



## The Changing Political Economy of India

**A**fter gaining independence from Britain in 1947, India adopted a democratic system of government. The economic system that developed in India after 1947 was a mixed economy characterized by many state-owned enterprises, central planning, and subsidies. This system constrained the growth of the private sector. Private companies could expand only with government permission. Under this system, dubbed the “License Raj,” private companies often had to wait for months for government approval of routine business activities such as expanding production or hiring a new director. It could take years to get permission to diversify into a new product. Much of heavy industry, such as auto, chemical, and steel production, was reserved for state-owned enterprises. Production quotas and high tariffs on imports also stunted the development of a healthy private sector, as did restrictive labour laws that made it difficult to fire employees. Access to foreign exchange was limited, investment by foreign firms was severely restricted, land use was strictly controlled, and the government routinely managed prices as opposed to letting them be set by market forces.

By the early 1990s, it was clear that after 40 years of near stagnation, this system was incapable of delivering the kind of economic progress that many Southeastern Asian nations had started to enjoy. In 1994, India’s economy was still smaller than Belgium’s, despite having a population of 950 million. Its gross domestic product (GDP) per capita was a paltry \$310; less than half the population could read; only 6 million had access to telephones; only 14 percent had access to clean sanitation; the World Bank estimated that some 40 percent of the world’s desperately poor lived in India; and only 23 percent of the population had a household income in excess of \$2,484.

In 1991, the lack of progress led the government of Prime Minister P. V. Narasimha Rao, a member of the Congress Party, to embark on an ambitious economic reform program. Much of

# Country Differences in Political Economy

the industrial licensing system was dismantled, and several areas once closed to the private sector were opened, including electricity generation, parts of the oil industry, steelmaking, air transport, and some areas of the telecommunications industry. Foreign investment, formerly allowed only grudgingly and subject to arbitrary ceilings, was suddenly welcomed. Approval was made automatic for foreign equity stakes of up to 51 percent in an Indian enterprise, and 100 percent foreign ownership was allowed under certain circumstances. The government announced plans to privatize many of India's state-owned businesses. Raw materials and many industrial goods could be freely imported, and the maximum tariff that could be levied on imports was reduced from 400 percent to 65 percent in 1994, and then to 35 percent in 1997.

Judged by some measures, the response to these economic reforms was impressive. The economy expanded at an annual rate of about 6.1 percent throughout the 1990s, exports began to grow at a respectable pace, and corporate profits jumped. Foreign investment surged from \$150 million in 1991 to an estimated \$3.5 billion in 1997.

However, by the late 1990s, economic reform had stalled. While economic growth remained reasonably strong, driven in part by a boom in certain sectors, such as India's computer software industry, the Indian government was running a budget deficit equivalent to 9.6 percent of GDP.

Moreover, a decade of reform had done little to solve India's crippling poverty problem. Although the Indian middle class had grown richer during the 1990s, by 2000 some 40 percent of India's nearly 1 billion people still lived in abject poverty, earning less than \$1 a day, a figure little changed from 1990. At the start of the new century, 44 percent of the adult population was illiterate, 19 percent had no access to safe water supplies, 25 percent had no access to health services, 71 percent had no access to sanitation, and 16 percent of the population was not expected to survive to age 40.

Against this background, in October 1999, the nationalist BJP Party was elected to power in India. There were fears that the BJP would withdraw from economic reform. The BJP has close ties to Hindu nationalist organizations that emphasize economic self-sufficiency, protectionism, and “Hindu first” policies, which are potentially socially divisive in a country with a large Muslim minority. Far from pulling back from economic reform, BJP Prime Minister Atal Behari Vajpayee, initiated a second wave of reforms aimed at increasing privatization, reducing subsidies and import barriers, and dismantling the bureaucratic mishmash of laws that interfere with private business.

By 2003, the BJP party continued to defend privatization, pointing out the increases in production in sectors that had been privatized, as well as rising wages. Yet, the party recognized that rural poor were being left behind by many of these reforms. At the party’s National Executive meeting, they demanded that states be given substantial incentives for completing irrigation works, and that the government must pursue accelerated development of all infrastructure. Farmers, they added, should be provided with adequate security against market uncertainty.

The 2004 elections saw the victory of the Congress Party, riding a wave of discontentment among the unemployed and rural voters. As the election was announced, India’s stock market declined by 6 percent in one day. While the party has announced that reforms will continue, as it points out that they were the party that initiated the process of dismantling the old socialist economy in 1991, it has said that priorities will be different from those of the BJP. The Congress Party will be attempting to stimulate the agricultural sector, and increase jobs for the poor by bringing development to the countryside. These actions, combined with an increase in infrastructure spending, can be good for the people and good for the economy.

The jury is still out as to whether all of these goals can be met. Economists are projecting that India’s economy will grow by 6 percent annually; down from the remarkable 10.4 percent growth in the last quarter of 2003, but far ahead of other countries.

Sources: “A Survey of India: The Tiger Steps Out,” *The Economist*, January 21, 1995; “Tarnished Silver,” *The Economist*, September 6, 1997, pp. 64–65; P. Moore, “Three Steps Forward,” *EuroMoney*, September 1997, pp. 190–195; “India’s Breakthrough Budget?” *The Economist*, March 3, 2001; Shankar Aiyar, “Reforms: Time to Just Do It,” *India Today*, January 24, 2000, p. 47; United Nations Development Program, *Human Development Report 2000* (New York Oxford University Press, 2000); and “India’s Economy, Shining Less Brightly,” *Time Asia Magazine*, May 17, 2004, at [www.time.com/time/searchresults?query=india%27s%20economy%20shining%20less%20brightly&venue=timeasia&search\\_date\\_range=all](http://www.time.com/time/searchresults?query=india%27s%20economy%20shining%20less%20brightly&venue=timeasia&search_date_range=all).

## LEARNING OBJECTIVES

1. Understand how the political systems of countries differ.
2. Understand how the economic systems of countries differ.
3. Understand how the legal systems of countries differ.
4. Understand how political, economic, and legal systems collectively influence a country’s ability to achieve meaningful economic progress.
5. Be familiar with the main changes that are currently reshaping the political, economic, and legal systems of many nation-states.
6. Appreciate how a country’s political, economic, and legal systems influence the benefits, costs, and risks associated with doing business in that country.
7. Be conversant with the ethical issues that can arise when doing business in a nation in which the political and legal systems do not support basic human rights.

## INTRODUCTION

As noted in Chapter 1, international business is much more complicated than domestic business because countries differ in many ways. Countries have different political, economic, and legal systems. Cultural practices can vary dramatically from country to country, as can the education and skill level of the population, and countries are at

different stages of economic development. 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. A main function of this chapter and the next is to develop an awareness of and appreciation for the significance of country differences in political systems, economic systems, legal systems, and national culture. Another function of this chapter and the next 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.

The opening case illustrates the changes occurring in the political and economic systems of one nation, India. As in many other countries, since the early 1990s, political and economic ideology in India has shifted away from state planning and toward a free market orientation. One consequence of this shift in ideology has been adoption of an economic reform program that includes as its main elements the privatization of state-owned enterprises, the removal of subsidies, the repeal of laws that hamstring private business practice, and the removal of barriers to foreign investment and trade. This program has made India a more attractive location in which international businesses can operate, thus increasing foreign investment in India during the 1990s.

However, as the opening case makes clear, while the Indian program has had some success, it has also run into significant roadblocks and it has yet to alleviate the poverty that afflicts so much of the nation's population. Advocates of economic reform will claim that India's economic reform program achieved only partial success because political opposition has significantly slowed the pace of reform. There is probably much truth to this claim. At the same time, the combination of political and cultural legacies and current realities in India is such that rapid reform would be difficult even under the most pro-reform government. This is not unique to India. The pace of reform in many countries is determined by the interplay between the economic goals of the reformers and the political and cultural realities of the country.

The Indian example suggests that the economic, political, legal, and cultural systems of a country are not independent of each other. After all, it is politicians who write the laws that help to shape economic activity in a nation-state, and politicians, like all of us, are influenced by the prevailing culture or cultures of their nation. To understand the economic prospects of a nation such as India and to appreciate its importance to international business, we must also understand the interplay between the political, economic, legal, and cultural systems prevailing in that country.

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 not independent of each other. They interact and influence each other, and in doing so they affect the level of economic well-being in a country. In addition to reviewing these systems, we also explore how differences in political economy influence the benefits, costs, and risks associated with doing business in different countries, and how they affect management practice and strategy. In the next chapter, we will look at how differences in culture influence the practice of international business. The political economy and culture of a nation are not independent of each other. As will become apparent in Chapter 3, culture can affect political economy—political, economic, and legal systems in a nation—and the converse can also hold true.

**POLITICAL ECONOMY** The political, economic, and legal systems of a country.

## POLITICAL SYSTEMS

**POLITICAL SYSTEM** System of government in a nation.

The economic and legal systems of a country are shaped by its political system.<sup>1</sup> As such, it is important that we 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 related dimensions. The first is the degree to which they emphasize collectivism as opposed to individualism. The second dimension is the degree to which they are democratic or totalitarian. These dimensions are interrelated; systems that emphasize collectivism tend toward totalitarian, while systems that place a high value on individualism tend to be democratic. However, a large grey 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** A political system that emphasizes collective goals as opposed to individual goals.

The term **collectivism** refers to a political system that stresses the primacy of collective goals over individual goals.<sup>2</sup> 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. It should be noted that 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 back to Plato). Marx argued that the few benefit at the expense of the many in a capitalist society where individual freedoms are not restricted. According to Marx, the pay of workers does not reflect the full value of their labour. 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 labour. Thus, the idea is to manage state-owned enterprise to benefit society as a whole, rather than individual capitalists.<sup>3</sup>

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, while the **social democrats** committed themselves to achieving socialism by democratic means and turned 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, 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, most of which were at least nominally structured as democracies. Communism was swept out of Eastern Europe by the largely bloodless revolutions of 1989. Apart from China, communism hangs on only in some small states, such as North Korea and Cuba.

**COMMUNISTS** Those who believe socialism can be achieved only through revolution and totalitarian dictatorship.

**SOCIAL DEMOCRATS** Those committed to achieving socialism by democratic means.

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, Great Britain, France, Germany, Norway, Spain, and Sweden, where Social Democratic parties have from time to time held political power. Other countries where social democracy has had an important influence include India and Brazil. Consistent with their Marxists roots, many social democratic governments nationalized private companies in certain industries, transforming them into state-owned enterprises to be run for the “public good rather than private profit.” Protected from significant competition by their monopoly position and guaranteed government financial support, many state-owned companies became increasingly inefficient. In the end, individuals found themselves paying for the luxury of state ownership through higher prices and higher taxes. Many Social Democratic parties were voted out of office during the 1970s and 1980s.

### Individualism

**Individualism** is the opposite of collectivism. In a political sense, 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). The philosophy of individualism exercised a profound influence on those in the American colonies who sought independence from Great Britain. Individualism underlies the ideas expressed in the Declaration of Independence.

Individualism is built on two central tenets. The first is an emphasis on the importance of guaranteeing individual freedom and self-expression. As John Stuart Mill put it,

The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number is self-protection . . . The only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant . . . The only part of the conduct of any one, for which he is amenable to society, is that which concerns others. In the part which merely concerns himself, his independence is, of right, absolute. Over himself, over his own body and mind, the individual is sovereign.<sup>4</sup>

#### INDIVIDUALISM

An emphasis on the importance of guaranteeing individual freedom and self-expression.

#### ANOTHER

#### PERSPECTIVE

##### Marx on globalization

Karl Marx, the originator of communist political and economic doctrines, wrote in the mid-1800s and predated the concept of globalization by some 115 years, his writings indicate a concern with issues directly related to the effects of globalization. In the following excerpt, he summarizes his concern for the alienation of labour. His understanding of possible effects of economies of scale and market size relative to production is interesting. He thought there was a connection between mass production, materialism, and a spiritual void. What do you think of Marx’s argument?

We shall begin from a contemporary economic fact. The worker becomes poorer the more wealth he produces and the more his production increases in power and extent. The worker becomes an ever cheaper commodity the more goods he creates. The *devaluation* of the human world increases in direct relation with the *increase in value* of the world of things. Source: *Karl Marx: Early Writings, The Economic and Philosophic Manuscripts of 1844*, trans. T. B. Botto- more (New York: McGraw-Hill, 1963).

**DEMOCRACY**

Political system in which government is by the people, exercised either directly or through elected representatives.

**TOTALITARIANISM**

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.

**REPRESENTATIVE DEMOCRACY**

A political system in which citizens periodically elect individuals to represent them in government.

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 which 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. I have never known much good done by those who effect to trade for the public good.<sup>5</sup>

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, while individualism asserts the opposite. This underlying ideological conflict has shaped much of the recent history of the world. The Cold War, for example, was essentially a war between collectivism, championed by the now-defunct Soviet Union, and individualism, championed by the United States. In practical terms, individualism translates into an advocacy for democratic political systems and free market economics.

**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 opposing political parties are prohibited. The democratic–totalitarian dimension is not independent of the collectivism–individualism dimension. Democracy and individualism go hand in hand, as do the communist version of collectivism and totalitarianism.

**Democracy**

The pure form of democracy, as originally practised 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 practise what is commonly referred to as **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. A representative democracy rests on the assumption that if elected representatives fail to perform this job adequately, they will be voted down 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.<sup>6</sup>

**Totalitarianism**

In a totalitarian country, all the constitutional guarantees on which representative democracies are built—such as an individual's right to freedom of expression and organization,



Democratic ideals and free market economics have swept away socialism and communism in many countries, as evidenced by this McDonald's in Moscow. AP Photo/Victor Yurchenko.

a free media, and regular elections—are denied to the citizens. In most totalitarian states, political repression is widespread 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**. As discussed earlier, communism is a version of collectivism that advocates that socialism can be achieved only through totalitarian dictatorship. Communism, however, is in decline worldwide and many of the old Communist Party dictatorships have collapsed since 1989. The major exceptions to this trend (so far) are China, Vietnam, Laos, North Korea, and Cuba, although all of these states exhibit clear signs that the Communist Party's monopoly on political power is under attack.

