

Chapter 2

UNDERSTANDING FORMAL INSTITUTIONS: POLITICS, LAWS, & ECONOMICS

Learning Objectives

After studying this chapter, you should be able to:

1. Identify two types of institutions.
2. Explain how institutions reduce uncertainty.
3. Identify the two core propositions underpinning an institution-based view of global business.
4. List the differences between democracy and totalitarianism.
5. List the differences among civil law, common law, and theocratic law.
6. Articulate the importance of property rights and intellectual property rights.
7. List the differences among market economy, command economy, and mixed economy.
8. Explain why it is important to understand the different institutions when doing business around the world.

Chapter Summary

This chapter takes an in-depth look at the institution-based view. After discussing what institutions do and how they influence global business, we look at three types of formal institutions: political systems, legal systems, and economic systems. As we discuss political systems, we look at the difference between democracy and totalitarianism and discuss political risk. In the section on legal systems, we discuss the differences among civil, common, and theocratic law and discuss property rights (including intellectual property rights).

Opening Case Discussion Guide

Adam Smith versus Deng Xiaoping compares the 2008 bank bailouts in the US and Europe to trends prior to that time and to trends within China. Prior to 2008, in the western countries there was a movement toward deregulation and privatization. China also began to move in that direction. Although China continued to move toward greater economic freedom, the collapse and near collapse of U.S. banks resulted in fear of a financial disaster. That fear brought an end to moving toward laissez faire and a shift in the opposite direction, including government ownership or control of financial institutions.

This case can yield many questions for class discussion. Should the government have simply used the FDIC to protect depositors while allowing the failing banks to go under and be taken over by other private banks? Did the drastic actions taken in the U.S. and overseas to deal with the crisis actually stimulate more fear on the part of the public and business community? If so, did that fear result in reduced business investment and

consumer spending which in turn produced a far greater economic downturn than would otherwise have been the case? Did the events of 2008 (as well as those in 2009 not covered by the case) mean that our economic system has been changed permanently – or temporarily?

LESSON PLAN FOR LECTURE

Outline and Suggested PowerPoint Slides

Learning Outcome	PowerPoint Slides
Learning Objectives Overview	2-3: Learning Objectives
LO1 Identify two types of institutions.	4: Institutions 5: Two Types of Institutions 6: Two Types of Institutions – Formal Institutions 7: Two Types of Institutions – Informal Institutions
LO2 Explain how institutions reduce uncertainty.	8: What Do Institutions Do?
LO3 Identify the two core propositions underpinning an institution-based view of global business.	9: Institution-Based View of Global Business 10: Two Propositions
LO4 List the differences between democracy and totalitarianism.	11: Political Systems 12: Political Systems – Democracy 13: Political Systems – Totalitarianism 14: Political Systems and Business
LO5 List the differences among civil law, common law, and theocratic law.	15: Legal Systems
LO6 Articulate the importance of property rights and intellectual property rights.	16: Property Rights 17: Intellectual Property Rights

LO7 List the differences among market economy, command economy, and mixed economy.	18: Economic Systems 19: What Drives Economic Development
LO8 Explain why it is important to understand the different institutions when doing business around the world.	20: Understanding Different Institutions
Debate	21: Private Ownership vs. State Ownership

CHAPTER OUTLINE

LO1: Identify two types of institutions.

1. *Key Concepts*

This section elucidates the nature of institutions by comparing them to the rules of a game. Three pillars support formal and informal institutions: regulatory, normative, and cognitive. “Institutions” is further broken down into two sub-categories, formal and informal. Formal institutions refer to laws, regulations and rules, while informal institutions include norms, cultures and ethics.

2. *Key Terms*

- **Cognitive pillar** refers to the internalized, taken-for-granted values and beliefs that guide individual and firm behavior.
- **Institutional transitions** are “fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect firms as players.”
- **Normative pillar** refers to the mechanisms through which norms influence individual and firm behavior.
- **Regulatory pillar** is the coercive power of governments exercised through laws, regulations, and rules.

3. *Discussion Exercise*

In the following list of activities, have the students identify whether they are influenced by formal institutions or informal institutions.

- McDonald’s of India does not sell any products made with beef or pork, offering instead only chicken, fish and vegetarian sandwiches.
- The economic stimulus bill enacted in February 2009 (The American Recovery and Reinvestment Act of 2009) includes a provision that requires the funds to be spent for American goods.
- In August 2009, Proctor & Gamble test-marketed a lower-cost, “basic” version of its Tide product line to woo cost-conscious shoppers.

