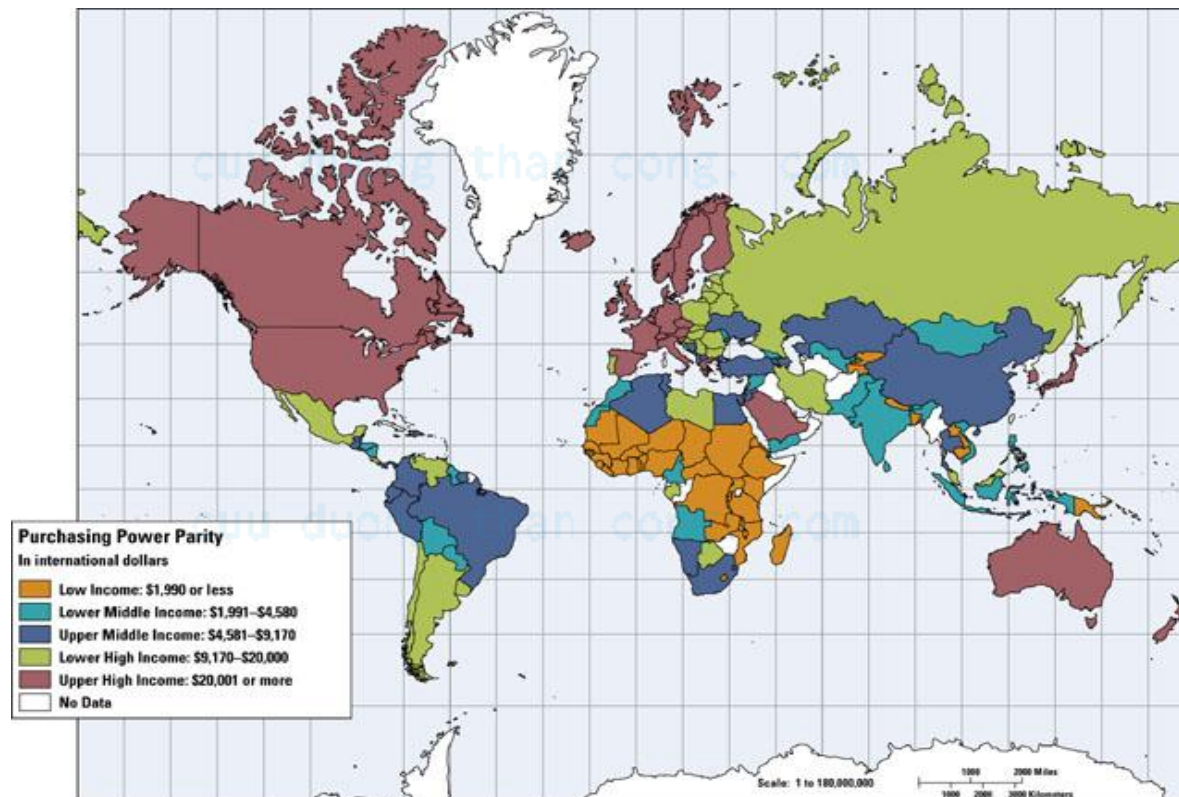
Differences in Economic Development

GNI per Capita, 2006



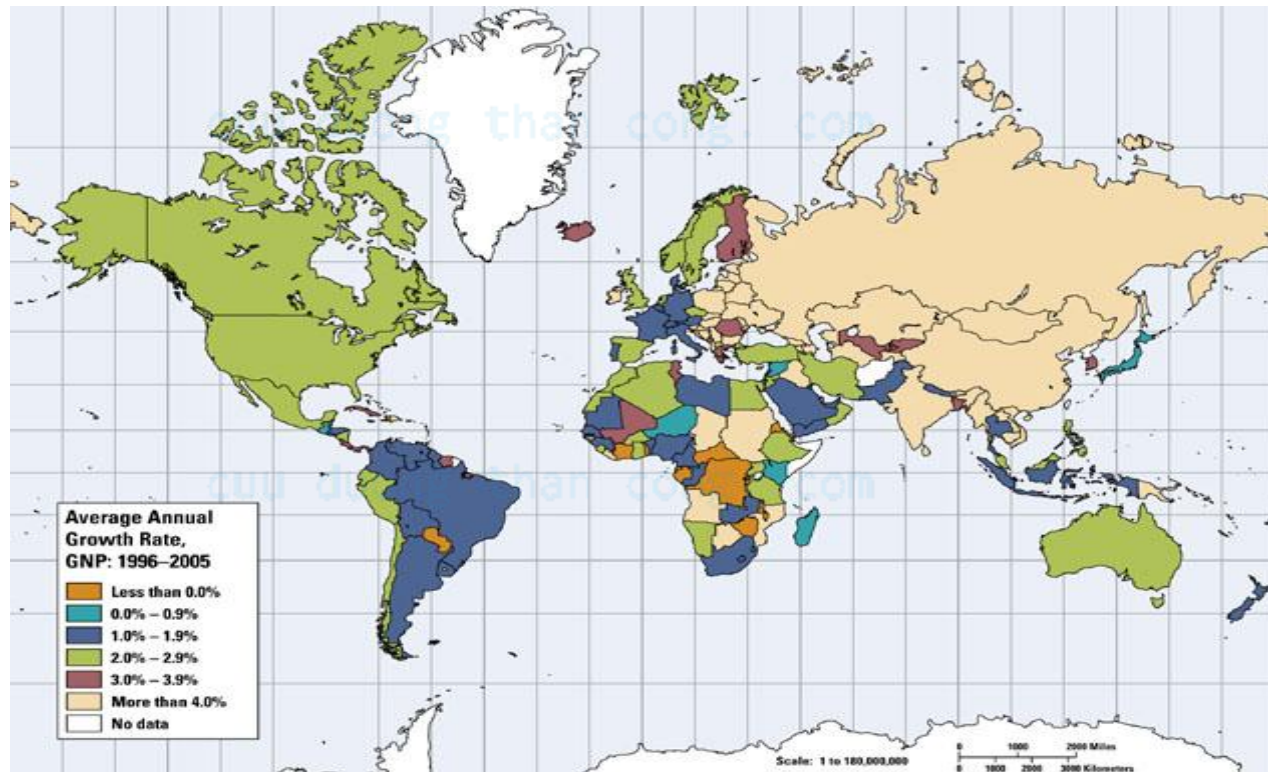
Differences in Economic Development

GNI PPP per Capita, 2006



Differences in Economic Development

Growth Rate in GDP per Capita, 1997 - 2006

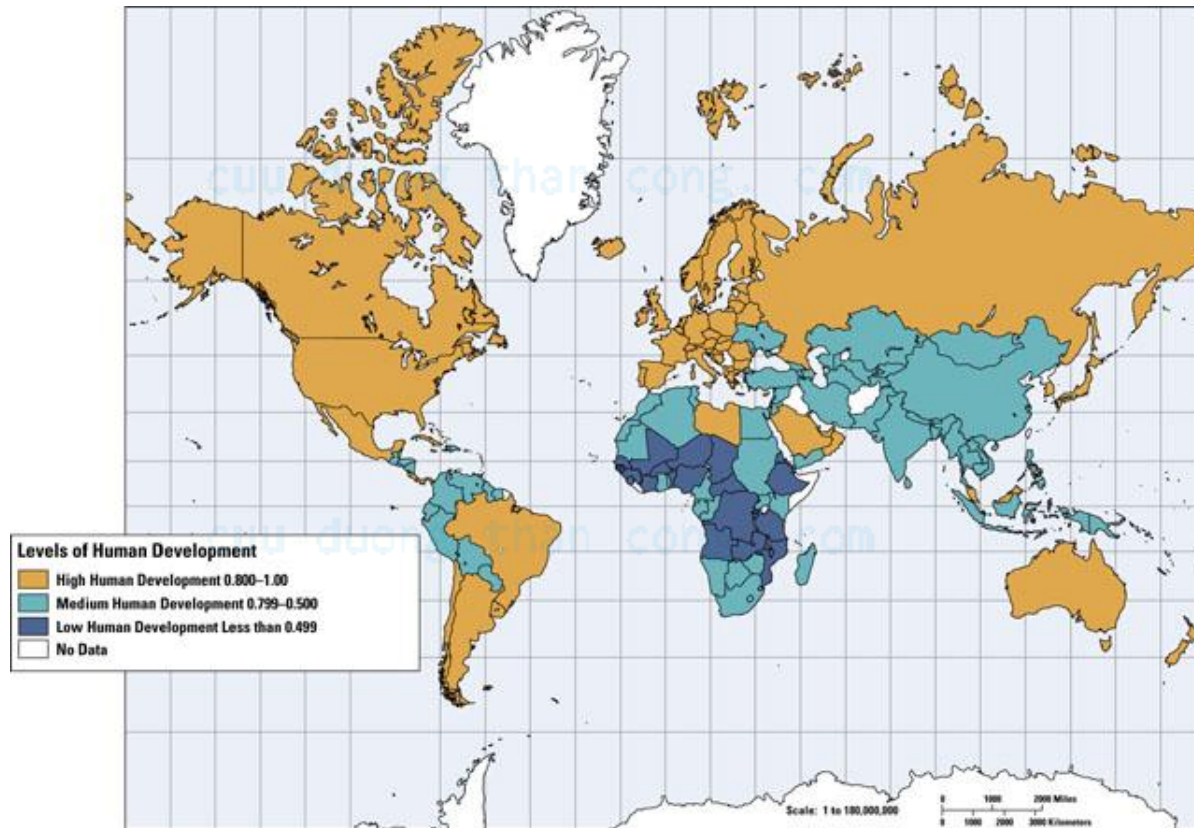


Broader Conceptions of Development: Amartya Sen

- Nobel Prize winning economist Amartya Sen argued that development should be assessed less by material output and more by the capabilities and opportunities that people enjoy
- To reflect Sen's ideas and gauge a country's economic development and likely future growth rate, the United Nations created the **Human Development Index** based on life expectancy, education attainment, and whether average incomes are sufficient to meet the basic needs of life in a country

Broader Conceptions of Development: Amartya Sen