A second form of totalitarianism might be labelled **theocratic totalitarianism**. Theocratic totalitarianism is found in states where political power is monopolized by a 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 while the laws of the state are 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 different tribes. Tribal totalitarianism occurs when a political party that represents the interests of a particular tribe (and not always the majority tribe) monopolizes power. Such one-party states still exist in Africa.

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 on the grounds that it would lead to the rise of communism. One common feature of most right-wing

#### COMMUNIST TOTALITARIANISM

A version of collectivism advocating that socialism can be achieved only through a totalitarian dictatorship.

#### THEOCRATIC TOTALITARIANISM

A political system in which political power is monopolized by a party, group, or individual that governs according to religious principles.

#### TRIBAL TOTALITARIANISM

A political system in which a party, group, or individual that represents the interests of a particular tribe (ethnic group) monopolizes political power.

#### RIGHT-WING TOTALITARIANISM

A political system in which political power is monopolized by a party, group, or individual that generally permits individual economic freedom but restricts individual political freedom, including free speech, often on the grounds that it would lead to the rise of communism.

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. They were also found in several Asian countries, particularly South Korea, Taiwan, Singapore, Indonesia, and the Philippines.

## ECONOMIC SYSTEMS

It should be clear from the previous section that there is a connection between political ideology and economic systems. In countries where individual goals are given primacy over collective goals, we are more likely to find free market economic systems. In contrast, in countries where collective goals are given preeminence, the state may have taken control over many enterprises, while 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

#### MARKET ECONOMY

An economic system in which the interaction of supply and demand determines the quantity in which goods and services are produced.

In a 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, and the quantity in which they are produced, are not planned by anyone. Rather, production is determined by the interaction of supply and demand and signalled to producers through the price system. If demand for a product exceeds supply, prices will rise, signalling producers to produce more. If supply exceeds demand, prices will fall, signalling producers to produce less. In this system consumers are sovereign. The purchasing patterns of consumers, as signalled 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 there must be no restrictions on supply. A restriction on supply occurs when a market is monopolized by a single firm. 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. Since 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, while society suffers as a consequence.

Given the dangers inherent in monopoly, the role of government in a market economy is to encourage vigorous competition between private producers. Governments do this by outlawing monopolies and restrictive business practices designed to monopolize a market (antitrust laws serve this function in the United States). 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 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.<sup>7</sup>

## COMMAND ECONOMY

In a pure **command economy**, the goods and services that a country produces, the quantity in which they are produced, and the prices at which they are sold are all planned by the government. 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 disfavour in both countries.

While the objective of a command economy is to mobilize economic resources for the public good, the opposite 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. Also, 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 be characterized by stagnation.

## MIXED ECONOMY

Between market economies and command economies can be found mixed economies. In a **mixed economy**, certain sectors of the economy are left to private ownership and free market mechanisms while other sectors have significant state ownership and government planning. India, which was profiled in the opening case, has a mixed economy. Mixed economies were once very common throughout much of the world, although they are becoming much less so. Not long ago, Great Britain, France, and Sweden were mixed economies, but extensive privatization has reduced state ownership of businesses in all three countries. As we saw in the opening case, a similar trend can be observed in India and in many other countries where there was once a large state sector, such as Brazil and Italy.

In mixed economies, governments also tend to take into state ownership troubled firms whose continued operation is thought to be vital to national interests. The French automobile company Renault was state owned until recently. The government took over the company when it ran into serious financial problems. The French government reasoned that the social costs of the unemployment that might result if Renault collapsed were unacceptable, so it nationalized the company to save it from bankruptcy. Renault’s competitors weren’t thrilled by this move, since they had to compete with a company whose costs were subsidized by the state.

## LEGAL SYSTEMS

The **legal system** of a country refers to the rules, or laws, that regulate behaviour 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

### COMMAND

**ECONOMY** An economic system where the allocation of resources, including determination of what goods and services should be produced, and in what quantity, is planned by the government.

### MIXED ECONOMY

Certain sectors of the economy are left to private ownership and free market mechanisms, while other sectors have significant government ownership and government planning.

### LEGAL SYSTEM

System of rules that regulate behaviour and the processes by which the laws of a country are enforced and through which redress of grievances is obtained.

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 and/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, while 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. Next we look at contract law. Third, we look at the laws governing property rights with particular reference to patents, copyrights, and trademarks. Fourth, we look at laws covering product safety and product liability.

## DIFFERENT LEGAL SYSTEMS

There are three main types of legal systems—or legal tradition—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. **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 very 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, Canada (Quebec), and Russia, operate with a civil law system. A civil law system tends to be less adversarial than a common law system, since the judges rely upon detailed legal codes rather than tradition, precedent, and custom, which they interpret. 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, while 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 practised 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.<sup>8</sup> 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

**COMMON LAW** A system of law based on tradition, precedent, and custom. When law courts interpret common law, they do so with regard to these characteristics.

**CIVIL LAW** A system of law based on a very detailed set of written laws and codes.

**THEOCRATIC LAW** A system of law based on religious teachings.

and the Sunnah. Since the Koran and Sunnah are holy documents, this means 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. Moreover, many Muslim countries have legal systems that are a blend of Islamic law and a common or civil law system. Moreover, in the province of Ontario, the use of Sharia law, or Islamic law, has been instituted for those Muslims wishing to resolve marital agreements and other civil disputes, and make decisions. Muslims cannot be excluded from Ontario's 1991 Arbitration Act, which allows religious groups to resolve family disputes. Hassidic Jews have been running their own Beit Din arbitrations based on Jewish law for years, as well as Catholics and even Ismaili Muslims. Rulings are to be binding, but must be consistent with Canadian laws and the Charter of Rights.<sup>9</sup>

Although Islamic law is primarily concerned with moral behaviour, 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 very 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 1992, for example, Pakistan's Federal Shariat Court, the highest Islamic law-making 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.<sup>10</sup>

## DIFFERENCES IN CONTRACT LAW

The difference between common law and civil law system 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. Many business transactions are regulated by some form of contract. **Contract law** is the body of law that governs contract enforcement. The parties to an agreement normally resort to contract law when one party believes the other has violated either the letter or the spirit of an agreement.

Since 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 typically covered in a common law contract are already covered in a civil code. This implies that it is more expensive to draw up contracts in a common law jurisdiction, and that resolving contract disputes can be a very adversarial process in common law systems. On the other hand, common law systems have the advantage of greater flexibility and allow for judges to interpret a contract dispute in light of the prevailing situation. International businesses need to be sensitive to these differences since 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 apply. To try to resolve this issue, a number of countries including Canada have ratified the **United Nations Convention on Contracts for the International Sale of Goods (CIGS)**. 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. By adopting CIGS, a nation signifies to the other nations that have adopted it that it will treat the convention's rules as part of its law. CIGS 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 CIGS,

**CONTRACT** A document that specifies the conditions under which an exchange is to occur and details the rights and obligations of the parties involved.

**CONTRACT LAW** The body of law that governs contract enforcement.

**UNITED NATIONS CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS (CIGS)** A set of rules governing certain aspects of the making and performance of commercial contracts between sellers and buyers who have their places of businesses in different nations.

however, is that only 61 nations have ratified the convention as of 2002 (CIGS went into effect in 1988).<sup>11</sup> Many of the world's larger trading nations, including Japan and the United Kingdom, have not ratified it.

When firms do not wish to accept CIGS, they often opt for arbitration by a recognized arbitration court to settle contract disputes. Most well known of these is the International Court of Arbitration of the International Chamber of Commerce in Paris. In 2001, this court handled 566 requests for arbitration involving 1492 parties from 116 countries.<sup>12</sup> The size of the disputes ranged from \$50,000 to more than \$1 billion.

## PROPERTY RIGHTS

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 (such as patents, copyrights, and trademarks). **Property rights** refer to the bundle of 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.<sup>13</sup> Countries differ significantly in the extent to which their legal system protects property rights. Although almost all countries have laws on their books that protect property rights, the reality is that in many countries these laws are not well 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

**Private action** refers to theft, piracy, blackmail, and the like by private individuals or groups. While theft occurs in all countries, a weak legal system allows for a much higher level of criminal activity in some than in others. One example was Russia, in the chaotic period following the collapse of communism. 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 in

1995 and again in 1996).<sup>14</sup> In one example, Ivan Kivelidi, a banker and founder of the Russian Business Roundtable, was murdered by poison applied to the rim of his coffee cup. In another, Vladislav Listiev, the head of Channel 1, Russia's largest nationwide TV network, announced in 1996 that he was going to remove unsavoury elements (i.e., Mafia) from the network. Soon afterward he was gunned down by professional assassins outside his apartment building.<sup>15</sup> In another example, Norex Petroleum, a Calgary-based company operating its Russian subsidiary, Yugraneft, in Western Siberia lost US\$40 million when it was taken over at gunpoint by the Tyumen Oil Company (TNK) in 2001. TNK is owned by the Russian corporate giant Alfa Group with close ties to the Kremlin, and Russian emigrés living in America, working in unison with the Alfa Group.<sup>16</sup>

In another instance, in 2002, Acres International, a Canadian engineering firm that operates internationally was convicted of bribing an official in the southern African country of Lesotho. The case arose after Acres hired a Lesotho engineer, Zalisiwonga Bam, to be its local representative as it sought and won contracts for a massive electrical project. Bam, whose pay was deposited by Acres in a Swiss bank account, secretly relayed part of his fees

### PROPERTY RIGHTS

Bundle of 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.

### PRIVATE ACTION

The theft, piracy, blackmail, and the like by private individuals or groups.

## ANOTHER

## PERSPECTIVE

### No interest? How can that work?

In Islam, charging interest is forbidden. One reason for this is that Islam recognizes that business is all about risks. The successful businessperson figures out which risks are the right ones to take. Interest on a collateralized loan has little or no risk; the return is guaranteed. When a competent banker lends money with a legal contract and collateral, she has minimal risk, regardless of what results the business achieves. In Islam, the banker accepts some of the risk of the business venture, sharing it along with the business owner. If the business does well, the banker shares in the profit. If it doesn't do so well, neither does the banker. There are no guaranteed returns in Islamic banking.

to the director of the project, Masupha Ephraim Sole. Sole is appealing an 18-year sentence for accepting the equivalent of more than Cdn\$1.6 million from intermediaries for a dozen international companies, including \$320,000 from Bam.<sup>17</sup>

Of course, Russia, as discussed in the first three examples, is not alone in having Mafia problems (the situation in Russia has improved significantly since the mid-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.<sup>18</sup> However, there was (and perhaps still is) a big difference today between the magnitude of such activity in Russia and its limited impact in Japan and the United States. This difference arose because of the weak legal enforcement apparatus, such as the police and court system, in Russia following the collapse of communism. Many other countries have from time to time had problems similar to or even greater than those experienced by Russia. In Somalia from 1993 to 1994, for example, the breakdown of law and order was so complete that even U.N. food relief convoys proceeding to famine areas under armed guard were held up by bandits.

### Public Action and Corruption

**Public action** to violate property rights occurs when public officials, such as politicians and government bureaucrats, extort income or resources from property holders. This can be done through a number of legal mechanisms such as levying excessive taxation, requiring expensive licences or permits from property holders, or taking assets into state ownership without compensating the owners. It can also be done by illegal means, or corruption, by demanding bribes from businesses in return for the rights to operate in a country, industry, or location.<sup>19</sup> For example, 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.<sup>20</sup> The same was true of government officials in Indonesia under the rule of ex-President Suharto.

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 Indonesian government officials to the New York City Police Department. No society is immune to corruption. However, there are systematic differences in the extent of corruption across countries. In some countries, the rule of law is such that corruption is kept to a minimum. Corruption is seen and treated as illegal, and, when discovered, violators are punished by the full force of the law. Unfortunately, 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. On May 13, 2004, John Sewell, former Mayor of Toronto, said in a speech to the Schulich School of Business that:

The most well known recent incident of bad behaviour at Toronto City Hall is the MFP Scandal. City Council signed a contract with MFP Financial Services for the purchase and leasing of computers for a price it thought to be \$43 million. The actual cost to the city was more like \$110 million. .... It is now known that Mr. Domi withdrew 27-\$1,000 bills from his bank, shortly thereafter he telephoned a key lobbyist for MFP, Jeff Lyons, and a few minutes later Tom Jakobek. He then visited City Hall for about 15 minutes and the next day, Mr. Jakobek deposited about \$21,000 in his bank account. Whether the withdrawal by Mr. Domi and the deposits by Mr. Jakobek are directly linked is still unclear.<sup>21</sup>

Table 2.1 presents data concerning the degree of corruption as seen by business people, academics, and risk analysts in different countries.

#### PUBLIC ACTION

The extortion of income or resources from property holders by public officials, such as politicians and government bureaucrats.

**TABLE 2.1**

Country Rankings of Corruption in 2003

Source: Transparency International, *Corruption Perceptions Index 2003*, www.transparency.org.

COUNTRY RANK	COUNTRY	CPI 2003 SCORE	SURVEYS USED	STANDARD DEVIATION	HIGH-LOW RANGE
1	Finland	9.7	8	0.3	9.2–10.0
2	Iceland	9.6	7	0.3	9.2–10.0
3	Denmark	9.5	9	0.4	8.8–9.9
	New Zealand	9.5	8	0.2	9.2–9.6
5	Singapore	9.4	12	0.1	9.2–9.5
6	Sweden	9.3	11	0.2	8.8–9.6
7	Netherlands	8.9	9	0.3	8.5–9.3
8	Australia	8.8	12	0.9	6.7–9.5
	Norway	8.8	8	0.5	8.0–9.3
	Switzerland	8.8	9	0.8	6.9–9.4
11	Canada	8.7	12	0.9	6.5–9.4
	Luxembourg	8.7	6	0.4	8.0–9.2
	United Kingdom	8.7	13	0.5	7.8–9.2
124	Azerbaijan	1.8	7	0.3	1.4–2.3
	Cameroon	1.8	5	0.2	1.4–2.0
	Georgia	1.8	6	0.7	0.9–2.8
	Tajikistan	1.8	3	0.3	1.5–2.0
129	Myanmar	1.6	3	0.3	1.4–2.0
	Paraguay	1.6	6	0.3	1.2–2.0
131	Haiti	1.5	5	0.6	0.7–2.3
132	Nigeria	1.4	9	0.4	0.9–2.0
133	Bangladesh	1.3	8	0.7	0.3–2.2

**CPI 2003 Score** relates to the perceptions of the degree of corruption as seen by business people, academics, and risk analysts, and ranges between 10—highly clean and 0—highly corrupt. The least corrupt countries are in the top 11 grouping, stopping with Canada, Luxembourg, and the UK. The most corrupt countries ran from 129 to the absolute bottom of 133.