LO2: Explain how institutions reduce uncertainty.

1. *Key Concepts*

The key role of institutions is to reduce uncertainty. This is accomplished by influencing the decision-making process of both individuals and firms through a signaling of what is and is not legitimate conduct. It is imperative, therefore, that firms have a solid grasp of the institutional framework within which they conduct business. Further, because institutions are not static, firms need to monitor and plan for the potential institutional changes that may take place.

2. *Key Terms*

- **Opportunism refers to the** act of seeking self-interest with guile.
- **Transaction costs** are defined as the costs associated with economic transactions or, more broadly, the **costs of doing business**.

3. *Discussion Exercise*

Since the previous section defines institution as “rules of the game,” lead students in an exercise in which they invent a game. Have students break into small groups, with each group creating a game. It can be a variation of something already known or something completely new. The instructor can then allow a given number of groups to present their game and lead the rest of the class in playing it. During this time, the group in charge is free to change the rules as they see fit, either to clarify or revise rules that are unclear, or just for the sake of change.

The goals of this exercise is to demonstrate: 1) the importance of establishing clear and concise rules for an activity; 2) the importance of having sure knowledge of the rules; 3) the importance of monitoring changes in the rules; and 4) the volume of rules that are needed to cover various situations and contingencies.

LO3: Identify the two core propositions underpinning an institution-based view of global business.

1. *Key Concepts*

How do institutions matter? How do the rules of the game influence the business activities of a firm? This section suggests two answers to these questions: The first is that managers and firms rationally pursue their interests and make choices within institutional constraints. The second is that while formal and informal institutions combine to govern firm behavior, informal constraints play a larger role in reducing uncertainty and providing constancy for managers and firms in situations where formal constraints are unclear or fail.

2. *Discussion Exercise*

The importance of institutions to the conduct of business can be seen in recent attempts by world governments to stem the global financial downturn through various policy changes. In areas as diverse as lending, taxation, and infrastructure, governments have passed substantial legislation intended to stimulate economic growth. These policies thus provide a first-hand account of how institutions affect the conduct of business around the globe.

As an introduction to the role of institutions, have students consider the legal and economic policies that were enacted in the US in response to the global financial crisis of 2008-2009. First, have students research and identify what practical measures a particular policy called for. Then, have students discuss its positive or

negative impact on global business.

Examples of policies that could be discussed include:

- Housing and Economic Recovery Act (July 2008)
- The US government's takeover of the lenders Fannie Mae and Freddie Mac (September 2008).
- Troubled Asset Relief Program (September 2008)
- Temporary Liquidity Guarantee Program (October 2008)
- The American Recovery and Reinvestment Act of 2009 (February 2009)
- Car Allowance Rebate System (a.k.a Cash for Clunkers; July 2009)
- Health Care and Education Reconciliation Act (March 2010)

In this discussion, the focal point need not be on the details of each policy, but rather, the identification of how these policies established or changed the rules of the game in order to help businesses remain solvent.

LO4: List the differences between democracy and totalitarianism.

1. Key Concepts

A political system is the set of rules that determine how a country is governed. Their influence on business activities is considerable, since many of the rules and regulations that a firm must follow originate from legislation. After defining two primary political systems, democracy and totalitarianism, the chapter discusses their ramifications for political risk, and the implications they carry for global business.

2. Key Terms

- **Democracy** is a political system in which citizens elect representatives to govern the country on their behalf.
- **Political risk** is a risk associated with political changes that may negatively impact domestic and foreign firms.
- **Political system** refers to the rules of the game on how a country is governed politically.
- **Totalitarianism (or dictatorship)** is defined as a political system in which one person or party exercises absolute political control over the population.

3. Discussion Exercise

Because of the vast effects that political systems can have on business, changes in government represent significant opportunities or crises to MNEs. For 24 years, the nation of Iraq was a single-party, totalitarian state under the control of Saddam Hussein. In 2003, he was overthrown during the invasion of the US-led coalition. Totalitarian rule was replaced in 2004 with a US-sponsored Coalition Provisional Authority in 2004, and in 2006 by a democratically elected government. Now, imagine that you are a high-level executive of an oil company with extensive dealing in Iraq, which at its peak produced 2.6 million barrels per day. Compare and contrast your approach to business in Iraq under the Hussein regime and the newly created democratic regime. Explain which aspects of your business plan

would change and which would not given the radical change in government. Also, discuss how your business would react to the continuous political and security unrest in Iraq.

LO5: List the differences among civil law, common law, and theocratic law./ LO6: Articulate the importance of property rights and intellectual property rights.