Human Development Indicators, 2005



Political Economy and Economic Progress

Question: What is the relationship between political economy and economic progress?

- There is broad agreement among experts that **innovation** (new products, new processes, new organizations, new management practices, and new strategies) and entrepreneurship are the engines of long-run economic growth
 - **Entrepreneurs** first commercialize innovative new products and processes
- Some experts argue that economic freedom associated with a market economy creates greater incentives for innovation and entrepreneurship than either a planned or mixed economy

Political Economy and Economic Progress

- Strong legal protection of property rights is another requirement for a business environment conducive to innovation, entrepreneurship, and economic growth
- It seems likely that democratic regimes are more conducive to long-term economic growth than a dictatorship, even one of the benevolent kind
- It also seems evident that the subsequent economic growth leads to establishment of democratic regimes

Geography, Education, and Economic Development

- In addition to the political and economic systems, other factors can influence a country's rate of economic development
- Geography can influence economic policy, and thus economic development
 - Countries with favorable geography are more likely to engage in trade which can promote economic growth
- Education levels also influence economic development
 - Countries that invest more in the education of their young people develop faster economically

States in Transition

- Since the late 1980s, a wave of democratic revolutions has swept the world, and many of the previous totalitarian regimes collapsed
- There has been a move away from centrally planned and mixed economies towards free markets