**Surveys Used** refers to the number of surveys that assessed a country's performance. A total of 17 surveys were used from 13 independent institutions, and at least three surveys were required for a country to be included in the CPI.

**Standard Deviation** indicates differences in the values of the sources: the greater the standard deviation, the greater the differences of perceptions of a country among the sources.

**High–Low Range** provides the highest and lowest values of the different sources.

Economic evidence suggests that high levels of corruption significantly reduce the economic growth rate in a country.<sup>22</sup> By siphoning off profits, corrupt politicians and bureaucrats reduce the returns to business investment and, hence, reduce the incentive for both domestic and foreign businesses to invest in that country. The lower level of investment that results has a negative impact on economic growth. Thus, we would expect countries such as Nigeria and Bangladesh to have a much 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 progress is given in the accompanying Country Focus, which looks at the impact of corruption on economic growth in Nigeria.

**The American Foreign Corrupt Practices Act and Canadian Bill S-21**

In the United States, the **Foreign Corrupt Practices Act** was passed during the 1970s following revelations that U.S. companies had bribed government officials in foreign countries in an attempt to win lucrative contracts. This law makes it a violation of U.S. law 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 to allow someone to determine whether a violation of the act has occurred.

In May 1997, the Organization for Economic Cooperation and Development called for the negotiation of a binding convention to address the bribery of foreign public officials by the end of 1997, and recommended that member states submit legislative proposals to their national legislatures to criminalize such bribery and seek

**FOREIGN CORRUPT PRACTICES ACT**

U.S. law regulating behaviour regarding the conduct of international business in the taking of bribes and other unethical actions.

their enactment by the end of 1998. On June 21, 1997, leaders of the G-7 countries (including Prime Minister Chrétien) issued a statement in Denver endorsing this approach and timetable for the OECD. Negotiations of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (the OECD Convention) concluded on November 21, 1997, and Canada signed the Convention in Paris on December 17, 1997. In the Final Communiqué of the G-8 Birmingham Summit, dated May 17, 1998, heads of state or government pledged to make every effort to ratify the OECD Convention by the end of 1998.

Out of these initiatives, grew Canada's **Bill S-21**, an Act regarding the Corruption of Foreign Public Officials and the Implementation of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions was introduced in the Senate on December 1, 1998, and received Royal Assent on December 10 (S.C. 1998, c. 34). Canada ratified the OECD Convention on December 17, 1998, and the Corruption of Foreign Public Officials Act entered into force on February 14, 1999.<sup>23</sup>

As with the U.S. Foreign Corrupt Practices Act, the Canadian Bill S-21 does have "loophole" provisions to cover for those instances in which a bribe might be solely a perception, due to cultural considerations of gift giving, in other countries. Paragraph 3(3)(a) of Bill S-21, sets out a lawful exception that an accused could use as a defence, namely, that the payment was lawful in the foreign state or public international organization for which the foreign public official performs duties or functions. If successful, this would be a full defence to the offence in subsection 3(1). Paragraph 3(3)(b) sets out an additional defence. To use this defence, the accused must show that the loan, reward, advantage, or benefit was:

- a reasonable expense,
- incurred in good faith,
- made by or on behalf of the foreign public official, and *directly related* to the promotion, demonstration or explanation of the person's products and services or to the execution or performance of a contract between the person and the foreign state for which the official performs duties or functions.<sup>24</sup>

This defence is virtually identical to a defence in the U.S. Foreign Corrupt Practices Act.

## 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. Ownership rights over intellectual property are established through patents, copyrights, and trademarks. 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, often officially registered, by which merchants or manufacturers designate and 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 via pirated CDs or over the Internet (e.g., computer software, music and video recordings).<sup>25</sup>

The philosophy behind intellectual property laws is to reward the originator of a new invention, book, musical record, clothes design, restaurant chain, and

**BILL S-21** Otherwise known as the Corruption of Foreign Officials Act that entered into force on February 14, 1999. It is Canadian legislation that makes the bribery, or other business corruption "tool" of a foreign official by a Canadian business person, a criminal offence.

**PATENT** Grants 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.

#### 40 YEARS OF CORRUPTION IN NIGERIA

When Nigeria gained independence from Great Britain in 1960, there were hopes that the country might emerge as an economic heavyweight in Africa. Not only was Nigeria Africa's most populous country, but it was also blessed with abundant natural resources, particularly oil, which rose sharply in value in the 1970s after two rounds of increases in oil prices engineered by the Organization of Petroleum Exporting Countries (OPEC). Between 1970 and 2000, Nigeria earned more than \$300 billion from the sale of oil, but at the end of this period it remained one of the poorest countries in the world. In 2000, gross national product per capita was just \$300, 40 percent of the adult population was illiterate, life expectancy at birth was only 50 years, and the country was begging for relief on \$30 billion in debt. The Human Development Index compiled by the United Nations ranked Nigeria 151 out of 174 countries covered.

What went wrong? Although there is no simple answer, a number of factors seem to have conspired to damage economic activity in Nigeria. The country is composed of several competing ethnic, tribal, and religious groups, and the conflict between them has limited political stability and led to political strife, including a brutal civil war in the 1970s. With the legitimacy of the government always in question, political leaders often purchased support by legitimizing bribes and by raiding the national treasury to reward allies. Civilian rule after independence was followed by a series of military dictatorships, each of which seemed more corrupt and inept than the last (the country returned to civilian rule in 1999).

The most recent military dictator, Sani Abacha, openly and systematically plundered the state treasury for his own personal gain. His most blatant scam was the Petroleum Trust Fund, which he set up in the mid-1990s ostensibly to channel extra revenue from an increase in fuel prices into much-needed infrastructure projects and other investments. The fund was not independently audited and almost none of the money that passed through it was properly accounted for. It was, in fact, a vehicle for Abacha and his supporters to spend a sum that in 1996 was equivalent to some 25 percent of the total federal budget. Abacha, aware of his position as an unpopular and unelected leader, lavished money on personal security and handed out bribes to those whose support he coveted. With examples like this at the very top of the government, it is not surprising that corruption could be found throughout the political and bureaucratic apparatus.

Some of the excesses were astounding. In the 1980s, an aluminum smelter was built on the orders of the government, which wanted to industrialize Nigeria. The cost of the smelter was \$2.4 billion, some 60 to 100 percent higher than the cost of comparable plants elsewhere in the developed world. This high cost was widely interpreted to reflect the bribes that had to be paid to local politicians by the international contractors that built the plant. The smelter has never operated at more than a fraction of its intended capacity. Another example of corruption in Nigeria was the cement scandal of the early 1980s. At that time, the president announced a grand public housing project. Public officials promptly ordered vast quantities of cement from foreign contractors, taking a percentage of each contract in the form of a kickback. They ordered far more cement than was needed and more than Nigerian ports could cope with. Soon ships loaded with cement formed a line that stretched for several miles outside of Lagos harbor and that took months to unload. Meanwhile, the officials responsible were making a fortune from selling cement import licences.

Sources: "A Tale of Two Giants," *The Economist*, *Nigeria: a Survey*, January 15, 2000, p. 5; J. Coolidge and S. Rose Ackerman, "High Level Rent Seeking and Corruption in African Regimes," World Bank policy research working paper #1780, June 1997; and D. L. Bevan, P. Collier, and J. W. Gunning, *Nigeria and Indonesia: The Political Economy of Poverty, Equity and Growth* (Oxford: Oxford University Press, 1999).

the like, for his or her idea and effort. Such laws are a very important stimulus to 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 \$500 million in R&D and take 12 years to get a new drug on the market). Without the guarantees provided by patents, it is unlikely that companies would commit themselves to extensive basic research.<sup>26</sup>

The protection of intellectual property rights differs greatly from country to country. While 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 some of the 96 countries that have signed the **Paris Convention for the Protection of Industrial Property**, an important international agreement to protect intellectual property. Weak enforcement encourages the piracy of intellectual property. China and Thailand have recently been among the worst offenders in Asia. Pirated computer software is widely available in China. Similarly, the streets of Bangkok, the capital of Thailand, are lined with stands selling pirated copies of Rolex watches, Levi blue jeans, videotapes, and computer software.

Piracy in music recordings is rampant. In Canada, music swapping aficionados were beginning to feel the chill of impending American-style clampdowns on Internet file-swapping-music lovers, since the 2002 demise of U.S.-owned Napster. American recording studios were vigorously pursuing and suing everyone in their paths from 12-year-olds to grandparents.

Recording artists, wherever they are, normally feel that the music they create is to be paid for by their fans and so too they assumed the courts of Canada would agree during an April 2004 ruling brought down by Canadian Federal Court Judge, Konrad von Finkelstein. He essentially ruled that song-swapping in the Great White North is legal. The decision throws a curve ball at the music business, which has been ramping up its international efforts to thwart online music piracy. The most notable example is the International Federation of the Phonographic Industry, which started taking legal action against hundreds of suspected European file-sharers. The Recording Industry Association of America (RIAA) also has been on a lawsuit binge since 2004.<sup>27</sup> See Table 2.2 for a summary of domestic music piracy levels around the world.

International businesses have a number of possible responses to violations of their intellectual property. Firms 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 6, the most recent world trade agreement, which was signed in 1994, for the first time extends the scope of the General Agreement on Tariffs and Trade (GATT) to cover intellectual property. Under the new agreement, known as the **Trade Related Aspects of Intellectual Property Rights (TRIPS)**, as of 1995 a World Trade Organization council 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. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years' grace, and the very poorest have ten years.<sup>28</sup> (For further details of the TRIPS agreement, see Chapter 6.)

While many governments are increasing their enforcement of intellectual property rights and abiding by international agreements such as the WTO's TRIPS agreement, some have recently taken a counterposition and seem to support the selective violation of intellectual property rights within their borders. In the late 1990s, the government of South Africa passed a law that allowed the country to import cheap generic versions of patented medicines, including powerful new drugs for treating AIDS, without permission from the patent owner. In 2001, this law became the focus of a legal battle between

#### PARIS CONVENTION FOR THE PROTECTION OF INDUSTRIAL PROPERTY

International agreement to protect intellectual property; signed by 96 countries.

#### TRADE RELATED ASPECTS OF INTELLECTUAL PROPERTY RIGHTS (TRIPS)

An agreement among members of the WTO to enforce stricter intellectual property regulations, including granting and enforcing patents lasting at least 20 years and copyrights lasting 50 years.

TABLE 2.2

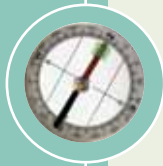
Domestic Music Piracy Levels Around the World in 2002 (units)

Source: IFPI, *The 2003 Recording Industry Commercial Piracy Report*, p. 7.

TERRITORY	OVER 50%	25–50%	10–25%	0–10%
North America				Canada USA
Western Europe	Greece	Cyprus Italy Portugal Spain	Belgium Finland Netherlands	Austria Denmark France Germany Iceland Ireland Norway Sweden Switzerland UK
Eastern Europe	Bulgaria Estonia Latvia Lithuania Romania Russia Ukraine	Croatia Czech Republic Hungary Poland Slovakia	Turkey Slovenia	
Asia	China Indonesia Malaysia Pakistan	Hong Kong India Philippines Taiwan Thailand	Singapore South Korea	Japan
Latin America	Argentina Bolivia Brazil Colombia Ecuador Mexico Paraguay Peru Uruguay Venezuela	Chile Costa Rica		
Middle East	Egypt Israel Lebanon	Kuwait Saudi Arabia	Bahrain Oman Qatar	UAE
Australasia				Australia New Zealand
Africa		South Africa	Zimbabwe	

multinational drug companies seeking to protect their intellectual property rights, AIDS activists demanding access to inexpensive treatments for the poor, and the government of South Africa.

In addition to lobbying governments, firms may want to file lawsuits on their own behalf, as the drug companies are doing in South Africa. They may also choose to stay out of countries where intellectual property laws are lax, rather than risk having their ideas stolen by local entrepreneurs (such reasoning partly underlay decisions by Coca-Cola Co. and IBM to pull out of India in the early 1970s). Firms also need to be on the alert to ensure that pirated copies of their products produced in countries where intellectual property laws are lax do not turn up in their home market or in third countries. U.S. computer software giant Microsoft, for example, discovered that pirated Microsoft software, produced illegally in Thailand, was being sold worldwide as the real thing (including in the United States). In addition, Microsoft has encountered significant problems with pirated software in China. See the accompanying Management Focus on the legal challenges of online gambling.



## BRINGING GAMBLING TO YOUR HOME

The 1980s and 1990s saw casino gambling spread across North America, as governments were attracted to the tax revenue that gambling can produce, and as cities sought to keep up with the growing number of jurisdictions that allowed casino gambling in at least some format.

Internet growth in the late 1990s spread the reach of gambling to a broader market than had previously been known. It also brought up an interesting legal question: if an online casino gets a gambling licence in an offshore jurisdiction, does that make it legal? Can it offer services to Canadians? Just as important, players want to know who regulates such gambling. Players know that a casino in Las Vegas will pay out if they win, but who will make sure that an online casino will do the same.

In this rapidly emerging field, there has been no single government response. Some jurisdictions, like Australia, have legalized online gambling and granted licences. Others, like the United Kingdom, are considering doing so. In the United States, some states have enacted an outright ban on online gambling. Oregon, for example, prevents the collection of online gambling debts.

In Canada, provincial governments are not permitted to issue licences to run online gambling operations. The operation of an unlicensed gambling facility is an offence. However, while it is easier to apply the Canadian Criminal Code to traditional gambling operations that have a physical location in Canada, it is far more difficult to apply the law where the casino is a virtual one. Canadian laws only operate within this country's borders.

No part of an online operation has to be located in Canada for Canadians to have access to casino gambling over the Internet. The question therefore becomes one of determining whether there is enough connection between the gambling operation and the Canadian jurisdiction.