1. Key Concepts

A legal system refers to the rules of the game on how a country's laws are enacted and enforced. By determining how rules are established and enforced, a legal system reduces transaction costs and minimizes uncertainty for firms. This section discusses three major types of legal systems – civil law, common law and theocratic law – and then moves to a consideration of a key legal issue, property rights and intellectual property rights, the proper enforcement of which is critical for economic development.

2. Key Terms

- **Civil law** is a legal tradition that uses comprehensive statutes and codes as a primary means to form legal judgments.
- **Common law** is a legal tradition that is shaped by precedents from previous judicial decisions.
- **Copyrights** are the exclusive legal rights of authors and publishers to publish and disseminate their work.
- **Intellectual property** specifically refers to intangible property that results from intellectual activity (such as the content of books, videos, and websites).
- **Intellectual property rights (IPRs)** are legal rights associated with the ownership of intellectual property.
- **Legal system** refers to the rules of the game on how a country's laws are enacted and enforced.
- **Patents** are exclusive legal rights of inventors to derive income from their inventions through activities such as manufacturing, licensing, or selling.
- **Piracy** refers to the unauthorized use of intellectual property rights.
- **Property rights** are the legal rights to use an economic property (resource) and to derive income and benefits from it.
- **Theocratic law** is a legal system based on religious teachings.
- **Trademarks** are the exclusive legal rights of firms to use specific names, brands, and designs to differentiate their products from others.

3. Discussion Exercise

Piracy, the unauthorized use of IPR, is a critical issue in the entertainment industry. Various file-sharing services, such as USENET, BitTorrent, and Limewire, allow users to download movies, TV programs, and music for virtually no cost. A principal means by which firms have sought to combat file-sharing is through Digital Rights Management (DRM), various technologies that restrict the use of digital content. DRM has been the target of extreme criticism, blamed for everything from hurting legitimate users to hampering viral marketing and

presenting a significant barrier to free trade. What is worse, most DRM systems have been cracked with relatively little difficulty.

Given both the ease of piracy and the relative lack of success of preventive measures, how should media firms protect their IPR and ensure their profitability? Should they pursue alternative IPR technologies? Should they aggressively pursue and prosecute offenders? Or, are there ways in which firms can earn a profit while allowing open access?

LO7: List the differences among market economy, command economy, and mixed economy.

1. Key Concepts

An economic system refers to the rules of the game on how a country is governed economically. It refers primarily to the level of governmental and institutional intervention in business activities. This section defines the three major types of economic systems – market, command and mixed.

A key principle of this section is that all economies, to one extent or another, are mixed economic systems. That is, there is no pure form of either a market economy or a command economy. Regardless of the economic system used, developing the economy is one goal of most governments. The question then arises as to why some countries are significantly more developed than others. The prevailing answer is that wealthier countries have achieved that state because they have developed better market supporting institutional frameworks.

2. Key Terms

- **Command economy** is an economy in which theoretically all factors of production are state-owned and state-controlled, and all supply, demand, and pricing are planned by the government.
- **Economic system** refers to the rules of the game on how a country is governed economically.
- **Market economy** is an economy that is characterized by the “invisible hand” of market forces.
- **Mixed economy** is an economy that has elements of both a market economy and a command economy.

LO8: Explain why it is important to understand the different institutions when doing business abroad.

1. Key Concepts

Managers considering working abroad should have a thorough understanding of the formal institutions before entering a country. In situations where formal constraints are unclear, managers can reduce uncertainty by relying on informal constraints, such as relationship norms.

Debate

Private Ownership Versus State Ownership

1. Key Concepts

The debate on private versus state ownership underpins much of the global economic evolution since the early 20th century. As providers of capital, private owners are otherwise known as capitalists, and their central role in the economic system gives birth to the term “capitalism.” State ownership emphasizes the social and public nature of economic ownership, and leads to the coinage of the term “socialism.” Both forms of ownership have their pros and cons. The debate is which form of ownership is better—whether the pros outweigh the cons.

2. Key Terms

- **Moral hazard** refers to recklessness when people and organizations (including firms and governments) do not have to face the full consequences of their actions.
- **Washington Consensus** is a view centered on the unquestioned belief in the superiority of private ownership over state ownership in economic policy making, which is often spearheaded by two Washington-based international organizations: the International Monetary Fund and the World Bank.