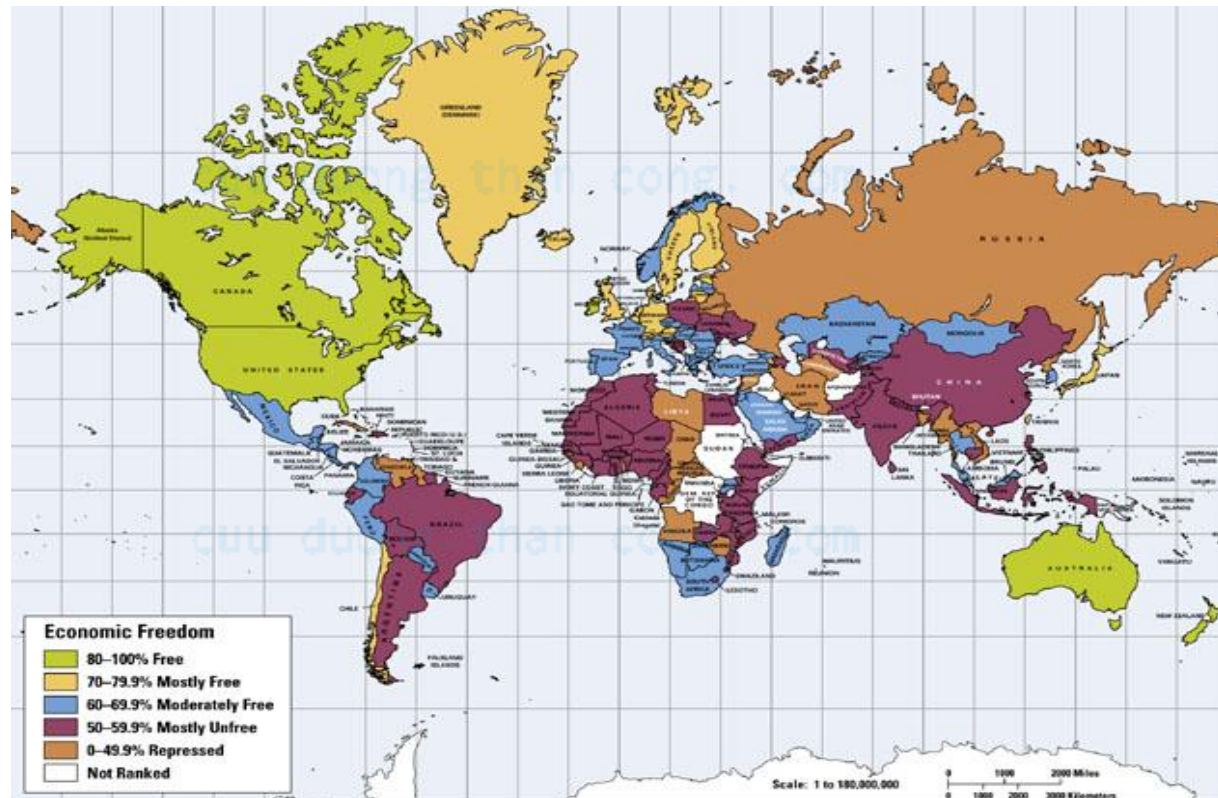
The Spread of Democracy

Democracy has spread to new countries because

- many totalitarian regimes failed to deliver economic progress to the majority of their population
- new information and communication technologies have broken down the ability of the state to control access to uncensored information
- economic advances of the last quarter century have led to the emergence of increasingly prosperous middle and working classes who have pushed for democratic reforms