Into this legal quagmire comes the Canadian firm CryptoLogic Inc. The company, founded in 1996, produces software for the Internet gambling industry. Since 1996, CryptoLogic states that its systems have securely processed over US\$16 billion in wagers for 1.7 million players in 240 countries. According to Lewis Rose, the company's president and CEO, "Online gaming is about trust—trusted brand name customers, trusted software solutions, and transparent, credible service providers."

To that end, CryptoLogic extended agreements with two companies well known in the U.K.: William Hill and Littlewoods Gaming. CryptoLogic sees international markets as providing further, though selective opportunities. While Asia, for example, offers a large potential market, fragmented legislation as well as the lack of any single popular form of online payment, means that entering the market will be costly and time consuming.

Challenges remain for the entire industry, as new legislation emerges, and as competitors become attracted to the field. For example, in 2002, some U.S. banks disallowed their credit cards from being used for online gambling due to the uncertain regulatory climate in the U.S. The result was that the entire online gambling industry was hit by a decline in card payments, which was one of the reasons for CryptoLogic's lower revenues in 2002. Internally, the company installed a new management team in the same year, including Lewis Rose as the new president, who had previously served as president of Alliance Atlantis Communications, and before that as president of Maple Leaf Foods' Grocery Products Division. These management changes may not be over, as in the summer of 2004, the company's CFO abruptly left and was "in employment talks with a rival."

Sources: CryptoLogic, *Annual Report*, 2003, 2002; CryptoLogic at [www.cryptologic.com](http://www.cryptologic.com); Fasken Martineau, *Is Internet Gaming Legal In Canada: A Look At Starnet*, at [www.fasken.com](http://www.fasken.com).



Piracy in countries like China and Thailand can be the result of weak enforcement of the protection of intellectual property rights. In this photo, a man in Thailand destroys thousands of counterfeit Winnie-the-Poohs. Why do you think the demand for these goods in these countries is so high as to make pirating a lucrative business? AFP/CORBIS.

**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 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. There are both civil and criminal product liability laws. 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 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 and/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 back home.

## THE DETERMINANTS OF ECONOMIC DEVELOPMENT

The political, economic, and legal systems of a country can have a profound impact on the level of economic development and hence on the attractiveness of a country as a possible market and/or production location for a firm. Here we look first at how countries differ in their level of development. Then we look at how political economy affects economic progress.

### DIFFERENCES IN ECONOMIC DEVELOPMENT

Different countries have dramatically different levels of economic development. One common measure of economic development is a country's gross national product per head of population. Prior to 2001, the term GNP (gross national product) was commonly used by the World Bank as a yardstick for economic activity of a country; it measures the total value of the goods and services produced annually. Since 2001 the

replacement term for GNP is **GNI (gross national income)**. The GNP was seen as the value (in US\$) of a country's final output of goods and services in a year. The value of GNP could be calculated by adding up the amount of money spent on a country's final output of goods and services, or by totalling the income of all citizens of a country including the income from factors of production used abroad (now applied to GNI).

Different countries have different levels of development. Table 2.3 summarizes the GNP (GNI) per capita of the world's ten wealthiest and two poorest nations in 2003 (the right column). On the left column, the World Bank Atlas method is used. It calculates gross national income (GNI—formerly referred to as GNP) and GNI per capita in U.S. dollars for certain operational purposes. The World Bank uses the Atlas conversion factor to reduce the impact of exchange rate fluctuations in the cross-country comparison of national incomes. The Atlas conversion factor for any year is the average of a country's exchange rate (or alternative conversion factor) for that year and its exchange rates for the two preceding years, adjusted for the difference between the rate of inflation in the country.<sup>29</sup>

However, GNI per capita figures can be misleading because they don't consider differences in the cost of living. For example, although the 2003 GNI per capita of Norway at \$37,300, exceeded that of Switzerland which was \$32,030, the higher cost of living in Norway meant that a Swiss could actually afford more goods and services than a Norwegian. To account for differences in the cost of living, one can adjust GNI per capita by purchasing power. Referred to as **purchasing power parity (PPP)** adjustment, it allows for a more direct comparison of living standards in different countries. The base for the adjustment is the cost of living in the United States. The PPP for different countries is then adjusted up (or down) depending upon whether the cost of living is lower (or higher) than in the United States. For example, in 2003, while the GNI per capita in China was \$1,100 (Atlas Method), the PPP per capita was \$4,990 suggesting that the cost of living was lower in China and that \$1100 in China would buy as much as \$4,990 in the United States. Table 2.3 gives the GNI per capita measured at PPP in 2003 for a selection of countries, along with their GNI per capita.<sup>30</sup>

#### GROSS NATIONAL INCOME (GNI)

Since 2001, the World Bank has used this term instead of the previously used GNP.

#### PURCHASING POWER PARITY (PPP)

An adjustment in gross domestic product per capita to reflect differences in the cost of living.

COUNTRY	ATLAS METHODOLOGY—US\$	RANK	COUNTRY	2003 PURCHASING POINT PARITY—US\$
Bermuda	(ranking available without figure)	1	Luxembourg	\$54,430
Luxembourg	\$43,940	2	Bermuda	(ranking available without figure)
Norway	\$43,350	3	United States	\$37,500
Switzerland	\$39,880	4	Norway	\$37,300
United States	\$37,610	5	Lichtenstein	(ranking available without figure)
Lichtenstein	(ranking available without figure)	6	Channel Islands	(ranking available without figure)
Japan	\$34,510	7	Switzerland	\$32,030
Denmark	\$33,750	8	Denmark	\$31,210
Channel Islands	(ranking available without figure)	9	Ireland	\$30,450
Iceland	\$30,810	10	Iceland	\$30,140
Sweden	\$28,840	11	Canada	\$29,740
Canada	\$23,930	23	Germany	\$27,460
Ecuador	\$1790	118	China	\$4990
China	\$1100	133	Jamaica	\$3790
DR—Congo	\$100	207	Malawi	\$600
Ethiopia	\$90	208	Sierra Leone	\$530

TABLE 2.3

GNI per capita in 2003, Atlas

Source: © World Bank, "GNI per Capita 2003, Atlas Method and PPP," excerpt from pages 1-4 of *World Development Indicators Database 2003*. This work is protected by copyright and the making of this copy was with the permission of *Access Copyright*. Any alteration of its content or further copying in any form whatsoever is strictly prohibited.

## BROADER CONCEPTIONS OF DEVELOPMENT: AMARTYA SEN

The Nobel prize-winning economist Amartya Sen has argued that development should be assessed less by material output measures such as GNP per capita and more by the capabilities and opportunities that people enjoy.<sup>31</sup> According to Sen, development should be seen as a process of expanding the real freedoms that people experience. Hence, development requires the removal of major impediments to freedom: poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as the intolerance of repressive states. In Sen's view, development is not just an economic process, but it is a political one too, and to succeed requires the "democratization" of political communities to give citizens a voice in the important decisions made for the community. This perspective leads Sen to emphasize basic health care, especially for children, and basic education, especially for women. Not only are these factors desirable for their instrumental value in helping to achieve higher income levels, but they are also beneficial in their own right. People cannot develop their capabilities if they are chronically ill or woefully ignorant.

Sen's influential thesis has been picked up by the United Nations, which has developed the **Human Development Index (HDI)** to measure the quality of human life in different nations. The HDI is based on three measures: life expectancy at birth (which is a function of health care), educational attainment (which is measured by a combination of the adult literacy rate and enrolment in primary, secondary, and tertiary education), and whether average incomes, based on PPP estimates, are sufficient to meet the basic needs of life in a country (adequate food, shelter, and health care). As such, the HDI comes much closer to Sen's conception of how development should be measured than narrow economic measures such as GNP per capita—although Sen's thesis suggests that political freedoms should also be included in the index, and they are not. The Human Development Index is scaled from 0 to 1. Countries scoring less than 0.5 are classified as having low human development (the quality of life is poor), those scoring from 0.5 to 0.8 are classified as having medium human development, while those countries that score above 0.8 are classified as having high human development. Map 2.1 summarizes the Human Development Index scores for 2001, the most recent year for which data are available.

## POLITICAL ECONOMY AND ECONOMIC PROGRESS

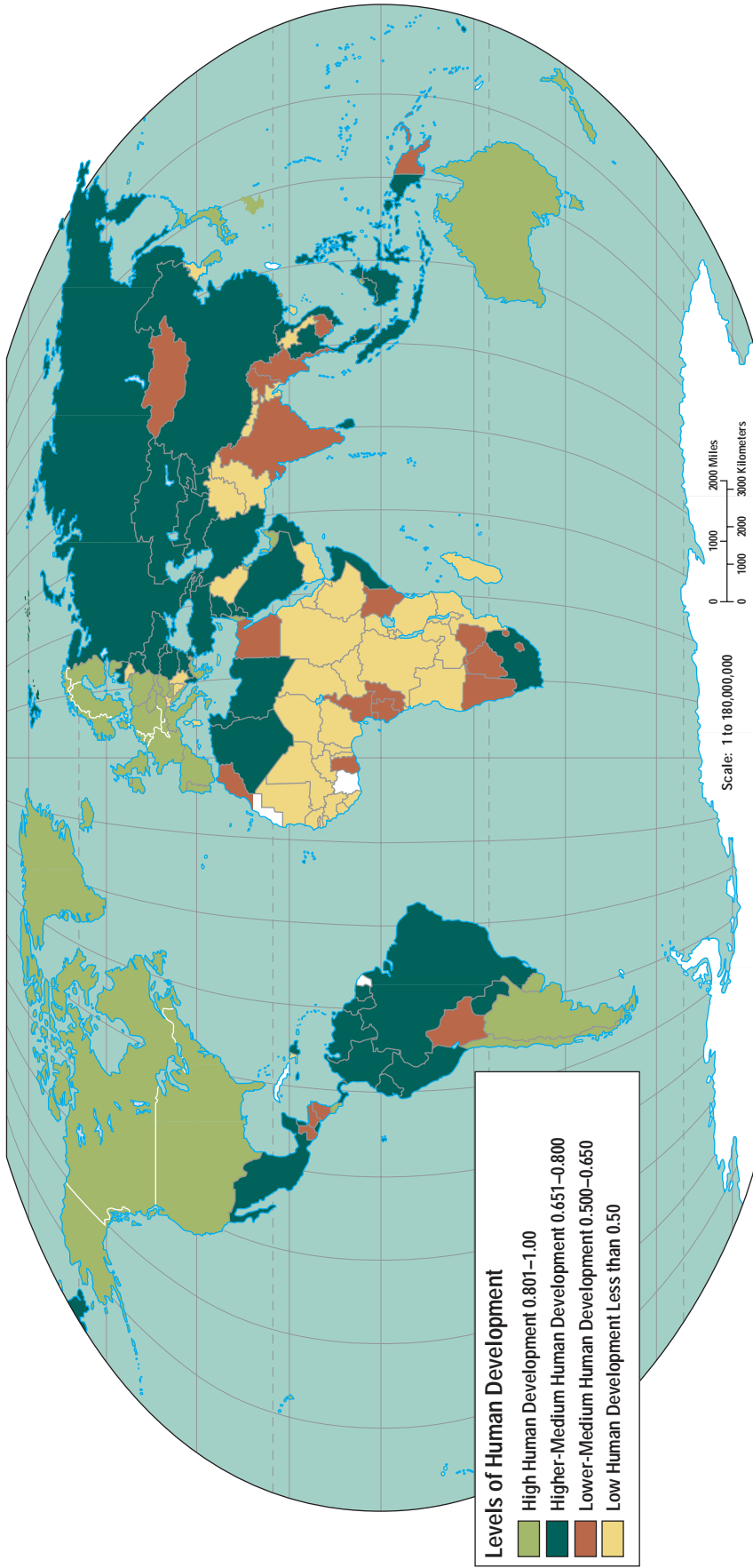
It is often argued that a country's economic development is a function of its economic and political systems. What then is the nature of the relationship between political economy and economic progress? This question has been the subject of vigorous debate among academics and policy makers for some time. Despite the long debate, this remains a question for which it is not possible to give an unambiguous answer. However, it is possible to untangle the main threads of the academic arguments and make a few broad generalizations as to the nature of the relationship between political economy and economic progress.

### Innovation and Entrepreneurship Are the Engines of Growth

Agreement is fairly wide that innovation and entrepreneurial activity are the engines of long-run economic growth.<sup>32</sup> Those who make this argument define **innovation** broadly to include not just new products, but also new processes, new organizations, new management practices, and new strategies. Thus, the Toys "R" Us strategy of establishing large warehouse-style toy stores and then engaging in heavy advertising and price discounting to sell the merchandise can be classified as an innovation because Toys "R" Us was the first company to pursue this strategy. Innovation is also seen as the product of entrepreneurial activity. Often, entrepreneurs first commercialize innovative new products and processes, and entrepreneurial activity provides much of the dynamism

**HUMAN DEVELOPMENT INDEX (HDI)** An attempt by the United Nations to assess the impact of a number of factors on the quality of human life in a country.

**INNOVATION** Development of new products, processes, organizations, management practices, and strategies.



**MAP 2.1**

The Human Development Index, 2001

Source: United Nations, Human Development Report, 2003, Human Development Index.

in an economy. For example, the economy of the United States has benefited greatly from a high level of entrepreneurial activity, which has resulted in rapid innovation in products and process. Firms such as Cisco Systems, Dell Computer Corp., Microsoft, and Oracle were all founded by entrepreneurial individuals to exploit advances in technology, and all these firms created significant economic value by helping to commercialize innovations in products and processes. Thus, one can conclude that if a country's economy is to sustain long-run economic growth, the business environment must be conducive to the consistent production of product and process innovations and to entrepreneurial activity.

### Innovation and Entrepreneurship Require a Market Economy

This leads logically to a further question—What is required for the business environment of a country to be conducive to innovation and entrepreneurial activity? Those who have considered this issue highlight the advantages of a market economy.<sup>33</sup> It has been argued that the economic freedom associated with a market economy creates greater incentives for innovation and entrepreneurship than either a planned or a mixed economy. In a market economy, any individual who has an innovative idea is free to try to make money out of that idea by starting a business (by engaging in entrepreneurial activity). Similarly, existing businesses are free to improve their operations through innovation. To the extent that they are successful, both individual entrepreneurs and established businesses can reap rewards in the form of high profits. Thus, market economies contain enormous incentives to develop innovations.