Closing Case

• **Closing Case Discussion Guide**

As this case illustrates, the oil rich region of the Middle East is a highly desirable place for multinational oil companies to operate. However, all of them must deal with a crucial question: What should these firms do when political risk in the region, or in a particular country arises? This question became especially relevant during the spring of 2011, as protests and uprisings spread across the Middle East and North Africa.

• **Closing Case Discussion Questions**

1. What lessons can be learned about political risk in countries run by totalitarian regimes such as those in the Middle East?

The case of Libya in particular illustrates the importance of contingency planning. As the conflicts in quickly Libya escalated, many multinationals were forced to shut down operations, evacuate expatriate workers, and in some cases abandon facilities, in order to ensure the safety of employees and their families. As these situations illustrate, multinationals must be prepared for such contingencies when working in these sorts of environments, and must make plans for how they will respond, both in protecting shareholder assets and the safety of their workers. Students may offer other lessons as well. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.

2. As an executive at ENI or ConocoPhillips, what are your plans for the future of your operations in Libya?

Students may offer different plans in response to this question. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.

3. As an executive at BP, Gazprom, or Sinopec, given this traumatic experience in Libya, would you recommend that in the future, your firm enter another oil rich country with a similar political system with its typical problems (such as dictatorship, corruption, and nepotism) that provoke mass unrest in the Middle East?

Student answers may vary. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.

Video Case

Watch “Entering the Chinese Market” by Eric Tarchoune of Dragonfly Group, Ltd.

1. In what ways did Tarchoune’s knowledge of the Chinese language contribute to his success? Why was it particularly important given the areas of China he visited?

He went to remote areas of China where there were few western people. His knowledge of both spoken and written Chinese enabled him to survive as well as become an object of curiosity that in turn enabled him to develop contacts and gain recognition.

2. Western businesses depend on documents and written contracts. What challenge did Tarchoune encounter and how did he cope?

Some Chinese were concerned that a contract would reveal confidential information. Trust was more important than a written contract.

3. What did Tarchoune mean when he said that the rules were “not written on the wall”? What does that suggest when doing business in other countries and cultures?

He felt that the complexities of the culture and relationships were such that one must learn by doing. That may indicate the need for patience when doing business in an unfamiliar culture.

4. In many parts of Asia, respect is gained with age, but Tarchoune was quite young when he went to China. If a young foreign manager were to be sent to China, what could he or she do to improve his or her managerial effectiveness in that country?

Understanding both the spoken and written language plus acting like a Chinese person enabled him to gain acceptance and respect – thus providing a model for others in a similar situation.

5. Tarchoune indicated that there would be some differences in doing business in the larger modern cities of China as compared to where he went. To what extent do you think that such might be the case in other parts of the world? Do you think that Western business people may have a preference for cities that may cause them to ignore opportunities in rural areas? Why?

Generally western business people tend to favor larger cities where the environment and ways of doing business are likely to be somewhat more similar to their home country. Students may have a variety of viewpoints concerning the impact on opportunities.

ADDITIONAL DISCUSSION MATERIAL

*Review Questions

*Critical Discussion Questions

Review Questions

1. Name and the one pillar that supports formal institutions and the two additional pillars that support informal institutions.
The formal and primary pillar is the regulatory pillar: it is the coercive power of governments. The informal pillars consist of the following: (1) the cognitive pillar which refers to the internalized, taken-for-granted values and beliefs that guide individual and firm behavior, and (2) the normative pillar which refers to how the values, beliefs, and actions of other relevant players—collectively known as norms—influence the behavior of focal individuals and firms.
 2. Explain the two core propositions behind the institution-based view of global business.
First, managers and firms rationally pursue their interests and make choices within institutional constraints. Second, formal and informal institutions combine to govern firm behavior but where formal constraints are unclear or fail; informal constraints play a larger role.
 3. How does political risk affect global business?
Political risk by definition is risk associated with political changes that may negatively impact domestic and foreign firms. When the risk is very high in a given country, it is not surprising that companies would rather go to “greener pastures” elsewhere.
 4. Describe the differences among the three types of legal systems.
The three systems: Civil Law, Common Law, and Theocratic Law. Civil law uses comprehensive statutes and codes as a primary means to form legal judgments. Common law is shaped by precedents and traditions from previous judicial decisions. Theocratic law is a legal system based on religious teachings.
 5. Name and describe the three economic systems. Which economic system is the most common and why?
 - *Command economy: under this system, all factors of production should be government- or state-owned and controlled, and all supply, demand, and pricing are planned by the government.*
 - *Market economy is a term referring to a system characterized by the “invisible hand” of market forces: government takes a hands-off approach known as the laissez faire.*
 - *Mixed economy, by definition, is an economic system that has elements of both a market economy and a command economy.*
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Overall, the economic system of most countries is a mixed economy. In practice, when we say a country has a market economy, it is really a shorthand version for a country that organizes its economy mostly (but not completely) by market forces and that still has certain elements of a command economy.