The Spread of Democracy

Political Freedom in 2007



The New World Order and Global Terrorism

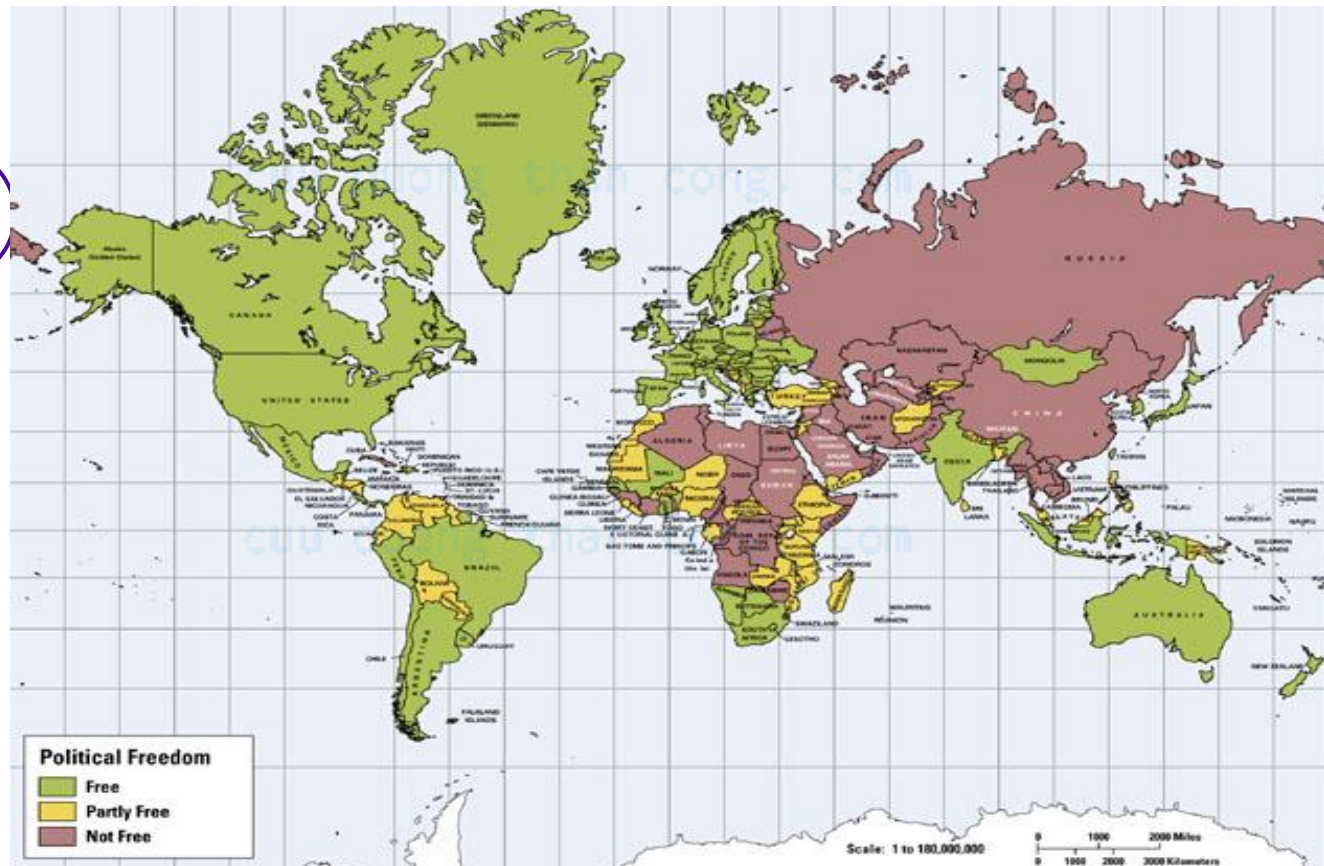
- The end of the Cold War and the “new world order” that followed the collapse of communism in Eastern Europe and the former Soviet Union, taken together with the collapse of many authoritarian regimes in Latin America, have given rise to intense speculation about the future shape of global geopolitics
- International businesses must be aware of geopolitical forces that could affect their ability to operate in certain countries

The Spread of Market-Based Systems

- Since the late 1980s there has been a transformation from centrally planned command economies to market-based economies
- In general, command and mixed economies failed to deliver the kind of sustained economic performance that was achieved by countries that had adopted market-based systems, prompting many countries to shift to a market-based system

The Spread of Market-Based Systems

Distribution of Economic Freedom in 2008



The Nature of Economic Transformation

○ The shift toward a market-based economic system typically involves at least three distinct activities

1. deregulation
2. privatization
3. the creation of a legal system to protect property rights

Deregulation

1. Deregulation

○ Involves removing legal restrictions on the free play of markets, the establishment of private enterprises, and the manner in which private enterprises operate

Privatization

2. Privatization

- Transfers the ownership of state property into the hands of private investors
- Because private investors are motivated by potential profits to increase productivity, privatization should increase economic efficiency

Legal System

- A well-functioning market economy requires laws protecting private property rights and providing mechanisms for contract enforcement
- Without a legal system that protects property rights, and without the machinery to enforce that system, growth is hampered
- Many countries have made significant strides toward creating a strong legal system, but more work is necessary

Implications of a Changing Economy

- The changes in the political and economic systems have significant implications for international firms
- Markets that were formerly off-limits to Western business are now open
 - China (population of 1.2 billion) could be a bigger market than the U.S., the EU, and Japan combined
 - India (population 1.1 billion) is also a potentially huge market
- However, just as the potential gains are large, so are the risks

Implications for Managers

Question: What are the implications of the political economy for international businesses?