In a planned economy, the state owns all means of production. Consequently, entrepreneurial individuals have little economic incentive to develop valuable new innovations, since it is the state, rather than the individual, that captures most of the gains. The lack of economic freedom and incentives for innovation was probably a main factor in the economic stagnation of so many former Communist states and led ultimately to their collapse at the end of the 1980s. Similar stagnation occurred in many mixed economies in those sectors where the state had a monopoly (such as health care and telecommunications in Great Britain). This stagnation provided the impetus for the widespread privatization of state-owned enterprises that we witnessed in many mixed economies during the mid-1980s and is still going on today (privatization refers to the process of selling state-owned enterprises to private investors).

A study of 102 countries over a 20-year period provided evidence of a strong relationship between economic freedom (as provided by a market economy) and economic growth.<sup>34</sup>

The study found that the more economic freedom a country had between 1975 and 1995, the more economic growth it achieved and the richer its citizens became. The three countries that had persistently high ratings of economic freedom from 1975 to 1995 (Hong Kong, Switzerland, and Singapore) were also all in the top ten in terms of economic growth rates. In contrast, no country with persistently low economic freedom achieved a respectable growth rate. For the 16 countries for which the index of economic freedom declined the most during the 1975–95 period, gross domestic product fell at an annual rate of 0.6 percent.

### Innovation and Entrepreneurship Require Strong Property Rights

Strong legal protection of property rights is another requirement for a business environment to be conducive to innovation, entrepreneurial activity, and hence economic

#### ANOTHER

#### PERSPECTIVE

##### Purchasing power parity and Big Macs

*The Economist*, a British weekly magazine worth taking a look at, compares currency valuations across countries by examining the prices of Big Macs sold at McDonald's. The Big Mac index applies the idea of purchasing power parity by assuming that across national-level economies, the Big Mac price should be at parity. By comparing exchange rates using the Big Mac price as a basis, the index describes the over- or undervaluation of the country's currency. This index is published in April and October. You can find the most recent one at [www.economist.com](http://www.economist.com).

growth.<sup>35</sup> Both individuals and businesses must be given the opportunity to profit from innovative ideas. Without strong property rights protection, businesses and individuals run the risk that the profits from their innovative efforts will be expropriated, either by criminal elements or by the state. The state can expropriate the profits from innovation through legal means, such as excessive taxation, or through illegal means, such as demands from state bureaucrats for kickbacks in return for granting an individual or firm a license to do business in a certain area (i.e., corruption). According to the Nobel prize-winning economist Douglass North, throughout history many governments have displayed a tendency to engage in such behaviour. Inadequately enforced property rights reduce the incentives for innovation and entrepreneurial activity—since the profits from such activity are “stolen”—and hence reduce the rate of economic growth.

### The Required Political System

There is a great deal of debate as to the kind of political system that best achieves a functioning market economy with strong protection for property rights.<sup>36</sup> We in the West tend to associate a representative democracy with a market economic system, strong property rights protection, and economic progress. Building on this, we tend to argue that democracy is good for growth.<sup>37</sup> However, some totalitarian regimes have fostered a market economy and strong property rights protection and have experienced rapid economic growth. Four of the fastest-growing economies of the past 30 years—South Korea, Taiwan, Singapore, and Hong Kong—had one thing in common at the start of their economic growth: undemocratic governments! At the same time, countries with stable democratic governments, such as India, experienced sluggish economic growth for long periods. In 1992, Lee Kuan Yew, Singapore’s leader for many years, told an audience, “I do not believe that democracy necessarily leads to development. I believe that a country needs to develop discipline more than democracy. The exuberance of democracy leads to undisciplined and disorderly conduct which is inimical to development.”<sup>38</sup> Others have argued that many of the current problems in Eastern Europe and the states of the former Soviet Union arose because democracy arrived before economic reform, making it more difficult for elected governments to introduce the policies that, while painful in the short run, were needed to promote rapid economic growth. China, which maintains a totalitarian government, has moved rapidly toward a market economy.

However, those who argue for the value of a totalitarian regime miss an important point: if dictators made countries rich, then much of Africa, Asia, and Latin America should have been growing rapidly from 1960 to 1990, and this was not the case. Only a certain kind of totalitarian regime is capable of promoting economic growth. It must be a dictatorship that is committed to a free market system and strong protection of property rights. Also, there is no guarantee that a dictatorship will continue to pursue such progressive policies. Dictators are rarely so benevolent. Many are tempted to use the apparatus of the state to further their own private ends, violating property rights and stalling economic growth. Given this, it seems likely democratic regimes are far more conducive to long-term economic growth than are dictatorships, even benevolent ones. Only in a well-functioning, mature democracy are property rights truly secure.<sup>39</sup> We should not forget Amartya Sen’s arguments that we reviewed earlier. Totalitarian states, by limiting human freedom, also suppress human development and therefore are detrimental to progress.

### Economic Progress Begets Democracy

While it is possible to argue that democracy is not a necessary precondition for a free market economy in which property rights are protected, subsequent economic growth often leads to establishment of a democratic regime. Several of the fastest-growing Asian economies adopted more democratic governments during the past two decades,

including South Korea and Taiwan. Thus, while democracy may not always be the cause of initial economic progress, it seems to be one consequence of that progress.

A strong belief that economic progress leads to adoption of a democratic regime underlies the fairly permissive attitude that many Western governments have adopted toward human rights violations in China. Although China has a totalitarian government in which human rights are abused, many Western countries have been hesitant to criticize the country too much for fear that this might hamper the country's march toward a free market system. The belief is that once China has a free market system, democracy will follow. Whether this optimistic vision comes to pass remains to be seen.

## GEOGRAPHY, EDUCATION, AND ECONOMIC DEVELOPMENT

While a country's political and economic system is probably the big locomotive driving its rate of economic development, other factors are also important. One that has received attention recently is geography.<sup>40</sup> But the belief that geography can influence economic policy, and hence economic growth rates, goes back to Adam Smith. The influential Harvard University economist Jeffrey Sachs argues

that throughout history, coastal states, with their long engagements in international trade, have been more supportive of market institutions than landlocked states, which have tended to organize themselves as hierarchical (and often military) societies. Mountainous states, as a result of physical isolation, have often neglected market-based trade. Temperate climates have generally supported higher densities of population and thus a more extensive division of labour than tropical regions.<sup>41</sup>

Sachs's point is that by virtue of favourable geography, certain societies were more likely to engage in trade than others and were thus more likely to be open to and to develop market-based economic systems, which in turn would promote faster economic growth. He also argues that, irrespective of the economic and political institutions a country adopts, adverse geographical conditions, such as the high rate of disease, poor soils, and hostile climate that afflict many tropical countries, can have a negative impact on development. Together with colleagues at Harvard's Institute for International Development, Sachs tested for the impact of geography on a country's economic growth rate between 1965 and 1990. He found that landlocked countries grew more slowly than coastal economies and that being entirely landlocked reduced a country's growth rate by roughly 0.7 percent per year. He also found that tropical countries grew 1.3 percent more slowly each year than countries in the temperate zone.

Education emerges as another important determinant of economic development (a point that Amartya Sen emphasizes). The general assertion is that nations that invest more in education will have higher growth rates because an educated population is a more productive population. Some rather striking anecdotal evidence suggests this is true. In 1960, Pakistanis and South Koreans were on equal footing economically. However, just 30 percent of Pakistani children were enrolled in primary schools, while 94 percent of South Koreans were. By the mid-1980s, South Korea's GNP per person was three times that of Pakistan's.<sup>42</sup> A survey of 14 statistical studies that looked at the relationship between a country's investment in education and its subsequent growth rates concluded investment in education had a positive and statistically significant impact on a country's rate of economic growth.<sup>43</sup> Similarly, the work by Sachs discussed above suggests that investments in education help explain why some countries in Southeast Asia, such as Indonesia, Malaysia, and Singapore, have been able to overcome the disadvantages associated with their tropical geography and grow far more rapidly than tropical nations in Africa and Latin America.

## STATES IN TRANSITION

The political economy of many of the world's nation-states has changed radically since the late 1980s. Two trends have been evident. First, during the late 1980s and early 1990s, a wave of democratic revolutions swept the world. Totalitarian governments collapsed and were replaced by democratically elected governments that were typically more committed to free market capitalism than their predecessors had been. The change was most dramatic in Eastern Europe, where the collapse of communism brought an end to the Cold War and led to the breakup of the Soviet Union, but similar changes were occurring throughout the world during the same period. Across much of Asia, Latin America, and Africa, there was a marked shift toward greater democracy. Second, there has been a strong move away from centrally planned and mixed economies and toward a more free market economic model. We shall look first at the spread of democracy and then turn our attention to the spread of free market economics.

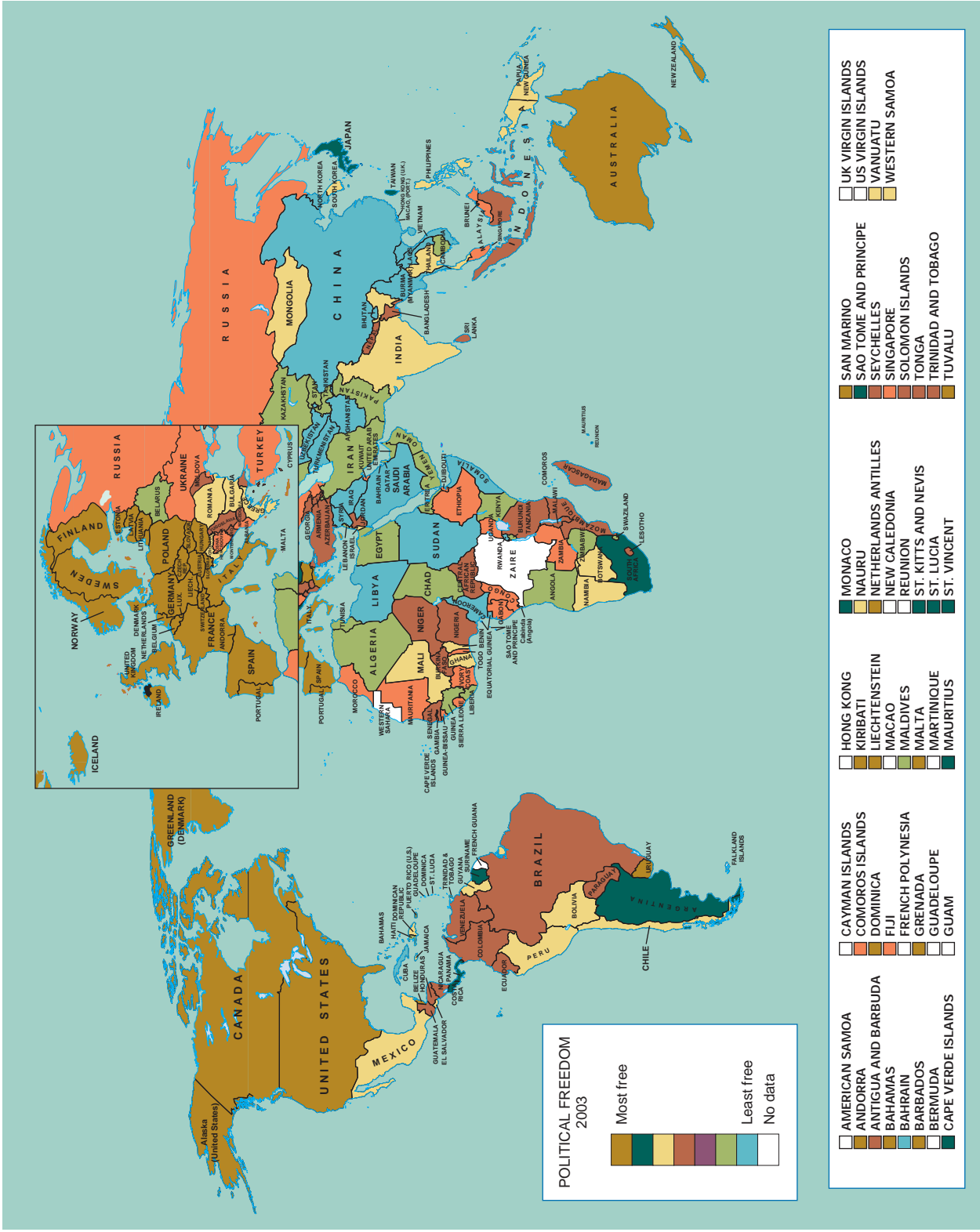
### THE SPREAD OF DEMOCRACY

Between 1993 and 2003, the number of not free countries grew from 43 to 48 nations. The Map of Political Freedom, 2003 (Map 2.2) also shows that there were less free countries in 2003 than there were in 1993 (55 in 2003 and 73 nations in 1993) while the number of free countries grew from 75 to 89. On a scale of 1, for the highest degree of political freedom to 7 for the lowest, Freedom House uses the following criteria for determining the ratings for political freedom:

- Free and fair elections of the head of state and legislative representatives.
- Fair electoral laws, equal campaigning opportunities, and fair polling.



Although Hong Kong switched from a British colony to Chinese sovereignty in 1997, its economy still displays democratic influence. This shopping district street in Hong Kong could be mistaken for a big city street in the United States. What do you think are some of the reasons that places like Hong Kong, Singapore, and Taiwan have flourished, while others in Eastern Europe, the former Soviet Union, and India have not? CORBIS. All rights reserved.



MAP 2.2

Political Freedom in 2003

Source: Freedom House, [www.freedomhouse.org](http://www.freedomhouse.org). Reprinted with permission.

- The right to organize into different political parties.
- A parliament with effective power.
- A significant opposition that has a realistic chance of gaining power.
- Freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies, or any other powerful group.
- A reasonable amount of self-determination for cultural, ethnic, and religious minorities.

Factors contributing to a low rating (i.e., to totalitarianism) include military or foreign control, the denial of self-determination to major population groups, a lack of decentralized political power, and an absence of democratic elections.