6. Generally, what is the result of strong, effective, market-supporting formal institutions?
Formal institutions include laws, regulations, and rules and are essential to the growth of global business.
7. In what ways do institutions influence individuals' and firms' behaviors? Explain your answer.
Institutional framework is made up of formal and informal institutions governing individual and firm behavior. Institution-based views require firms to constantly monitor, decode, and adapt to the changing rules of the game to survive and prosper.
8. Define institutional transitions, and give three examples of where they can be found.
Institutional transitions are defined as "fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect organizations as players." China, Poland, and Russia are among the emerging economies moving from central planning to market competition.
9. Which are generally more significant: formal or informal constraints? Explain your answer.
In situations where formal constraints are unclear or fail, informal constraints play a larger role in reducing uncertainty and providing constancy to managers and firms.
10. What fundamental aspect of democracy is relevant to the effective conduct of global business?
A fundamental aspect of democracy that is relevant to the effective conduct of global business is an individual's right to freedom of expression and organization. In most modern democracies, this right to organize economically has not only been extended to domestic individuals and firms but also to foreign individuals and firms that come to do business.
11. Name and describe the four types of totalitarianism.
 - *Communist totalitarianism centers on a communist party.*
 - *Right-wing totalitarianism is characterized by its intense hatred of communism.*
 - *Theocratic totalitarianism refers to the monopolization of political power in the hands of one religious party or group.*
 - *Tribal totalitarianism refers to one tribe or ethnic group (which may or may not be the majority of the population) monopolizing political power and oppressing other tribes or ethnic groups.*

12. Give an example of how theocratic law affects daily business operations.
There are many possible examples. In Saudi Arabia, McDonald's operates "ladies only" fast-food restaurants and banks have to maintain two retail branches: one for male customers staffed by men and another for female customers staffed by women. These requirements obviously increase costs.
13. Name three types of intellectual property, and explain how they could be used in business.
Intellectual property rights (IPRs) primarily include rights associated with (1) patents, (2) copyrights, and (3) trademarks. Patents are legal rights awarded by government authorities to inventors of new products or processes, who are given exclusive (monopoly) rights to derive income from such inventions through activities such as manufacturing, licensing, or selling. Copyrights are the exclusive legal rights of authors and publishers to publish and disseminate their work. Trademarks are the exclusive legal rights of firms to use specific names, brands, and designs to differentiate their products from others.
14. Our current system of intellectual property protection stems from what early patent law?
The Statute of Monopolies enacted in Great Britain in 1624 was the world's first patent law to formally protect the IPRs of inventors and make innovation financially lucrative.
15. Describe two contrasting examples of market transitions.
Market transition debate pertains to how to make the transitions work in a most effective and least disruptive way. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.
16. Which do you think offers a more accurate measure of political risk: one based on perception or one based on political and regulatory structures? Explain your answer.
Perceptions can be inaccurate but they affect what people and firms do. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.

Critical Discussion Questions

1. Without looking at any references, please identify the top three countries with the most significant change in political risk in the last five years. Why do you think so?
This is a question in which the answer is not as important as the thought process and the ability to clearly articulate.

2. **ON ETHICS:** As manager, you discover that your multinational firm's products are counterfeited by small family firms that employ child labor in rural Bangladesh. You are aware of the corporate plan to phase out these products soon. You also realize that once you report to the authorities, these firms will be shut down, employees will be out of work, and families and children will be starving. How would you proceed?

This is a question in which the answer is not as important as the thought process and the ability to clearly articulate.

3. **ON ETHICS:** Your multinational is the largest foreign investor and enjoys good profits in (1) Sudan, where government forces are reportedly cracking down on rebels and killing civilians, and (2) Vietnam, where religious leaders are reportedly being persecuted. As a country manager, you understand that your firm is pressured by activists to exit these countries. The alleged government actions, which you personally find distasteful, are not directly related to your operations. How would you proceed?

Although this is also a question in which the answer is not as important as the thought process and the ability to clearly articulate, there are some things that should be considered even by students who really do not care about social/humanitarian issues and are only concerned about the bottom line. In a global economy with instant global communication of news, the policies of a given country might not affect a firm's operations in that country but it might affect the firm's sales and problems with legislative initiatives in other countries.