○ There are two main implications

1. the political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business
2. the political, economic, and legal environment of a country clearly influences the attractiveness of that country as a market and/or investment site

Benefits

- The long-run benefits of doing business in a country are a function of market size, and current and future consumer purchasing power
- By identifying and investing early in a potential future economic stars, firms may be able to gain **first mover advantages** (advantages that accrue to early entrants into a market)

Costs

- Firms must be prepared to deal costs of doing business in foreign markets
 - Political costs include the cost of paying bribes or lobbying for favorable or fair treatment
 - Economic costs relate primarily to the sophistication of the economic system, including the infrastructure and supporting businesses
 - Legal costs can be higher in countries with dramatically different product, workplace, and pollution standards, or where there is poor legal protection for property rights

Risks

- Doing business in foreign markets involves risk
 - **Political risk** (the likelihood that political forces will cause drastic changes in a country's business environment that adversely affects the profit and other goals of a business enterprise)
 - **Economic risk** (the likelihood that economic mismanagement will cause drastic changes in a country's business environment that adversely affects the profit and other goals of a business enterprise)
 - **Legal risk** (the likelihood that a trading partner will opportunistically break a contract or expropriate property rights)

Overall Attractiveness

- The overall attractiveness of a country as a potential market and/or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country
- Generally, the costs and risks are lower in economically developed and politically stable markets
- However, the potential for growth may be higher in less developed nations

Classroom Performance System

Which type of risk involves the likelihood that a trading partner will opportunistically break a contract or expropriate intellectual property rights?

- a) Contract risk
- b) Economic risk
- c) Legal risk
- d) Political risk

Critical Discussion Question

1. Free market economies stimulate greater economic growth, whereas state-directed economies stifle growth! Discuss.

Critical Discussion Question

2. A democratic political system is an essential condition for sustained economic progress. Discuss.

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Critical Discussion Question

3. What is the relationship between corruption (i.e., bribe taking by government officials) in a country and economic growth? Is corruption always bad?

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Critical Discussion Question

- 4. The Nobel prize-winning economist Amartya Sen argues that the concept of development should be broadened to include more than just economic development. What other factors does Sen think should be included in an assessment of development? How might adoption of Sen's views influence government policy? Do you think Sen is correct that development is about more than just economic development? Explain.

Critical Discussion Question

5. You are the CEO of a company that has to choose between making a \$100 million investment in either Russia or the Czech Republic. Both investments promise the same long-run return, so your choice of which investment to make is driven by considerations of risk. Assess the various risks of doing business in each of these nations. Which investment would you favor and why?

Critical Discussion Question

6. Read the Opening Case on India in this chapter and answer the following questions:
- What kind of economic system did India operate during 1947-1990? What kind of system is it moving towards today? What are the impediments to completing this transformation?
 - How might widespread public ownership of businesses and extensive government regulations have impacted (i) the efficiency of state and private businesses, and (ii) the rate of new business formation in India during the 1947-1990 time frame? How do you think these factors affected the rate of economic growth in India during this time frame?
 - How would privatization, deregulation, and the removal of barriers to foreign direct investment affect the efficiency of business, new business formation, and the rate of economic growth in India during the post-1990 time period?
 - India now has pockets of strengths in key high technology industries such as software and pharmaceuticals. Why do you think India is developing strength in these areas? How might success in these industries help to generate growth in other sectors of the Indian economy?
 - Given what is now occurring in the Indian economy, do you think that the country represents an attractive target for inward investment by foreign multinationals selling consumer products? Why?