As of January 2003, Freedom House classified some 89 democracies as free while 55 countries were partly free and 48 countries were not free. There were 121 electoral democracies in the world at the end of 2002, which represent over 60 percent of the world's 192 countries. This represents a significant increase over the 40 percent of countries considered to be elected democracies in 1987. However, only 89 of today's 121 elected democracies are considered to be free, maintaining an environment in which there is broad respect for human rights and stable rule of law. Democracy is associated with prosperity. In 2002, the GDP of free countries stood at \$26.8 trillion, while the GDP of not free countries was \$1.7 trillion.<sup>44</sup>

Three main reasons account for the spread of democracy.<sup>45</sup> First, many totalitarian regimes failed to deliver economic progress to the vast bulk of their populations.

Second, new information and communication technologies, including shortwave radio, satellite television, fax machines, desktop publishing, and now the Internet, have broken down the ability of the state to control access to uncensored information. These technologies have created new conduits for the spread of democratic ideals and information from free societies.

Third, in many countries the 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. This was certainly a factor in the democratic transformation of South Korea. Entrepreneurs and other business leaders, eager to protect their property rights and ensure the dispassionate enforcement of contracts, are another force pressing for more accountable and open government.

Also, democracy is still rare in large parts of the world. In Africa, just 20 nations, one-third of those on the continent, are electoral democracies. Among the 12 countries that are full or associated members of the Commonwealth of Independent States (i.e., the republics of the former Soviet Union minus the Baltic states) only four are electoral democracies. And there are no democracies among the 16 Arabic states of the Middle East and North Africa.

### THE NEW WORLD ORDER?

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. Author Francis Fukuyama has argued that “we may be witnessing . . . the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government.”<sup>46</sup> Fukuyama goes on to say that the war of ideas may be at an end and that liberal democracy has triumphed.

Others have questioned Fukuyama's vision of a more harmonious world dominated by a universal civilization characterized by democratic regimes and free

market capitalism. In a controversial book, the influential political scientist Samuel Huntington argues that there is no “universal” civilization based on widespread acceptance of Western liberal democratic ideals.<sup>47</sup> Huntington maintains that while many societies may be modernizing—they are adopting the material paraphernalia of the modern world, from automobiles to Coca-Cola and MTV—they are not becoming more Western. On the contrary, Huntington theorizes that modernization in non-Western societies can result in a retreat toward the traditional, such as the resurgence of Islam in many traditionally Muslim societies:

The Islamic resurgence is both a product of and an effort to come to grips with modernization. Its underlying causes are those generally responsible for indigenization trends in non-Western societies: urbanization, social mobilization, higher levels of literacy and education, intensified communication and media consumption, and expanded interaction with Western and other cultures. These developments undermine traditional village and clan ties and create alienation and an identity crisis. Islamist symbols, commitments, and beliefs meet these psychological needs, and Islamist welfare organizations, the social, cultural and economic needs of Muslims caught in the process of modernization. Muslims feel a need to return to Islamic ideas, practices, and institutions to provide the compass and the motor of modernization.<sup>48</sup>

Thus, the rise of Islamic fundamentalism is portrayed as a response to the alienation produced by modernization.

In contrast to Fukuyama, Huntington sees a world that is split into different civilizations, each of which has its own value systems and ideology. In addition to Western civilization, Huntington predicts the emergence of strong Islamic and Sinic (Chinese) civilizations, as well as civilizations based on Japan, Africa, Latin America, Eastern Orthodox Christianity (Russian), and Hinduism (Indian). Huntington also sees the civilizations as headed for conflict, particularly along the “fault lines” that separate them, such as Bosnia (where Muslims and Orthodox Christians have clashed), Kashmir (where Muslims and Hindus clash), and the Sudan (where a bloody war between Christians and Muslims has persisted for decades). Huntington predicts conflict between the West and Islam and between the West and China. He bases his predictions on an analysis of the different value systems and ideology of these civilizations, which in his view tend to bring them into conflict with each other. While some commentators originally dismissed Huntington’s thesis, in the aftermath of the terrorist attacks on the United States on September 11, 2001, Huntington’s thesis received new attention.

If Huntington’s views are even partly correct—the events of September 11 added weight to his thesis—they have important implications for international business. They suggest many countries may be increasingly difficult places in which to do business, either because they are shot through with violent conflicts or because they are part of a civilization that is in conflict with an enterprise’s home country. Huntington’s views are speculative and controversial. It is not clear that his predictions will come to pass. More likely is the evolution of a global political system that is positioned somewhere between Fukuyama’s universal global civilization based on liberal democratic ideals and Huntington’s vision of a fractured world. That would still be a world, however, in which geopolitical forces periodically limit the ability of business enterprises to operate in certain foreign countries.

### THE SPREAD OF MARKET-BASED SYSTEMS

Paralleling the spread of democracy since the 1980s has been the transformation from centrally planned command economies to market-based economies. More than 30 countries that were in the former Soviet Union or the Eastern European Communist bloc are now changing their economic systems. A complete list of countries would also include Asian states such as China and Vietnam, as well as African countries such

as Angola, Ethiopia, and Mozambique.<sup>49</sup> There has been a similar shift away from a mixed economy. Many states in Asia, Latin America, and Western Europe have sold state-owned businesses to private investors (privatization) and deregulated their economies to promote greater competition.

The underlying rationale for economic transformation has been the same the world over. In general, command and mixed economies failed to deliver the kind of sustained economic performance that was achieved by countries adopting market-based systems, such as the United States, Switzerland, Hong Kong, and Taiwan. The Heritage Foundation's index of economic freedom is based on ten indicators, such as the extent to which the government intervenes in the economy, trade policy, the degree to which property rights are protected, foreign investment regulations, and taxation rules. A country can score between 1 (most free) and 5 (least free) on each of these indicators. The lower a country's average score across all ten indicators, the more closely its economy represents the pure market model. According to the 2004 index, which is summarized in Map 2.3, the world's freest economies are (in rank order) Hong Kong, Singapore, New Zealand, Luxembourg, Estonia, United Kingdom, Ireland, Denmark, Switzerland, and the United States. Japan is ranked at 38; France at 44; Mexico, 63; Brazil, 72; Russia, 114; India, 121; China, 128; while the command economies of Cuba, Laos, Iraq, and North Korea are to be found at the bottom of the rankings.<sup>50</sup>

Economic freedom does not necessarily equate with political freedom, as detailed in Map 2.3. For example, three of the top 16 countries in the Heritage Foundation index, Hong Kong, Singapore, and Bahrain, cannot be classified as politically free. Hong Kong was reabsorbed into Communist China in 1997, and the first thing Beijing did was shut down Hong Kong's freely elected legislature. Singapore is ranked as only partly free on Freedom House's index of political freedom due to practices such as widespread press censorship, while Bahrain is classified as least free due to the monopolization of political power by a hereditary monarchy.

## THE NATURE OF ECONOMIC TRANSFORMATION

The shift toward a market-based economic system often entails a number of steps: deregulation, privatization, and creation of a legal system to safeguard property rights.<sup>51</sup> We shall review each before looking at the track record of states engaged in economic transformation.

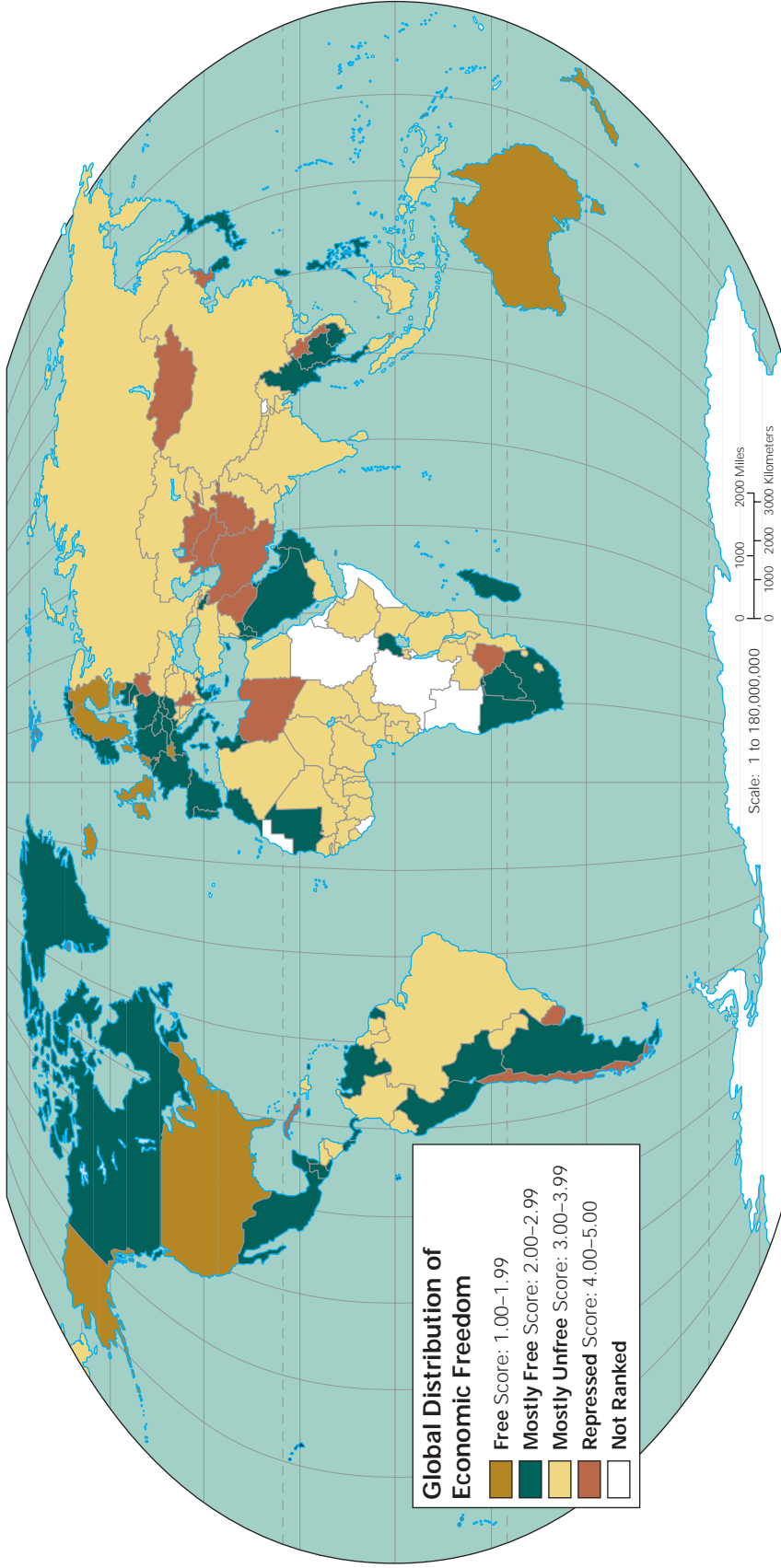
### Deregulation

**Deregulation** involves removing legal restrictions to the free play of markets, the establishment of private enterprises, and the manner in which private enterprises operate. Before the collapse of communism, the governments in most command economies exercised tight control over prices and output, setting both through detailed state planning. They also prohibited private enterprises from operating in most sectors of the economy, severely restricted direct investment by foreign enterprises, and limited international trade. Deregulation in these cases involved removing price controls, thereby allowing prices to be set by the interplay between demand and supply; abolishing laws regulating the establishment and operation of private enterprises; and relaxing or removing restrictions on direct investment by foreign enterprises and international trade.

In mixed economies, the role of the state was more limited, but here too, in certain sectors the state set prices, owned businesses, limited private enterprise, restricted investment by foreigners, and restricted international trade. For these countries, deregulation has involved the same kind of initiatives that we have seen in former command economies, although the transformation has been easier because there was always a vibrant private sector in these countries. India is a good example of a mixed

#### DEREGULATION

Removal of government restrictions concerning the conduct of a business.



MAP 2.3

Distribution of Economic Freedom

Source: Heritage Foundation, 2004 Index of Economic Freedom, [www.heritage.org](http://www.heritage.org). Reprinted with permission.

economy that is currently deregulating large areas of its economy. Deregulation has involved reforming the industrial licensing system that made it difficult to establish private enterprises and opening areas that were once closed to the private sector (including electricity generation, parts of the oil industry, steelmaking, air transport, and some areas of the telecommunications industry). It has also involved the removal of limits on foreign ownership of Indian assets and the lowering of barriers to international trade.

### Privatization

Hand in hand with deregulation has come a sharp increase in privatization. **Privatization** transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction.<sup>52</sup> Privatization is seen as a way to unlock gains in economic efficiency by giving new private owners a powerful incentive—the reward of greater profits—to search for increases in productivity, to enter new markets, and to exit losing ones.<sup>53</sup>

The privatization movement started in Great Britain in the early 1980s when then Prime Minister Margaret Thatcher started to sell state-owned assets such as the British telephone company, British Telecom (BT). In a pattern that has been repeated around the world, this sale was linked with the deregulation of the British telecommunications industry. By allowing other firms to compete head to head with BT, deregulation ensured that privatization did not simply replace a state-owned monopoly with a private monopoly. The opening case discussed privatization in India. As this example suggests, privatization has become a worldwide movement. In Africa, for example, Mozambique and Zambia are leading the way with very ambitious privatization plans. Zambia put more than 145 state-owned companies up for sale, while Mozambique has already sold scores of enterprises, ranging from tea plantations to a chocolate factory. The most dramatic privatization programs, however, have occurred in the economies of the former Soviet Union and its Eastern European satellite states. In the Czech Republic, three-quarters of all state-owned enterprises were privatized between 1989 and 1996, helping to push the share of gross domestic product accounted for by the private sector up from 11 percent in 1989 to 60 percent in 1995. In Russia, where the private sector had been almost completely repressed before 1989, 50 percent of GDP was in private hands by 1995, again much as a result of privatization. And in Poland, the private sector accounted for 59 percent of GDP in 1995, up from 20 percent in 1989.<sup>54</sup> However, Poland also illustrates how far some of these countries still have to travel. Despite an aggressive privatization program, Poland still had 4000 state-owned enterprises that dominate the heavy industry, mining, and transportation sectors.

The ownership structure of newly privatized firms also is important.<sup>55</sup> Many former command economies, for example, lack the legal regulations regarding corporate governance that are found in advanced Western economies. In advanced market economies, boards of directors are appointed by shareholders to make sure managers consider the interests of shareholders when making decisions and try to manage the firm in a manner that is consistent with maximizing the wealth of shareholders. However, some former Communist states lack laws requiring corporations to establish effective boards. In such cases, managers with a small ownership stake can often gain control over the newly privatized entity and run it for their own benefit, while ignoring the interests of other shareholders. Sometimes these managers are the same Communist bureaucrats who ran the enterprise before privatization. Because they have been schooled in the old ways of doing things, they often hesitate to take drastic action to increase the efficiency of the enterprise. Instead, they continue to run the firm as a private fiefdom, seeking to extract whatever economic value they can for their own betterment (in the form of perks that are not reported) while doing little to increase the economic efficiency of the enterprise so that shareholders benefit.

#### PRIVATIZATION

The sale of state-owned enterprises to private investors.

## Legal Systems

As noted earlier in this chapter, laws protecting private property rights and providing mechanisms for contract enforcement are required for a well-functioning market economy. Without a legal system that protects property rights, and without the machinery to enforce that system, the incentive to engage in economic activity can be reduced substantially by private and public entities, including organized crime, that expropriate the profits generated by the efforts of private-sector entrepreneurs. As noted earlier, this has become a problem in many former Communist states. When communism collapsed, many of these countries lacked the legal structure required to protect property rights, all property having been held by the state. Although many states have made big strides toward instituting the required system, it will be many more years before the legal system is functioning as smoothly as it does in the West. For example, in most Eastern European nations, the title to urban and agricultural property is often uncertain because of incomplete and inaccurate records, multiple pledges on the same property, and unsettled claims resulting from demands for restitution from owners in the pre-Communist era. Also, while most countries have improved their commercial codes, institutional weaknesses still undermine contract enforcement. Court capacity is often inadequate, and procedures for resolving contract disputes out of court are often inadequate or poorly developed.<sup>56</sup>

## The Rocky Road

In practice, the road that must be travelled to reach a market-based economic system has often been rocky.<sup>57</sup> This has been particularly true for the states of Eastern Europe in the post-Communist era. In this region, the move toward greater political and economic freedom has sometimes been accompanied by economic and political chaos.<sup>58</sup> Most Eastern European states began to liberalize their economies in the heady days of the early 1990s. They dismantled decades of price controls, allowed widespread private ownership of businesses, and permitted much greater competition. Most also planned to sell state-owned enterprises to private investors. However, given the vast number of such enterprises and how inefficient many were, making them unappealing to private investors, most privatization efforts moved forward slowly. In this new environment, many inefficient state-owned enterprises found that they could not survive without a guaranteed market. The newly democratic governments often continued to support these money-losing enterprises to stave off massive unemployment. The resulting subsidies to state-owned enterprises led to ballooning budget deficits that were typically financed by printing money. Printing money, along with the lack of price controls, often led to hyperinflation. In 1993, the inflation rate was 21 percent in Hungary, 38 percent in Poland, 841 percent in Russia, and a staggering 10 000 percent in the Ukraine. Since then, however, many governments have instituted tight monetary policies and reduced their inflation rates.

Another consequence of the shift toward a market economy was collapsing output as inefficient state-owned enterprises failed to find buyers for their goods. Real gross domestic product fell dramatically in many post-Communist states between 1990 and 1994. However, the corner has been turned in several countries. Poland, the Czech Republic, and Hungary now all boast growing economies and relatively low inflation. But some countries, such as Russia and the Ukraine, still find themselves grappling with major economic problems.

A study by the World Bank suggests that the post-Communist states that have been most successful at transforming their economies were those that followed an economic policy best described as “shock therapy.” In these countries—which include the Czech Republic, Hungary, and Poland—prices and trade were liberated quickly, inflation was held in check by tight monetary policy, and the privatization of state-owned

industries was implemented rapidly. Among the 26 economies of Eastern Europe and the former Soviet Union, the World Bank found a strong positive correlation between the imposition of such shock therapy and subsequent economic growth. Speedy reformers suffered smaller falls in output and returned to growth more quickly than those such as Russia and the Ukraine that moved more slowly.<sup>59</sup>

Despite variations within the group, in general, the transformation of former command economies has progressed significantly.

## IMPLICATIONS

The global changes in political and economic systems discussed above have several implications for international business. The ideological conflict between collectivism and individualism that so defined the twentieth century is less in evidence today. The West won the Cold War, and Western ideology has never been more widespread than it was at the beginning of the millennium. Although command economies still remain and totalitarian dictatorships can still be found around the world, the tide has been running in favour of free markets and democracy.

The implications for business are enormous. For the best part of 50 years, half of the world was off-limits to Western businesses. Now all that is changing. Many of the national markets of Eastern Europe, Latin America, Africa, and Asia may still be undeveloped and impoverished, but they are potentially enormous. With a population of 1.2 billion, the Chinese market alone is potentially bigger than that of the United States, the European Union, and Japan combined! Similarly India, with its 1 billion people, is a potentially huge future market. Latin America has another 400 million potential consumers. It is unlikely that China, Russia, Poland, or any of the other states now moving toward a free market system will attain the living standards of the West anytime soon. Nevertheless, the upside potential is so large that companies need to consider making inroads now.

However, just as the potential gains are large, so are the risks. There is no guarantee that democracy will thrive in the newly democratic states of Eastern Europe, particularly if these states have to grapple with severe economic setbacks. Totalitarian dictatorships could return, although they are unlikely to be of the communist variety. Although the bipolar world of the Cold War era has vanished, it may be replaced by a multipolar world dominated by a number of civilizations. In such a world, much of the economic promise inherent in the global shift toward market-based economic systems may evaporate in the face of conflicts between civilizations. While the long-term potential for economic gain from investment in the world's new market economies is large, the risks associated with any such investment are also substantial. It would be foolish to ignore these.

## IMPLICATIONS FOR BUSINESS

The implications for international business of the material discussed in this chapter fall into two broad categories. First, the political, economic, and legal environment of a country clearly influences the attractiveness of that country as a market and/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. Second, the political, economic, and legal systems of a country can raise important ethical issues that have implications for the practice of international business. Here we consider each of these issues.

### ATTRACTIVENESS

The overall attractiveness of a country as a market and/or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Below we consider the determinants of benefits, costs, and risks.

## Benefits

In the most general sense, the long-run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers. While some markets are very large when measured by number of consumers (e.g., China and India), low living standards may imply limited purchasing power and, therefore, a relatively small market when measured in economic terms. While international businesses need to be aware of this distinction, they also need to keep in mind the likely future prospects of a country. In 1960, for example, South Korea was viewed as just another impoverished Third World nation. By 2000 it was the world's 12th largest economy, measured in terms of GDP. International firms that recognized South Korea's potential in 1960 and began to do business in that country may have reaped greater benefits than those that wrote off South Korea.

By identifying and investing early in a potential future economic star, international firms may build brand loyalty and gain experience in that country's business practices. These will pay back substantial dividends if that country achieves sustained high economic growth rates. In contrast, late entrants may find that they lack the brand loyalty and experience necessary to achieve a significant presence in the market. In the language of business strategy, early entrants into potential future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to late-mover disadvantages.<sup>60</sup> (**First-mover advantages** are the advantages that accrue to early entrants into a market. **Late-mover disadvantages** are the handicap that late entrants might suffer.)

A country's economic system and property rights regime are reasonably good predictors of economic prospects. Countries with free market economies in which property rights are well protected tend to achieve greater economic growth rates than command economies and/or economies where property rights are poorly protected. It follows that a country's economic system and property rights regime, when taken together with market size (in terms of population), probably constitute reasonably good indicators of the potential long-run benefits of doing business in a country.

## Costs

A number of political, economic, and legal factors determine the costs of doing business in a country. With regard to political factors, the costs of doing business in a country can be increased by a need to pay off the politically powerful to be allowed by the government to do business. The need to pay what are essentially bribes is greater in closed totalitarian states than in open democratic societies where politicians are held accountable by the electorate (although this is not a hard-and-fast distinction). Whether a company should actually pay bribes in return for market access should be determined on the basis of the legal and ethical implications of such action. We discuss this consideration below.

With regard to economic factors, one of the most important variables is the sophistication of a country's economy. It may be more costly to do business in relatively primitive or undeveloped economies because of the lack of infrastructure and supporting businesses. At the extreme, an international firm may have to provide its own infrastructure and supporting business, which obviously raises costs. When McDonald's decided to open its first restaurant in Moscow, it found that to serve food and drink indistinguishable from that served in McDonald's restaurants elsewhere, it had to vertically integrate backward to supply its own needs. The quality of Russian-grown potatoes and meat was too poor. Thus, to protect the quality of its product, McDonald's set up its own dairy farms, cattle ranches, vegetable plots, and food processing plants within Russia. This raised the cost of doing business in Russia, relative to the cost in more sophisticated economies where high-quality inputs could be purchased on the open market.

As for legal factors, it can be more costly to do business in a country where local laws and regulations set strict standards with regard to product safety, safety in the workplace, environmental pollution, and the like (since adhering to such regulations is costly). It can also be more costly to do business in a country like the United States, where the absence of a cap on damage awards has meant spiralling liability insurance rates. It can be more costly to do business in a country that lacks well-established laws for regulating business practice (as is the case in many of the former Communist nations). In the absence of a well-developed body of business contract law, international firms may find no satisfactory way to resolve contract disputes and, consequently, routinely face large losses from contract violations. Similarly, local laws that fail to adequately protect intellectual property can lead to the "theft" of an international business's intellectual property, and lost income.

### FIRST-MOVER ADVANTAGES

Advantages accruing to the first to enter a market.

### LATE-MOVER DISADVANTAGES

Handicap experienced by being a late entrant in a market.

## Risks

As with costs, the risks of doing business in a country are determined by a number of political, economic, and legal factors. **Political risk** has been defined as the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise.<sup>61</sup> So defined, political risk tends to be greater in countries experiencing social unrest and disorder or in countries where the underlying nature of a society increases the likelihood of social unrest. Social unrest typically finds expression in strikes, demonstrations, terrorism, and violent conflict. Such unrest is more likely to be found in countries that contain more than one ethnic nationality, in countries where competing ideologies are battling for political control, in countries where economic mismanagement has created high inflation and falling living standards, or in countries that straddle the "fault lines" between civilizations, such as Bosnia.

Social unrest can result in abrupt changes in government and government policy or, in some cases, in protracted civil strife. Such strife tends to have negative economic implications for the profit goals of business enterprises. For example, in the aftermath of the 1979 Islamic revolution in Iran, the Iranian assets of numerous U.S. companies were seized by the new Iranian government without compensation. Similarly, the violent disintegration of the Yugoslavian federation into warring states, including Bosnia, Croatia, and Serbia, precipitated a collapse in the local economies and in the profitability of investments in those countries.

Although likely never at risk from a violent Yugoslav-type disintegration, the perception of Canada as a unified and politically stable country has, over the past four decades been intermittently tested in the eyes of the world. The FLQ crisis of the 1960s brought bombings, violence, and political kidnappings to Montreal. Since then, however, the flare-ups have been, for the most part, peaceful. Quebec separatism, still on the Parti Quebecois agenda as an achievable reality, has taken a back seat over the past few years to economic concerns.

On the economic front, economic risks arise from economic mismanagement by the government of a country. **Economic risk** can be defined as the likelihood that economic mismanagement will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise. Economic risks are not independent of political risk. Economic mismanagement may give rise to significant social unrest and hence political risk. Nevertheless, economic risks are worth emphasizing as a separate category because there is not always a one-to-one relationship between economic mismanagement and social unrest. One visible indicator of economic mismanagement tends to be a country's inflation rate. Another tends to be the level of business and government debt in the country.

In Asian states such as Indonesia, Thailand, and South Korea, businesses increased their debt rapidly during the 1990s, often at the bequest of the government, which was encouraging them to invest in industries deemed to be of "strategic importance" to the country. The result was overinvestment, with more industrial (factories) and commercial capacity (office space) being built than could be justified by demand conditions. Many of these investments turned out to be uneconomic. The borrowers failed to generate the profits required to meet their debt payment. In turn, the banks that had lent money to these businesses suddenly found that they had rapid increases in nonperforming loans on their books. Foreign investors, believing that many local companies and banks might go bankrupt, pulled their money out of these countries, selling local stock, bonds, and currency. This action precipitated the 1997–1998 financial crisis in Southeast Asia. The crisis included a precipitous decline in the value of Asian stock markets, which in some cases exceeded 70 percent; a similar collapse in the value of many Asian currencies against the U.S. dollar; an implosion of local demand; and a severe economic recession that will affect many Asian countries for years to come. In short, economic risks were rising throughout Southeast Asia during the 1990s. Astute foreign businesses and investors, seeing this situation, limited their exposure in this part of the world. More naive businesses and investors lost their shirts!

On the legal front, risks arise when a country's legal system fails to provide adequate safeguards in the case of contract violations or to protect property rights. When legal safeguards are weak, firms are more likely to break contracts and/or steal intellectual property if they perceive it as being in their interests to do so. Thus, **legal risk** might be defined as the likelihood that a trading partner will opportunistically break a contract or expropriate property rights. When legal risks in a country are high, an international business might hesitate entering into a long-term contract or joint-venture agreement with a firm in that country. For example, in the 1970s when the Indian government passed a law

### POLITICAL RISK

The likelihood that political forces will cause drastic changes in a country's business environment that will adversely affect the profit and other goals of a particular business enterprise.

### ECONOMIC RISK

The likelihood that events, including economic mismanagement, will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a particular business enterprise.

### LEGAL RISK

The likelihood that a trading partner will opportunistically break a contract or expropriate intellectual property rights.

requiring all foreign investors to enter into joint ventures with Indian companies, U.S. companies such as IBM and Coca-Cola closed their investments in India. They believed that the Indian legal system did not provide for adequate protection of intellectual property rights, creating the very real danger that their Indian partners might expropriate the intellectual property of the American companies—which for IBM and Coca-Cola amounted to the core of their competitive advantage.

### 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 associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. The calculus is complicated, however, by the fact that the potential long-run benefits are not dependent only upon a nation's current stage of economic development or political stability. Rather, the benefits depend on likely future economic growth rates. Economic growth appears to be a function of a free market system and a country's capacity for growth (which may be greater in less developed nations). This leads one to conclude that, other things being equal, the benefit–cost–risk trade-off is likely to be most favourable in politically stable developed and developing nations that have free market systems and no dramatic upsurge in either inflation rates or private-sector debt. It is likely to be least favourable in politically unstable developing nations that operate with a mixed or command economy or in developing nations where speculative financial bubbles have led to excess borrowing.

### ETHICS AND REGULATIONS

Country differences give rise to some important and contentious ethical issues. Three important issues that have been the focus of much debate in recent years are (1) the ethics of doing business in nations that violate human rights, (2) the ethics of doing business in countries with very lax labour and environmental regulations, and (3) the ethics of corruption.

#### Ethics and Human Rights

One major ethical dilemma facing firms from democratic nations is whether they should do business in totalitarian countries, such as China, that routinely violate the human rights of their citizens. There are two sides to this issue. Some argue that investing in totalitarian countries provides comfort to dictators and can help prop up repressive regimes that abuse basic human rights. For instance, Human Rights Watch, an organization that promotes the protection of basic human rights around the world, has argued that the progressive trade policies adopted by Western nations toward China has done little to deter human rights abuses.<sup>62</sup> According to Human Rights Watch, the Chinese government stepped up its repression of political dissidents in 1996 after the Clinton administration removed human rights as a factor in determining China's trade status with the United States. Without investment by Western firms and the support of Western governments, many repressive regimes would collapse and be replaced by more democratically inclined governments, critics such as Human Rights Watch argue. Firms that have invested in Chile, China, Iraq, and South Africa have all been the direct targets of such criticisms. The 1994 dismantling of the apartheid system in South Africa has been credited to economic sanctions by Western nations, including a lack of investment by Western firms. This, say those who argue against investment in totalitarian countries, is proof that investment boycotts can work (although decades of U.S.-led investment boycotts against Cuba and Iran, among other countries, have failed to have a similar impact).

In contrast, some argue that Western investment, by raising the level of economic development of a totalitarian country, can help change it from within. They note that economic well-being and political freedoms often go hand in hand. Thus, when arguing against attempts to apply trade sanctions to China in the wake of the violent 1989 government crackdown on pro-democracy demonstrators, the U.S. government claimed that U.S. firms should continue to be allowed to invest in mainland China because greater political freedoms would follow the resulting economic growth. The Clinton administration used similar logic as the basis for its 1996 decision decoupling human rights issues from trade policy considerations.

Since both positions have some merit, it is difficult to arrive at a general statement of what firms should do. Unless mandated by government (as in the case of investment in South Africa) each firm must make its own judgments about the ethical implications of investing in totalitarian states on a case-by-case basis. The more repressive the regime, however, and the less amenable it seems to be to change, the greater the case for not investing.

## Ethics and Regulations

A second important ethical issue is whether an international firm should adhere to the same standards of product safety, work safety, and environmental protection that are required in its home country. This is of particular concern to many firms based in Western nations, where product safety, worker safety, and environmental protection laws are among the toughest in the world. Should Western firms investing in less developed countries adhere to tough Western standards, even though local regulations don't require them to do so? This issue has taken on added importance in recent years following revelations that Western enterprises have been using child labour or very poorly paid "sweatshop" labour in developing nations. Companies criticized for using sweatshop labour include the Gap, Disney, Wal-Mart, and Nike.<sup>63</sup>

Again there is no easy answer. While the argument for adhering to Western standards might seem strong, on closer examination the issue becomes more complicated. What if adhering to Western standards would make the foreign investment unprofitable, thereby denying the foreign country much-needed jobs? What is the ethical thing to do? To adhere to Western standards and not invest, thereby denying people jobs, or to adhere to local standards and invest, thereby providing jobs and income? As with many ethical dilemmas, there is no easy answer. Each case needs to be assessed on its own merits.

## Ethics and Corruption

A final ethical issue concerns bribes and corruption. Should an international business pay bribes to corrupt government officials to gain market access to a foreign country? To most Westerners, bribery seems to be a corrupt and morally repugnant way of doing business, so the answer might initially be no. Some countries have laws on their books that prohibit their citizens from paying bribes to foreign government officials in return for economic favours. As noted earlier, in the United States the Foreign Corrupt Practices Act prohibits U.S. companies from making "corrupt" payments to foreign officials to obtain or retain business, although many other developed nations lack similar laws. Similarly, the Canadian Bill S-21 encompasses the same spirit of checks and balances against corrupt business practices on the international stage. Trade and finance ministers from the member states of the Organization for Economic Cooperation and Development (OECD), an association of the world's 20 or so most powerful economies, are working on a convention that would oblige member states to make the bribery of foreign public officials a criminal offence.

However, in many parts of the world, payoffs to government officials are a part of life. One can argue that not investing ignores the fact that such investment can bring substantial benefits to the local populace in terms of income and jobs. From a pragmatic standpoint, the practice of giving bribes, although a little evil, might be the price that must be paid to do a greater good (assuming the investment creates jobs where none existed before and assuming the practice is not illegal). Several economists advocate this reasoning, suggesting that in the context of pervasive and cumbersome regulations in developing countries, corruption may actually improve efficiency and help growth! These economists theorize that in a country where preexisting political structures distort or limit the workings of the market mechanism, corruption in the form of black-marketeering, smuggling, and side payments to government bureaucrats to "speed up" approval for business investments may actually enhance welfare.<sup>64</sup> Arguments like this persuaded the U.S. congress to exempt certain "grease payments" from the Foreign Corrupt Practices Act. Similarly, Bill S-21 allows for exemptions under such circumstances.

However, other economists have argued that corruption reduces the returns on business investment.<sup>65</sup> In a country where corruption is common, the profits from a business activity may be siphoned off by unproductive bureaucrats who demand side payments for granting the enterprise permission to operate. This reduces the incentive that businesses have to invest and may hurt a country's economic growth rate. One economist's study of the connection between corruption and growth in 70 countries found that corruption had a significant negative impact on a country's economic growth rate.<sup>66</sup> Given the debate and the complexity of this issue, one again might conclude that generalization is difficult. Yes, corruption is bad, and yes, it may harm a country's economic development, but yes, there are also cases where side payments to government officials can remove the bureaucratic barriers to investments that create jobs. This pragmatic stance ignores, however, that corruption tends to "corrupt" both the bribe giver and the bribe taker. Corruption feeds on itself, and once an individual has started to walk down the road of corruption, pulling back may be difficult if not impossible. This strengthens the moral case for never engaging in corruption, no matter how compelling the benefits might seem.

## KEY TERMS

- Bill S-21, p. 55
- civil law, p. 50
- collectivism, p. 44
- command economy, p. 49
- common law, p. 50
- communist totalitarianism, p. 47
- communists, p. 44
- contract, p. 51
- contract law, p. 51
- copyrights, p. 55
- democracy, p. 46
- deregulation, p. 71
- economic risk, p. 77
- first-mover advantages, p. 76
- Foreign Corrupt Practices Act, p. 54
- gross national income (GNI), p. 61
- Human Development Index (HDI), p. 62
- individualism, p. 45
- innovation, p. 62
- late-mover disadvantages, p. 76
- legal risk, p. 77
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- trademarks, p. 55
- tribal totalitarianism, p. 47
- United Nations Convention on Contracts for the International Sale of Goods (CIGS), p. 51

## SUMMARY

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

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 built on an emphasis of the primacy of 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.

7. The rate of economic progress in a country seems to depend on the extent to which that country has a well-functioning market economy in which property rights are protected.
8. Many countries are now in a state of transition. There is a marked shift away from totalitarian governments and command or mixed economic systems and toward democratic political institutions and free market economic systems.
9. The attractiveness of a country as a market and/or investment site depends on balancing the likely long-run benefits of doing business in that country against the likely costs and risks.
10. The benefits of doing business in a country are a function of the size of the market (population), its present wealth (purchasing power), and its future growth prospects. By investing early in countries that are currently poor but are nevertheless growing rapidly, firms can gain first-mover advantages that may pay back substantial dividends in the future.
11. The costs of doing business in a country tend to be greater where political payoffs are required to gain market access, where supporting infrastructure is lacking or underdeveloped, and where adhering to local laws and regulations is costly.
12. The risks of doing business in a country tend to be greater in countries that are (i) politically unstable, (ii) subject to economic mismanagement, and (iii) lacking a legal system to provide adequate safeguards in the case of contract or property rights violations.
13. Country differences give rise to several ethical dilemmas, including (i) should a firm do business in a repressive totalitarian state, (ii) should a firm conform to its home product, workplace, and environmental standards when they are not required by the host country, and (iii) should a firm pay bribes to government officials to gain market access?

## 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., bribe taking by government officials) and economic growth? Is corruption always bad?
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.
5. During the late 1980s and early 1990s, China was routinely cited by various international organizations such as Amnesty International and Freedom Watch for major human rights violations, including torture, beatings, imprisonment, and executions of political dissidents. Despite this, in the late 1990s, China received record levels of foreign direct investment, mainly from firms based in democratic societies such as the United States, Japan, and Germany. Evaluate this trend from an ethical perspective. If you were the CEO of a firm that had the option of making a potentially very profitable investment in China, what would you do?
6. You are the CEO of a company that has to choose between making a \$100-million investment in Russia or the Czech Republic. 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 favour and why?

## RESEARCH TASK [globaledge.msu.edu](http://globaledge.msu.edu)

Use the globalEDGE™ site to complete the following exercises:

1. The “Freedom in the World” survey 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 leaders and laggards. What factors are considered in this survey when forming the rankings?
2. Market Potential Indicators (MPI) is an indexing study conducted by the Michigan State University Center for International Business Education and Research (MSU-CIBER) to compare emerging markets on a variety of dimensions. Provide a description of the indicators used in the indexing procedure. Which of the indicators would have greater importance for a company that markets laptop computers? Considering the MPI rankings, which developing countries would you advise this company to enter first?



## CLOSING CASE

### DELIVERING ELECTRICITY IN CANADA

Electricity is a unique raw material in the world, and its methods of delivery show how interconnected our globe has become. The way electricity is traded also shows how the notion of the role that government should play in the Canadian economy is influenced by events in other jurisdictions.

Canada is the fifth largest electricity producer in the world—only the United States, China, Russia, and Japan produce more. Electricity is a unique product in that it cannot easily be stored in the same way that other commodities, such as oil and natural gas, can be. Since electricity must be used as it is produced, trade of electricity across provincial and country borders becomes very important. For example, while the Province of Ontario is a net exporter of electricity, it also imports power from Quebec, Manitoba, and the United States.

For much of the 1900s, electricity in Canada and in other industrialized nations was highly monopolized and regulated. Electricity was thought of as being too important to be left in the hands of the private sector. However, starting in the 1980s, it was becoming clear that public monopolies were introducing unnecessary, costly, and often unsafe practices to the delivery of a wide range of essential services. As governments watched market forces wring efficiencies from regulated monopolies such as airlines and telecommunications, there was the inevitable look to see if the same price mechanism could create efficiencies in the electricity market.

These forces impacted the Canadian electricity industry. While the electrical and regulatory situation across the country varied widely by province, some provinces, such as Alberta and Ontario undertook major changes in their regulatory environment. Alberta, for example, was the first province to introduce privatization legislation in 1995, with later amendments allowing retail customers to choose their suppliers of electricity from the beginning of 2001. Ontario introduced its own privatization legislation in 1998 and retail access was to be provided in Ontario in May 2002.

However, other forces in the United States were emerging to cast great suspicion on deregulated electricity markets. California deregulated its markets in 1998, and for its first two years the system worked very well. However, beginning in May 2000, electricity prices increased dramatically. This was due to a combination of factors, including natural gas prices that had increased by 400 percent in one year, a dry year that affected the demand for hydroelectric power, hot summer weather and cold winter temperatures, both of which increased demand, and lack of new supply. During the 1990s no major power plants were built in California, as utilities and other private companies were unwilling to make such large investments in an uncertain regulatory environment. The result was a series of rolling blackouts, the bankruptcy of some utilities, and questioning of the role of private companies.

This situation was made worse as information came forward about the role of Enron in California's power crisis. The name Enron has now entered the public realm as a synonym for greed, corruption, and everything that is seemingly wrong with capitalism.

Enron and other power companies abused the system that was in place, sometimes by giving false information to electricity price reporting agencies. None of these findings have added any credibility to the increasingly fragile electricity marketplace throughout North America.

In Ontario, in 2002 and 2003, events including changing political leaders, shifting public sentiment, and political expediency combined to present an erratic landscape for electricity. In December 2001, it was announced that the province would sell the former Ontario Hydro's electricity delivery business, to become the largest privatization in Canadian history. In 2002, a judge ruled that the government did not have the authority to sell the business. By the end of 2002, new Premier Ernie Eves announced a freezing of power rates, effectively ending the experiment with market forces determining the price of power.

In August 2003, the downside of having an interconnected marketplace was shown as 50 million North Americans suffered through a power blackout. A power failure that began in Ohio quickly cascaded through eight U.S. states and into Canada. Some parts of Ontario suffered rolling blackouts for more than a week before electricity was fully restored. It is estimated that in Canada 18.9 million work hours were lost due to the blackout. An aging power grid was one culprit, as were the actions of FirstEnergy Corp, a power utility based in Akron, Ohio, which failed to contain what should have been a routine interruption of local service.

In place of market mechanisms, government struggled with the issues of electricity lows. By the end of 2004, Ontario did not have a policy on the long-term future of nuclear en-

ergy, and consumers did not know how much they would be paying for electricity in the coming year, or how the price would be determined.

Sources: Canadian Securities Institute, *Energy Markets-Risk Management*, 2003; A. Lindgren, "Ontario to Get U.S.-Style Power Authority," *National Post*, June 16, 2004; CBC at [www.cbc.ca/national/news/electricity](http://www.cbc.ca/national/news/electricity).

## CASE DISCUSSION QUESTIONS

1. In a switch from government regulated monopolies to competitive markets, who wins, and who loses?
2. Is electricity too important to be left in private hands?
3. How can political and policy changes in one country impact another?