chapter 6

Political and Legal Systems in National Environments

Learning Objectives

In this chapter, you will learn about:

1. What is country risk?
2. What are political and legal systems?
3. Political systems
4. Legal systems
5. Actors in political and legal systems
6. Types of country risk produced by the political system
7. Types of country risk produced by the legal system
8. Managing country risk

Doing Business in Russia: Evolving Legal and Political Realities

Take a walk down the open-air markets in Moscow and you will see market forces in action—vendors strewn about with stalls selling various goods. If you take a closer look, you will likely find vendors selling all variety of pirated software, music, and movie DVDs. Russian police officers are aware of these products but do not issue fines or arrest the sellers. Some corrupt officers may even get a cut of the total sales from these vendors.

Bribery is commonplace in Russia. One expert estimated that Russian small and medium-sized enterprises spend one-fifth of their net income on bribes. Because of a weak legal environment, the country is a tough place to do business. President Vladimir Putin once remarked that anyone who successfully registers a business in Russia deserves a medal. Vague and overlapping regulations enrich a host of public officials. Any new venture may necessitate dozens of government licenses, and each license may require paying a bribe. Government bureaucrats are often the most corrupt, many somehow taking expensive vacations despite receiving modest salaries. In addition to incessant bribery, there have been countless incidents of strong-handed government interference in the private sector. Crim-

inal raiders, sometimes in collaboration with government officials, seize independently operating businesses.

One well-known example is the Russian firm Yukos—an oil company once controlled by the Russian industrialist Mikhail Khodorkovsky, who has been imprisoned by the government for alleged tax evasion. Claiming that Yukos owed back taxes, Russia's government sold part of the firm and kept the $9.3 billion in proceeds. Yukos' buyer was Baikal Finance Group, which happened to have the same address as a grocery store in a small town. This prompted many to question Baikal's existence, which led a state-owned firm known as Rosneft to announce that it had purchased Yukos for an undisclosed sum. Yukos' original buyer no longer exists, and perhaps never did. As the chain of events unfolded, so did the central government's plan to convert privatized energy firms into a patchwork of state enterprises.

Russia is also plagued by organized crime. For example, in 2006, the deputy chairman of Russia's central bank was shot dead in Moscow. He had spearheaded the country's effort to reform its corrupt banking system and had closed dozens of banks linked to organized crime, making dangerous enemies in the process.

Numerous other contract killings have taken place, as criminal organizations attempt to maintain their stronghold on much of Russia's economy. One official estimated that criminal groups control 500 large Russian firms. Foreign MNEs routinely perform background checks on employees and contractors in an effort to identify people who may be linked to organized crime or have false credentials. Foreign companies also attempt to provide for the security of staff and facilities.

Rampant corruption and crime have raised doubts about Russia's evolving legal system and its commitment to market economics. The country is transitioning from a command economy to a market economy. The shift has created much uncertainty for foreign firms doing business there. Managers must be mindful of the political and legal environments that characterize transition economies, particularly in Russia. Ambiguous regulations, nonexistent laws, inadequate enforcement, a rudimentary court system, and a formerly totalitarian government all pose numerous difficulties. Although firms can take precautionary measures to minimize risk, not all risk is avoidable. Russia continues to improve its legal system so as to clarify business transactions and commercial law, and officials have taken tougher stances on organized crime. Numerous firms, from Boeing to IKEA, have invested billions in the country. But operating in Russia continues to pose many challenges. Potential rewards are promising for firms that plan ahead and protect their assets.

Sources: Chazan, G. (2004). "Russian Trial Opens Messy Chapter; Yukos Case Could Influence Course of Commercial Law and Business Under Putin." *Wall Street Journal*, June 16; *Economist.* (2006). "Business: The Reluctant Briber." Nov 4, p. 79; Gantz, J., and J. Rochester. (2005). "Global Fallout." In *Pirates of the Digital Millennium.* New York: Prentice Hall; Giddings, J. (2002). "Doing Business in Russia Today: Steps for Security." *BISNIS Bulletin*, February; Kvint, Vladimir. (2005). "The Scary Business of Russia." *Forbes*, May 23, p. 42.

What Is Country Risk?

Every country is characterized by diverse political and legal systems that pose significant challenges for company strategy and performance. Managers must adhere to laws and regulations that govern business transactions. For example, government-imposed import tariffs lead many firms to enter foreign markets through FDI instead of exporting. At the same time, the political and legal context presents opportunities. Preferential subsidies, government incentives, and protection from competition reduce business costs and influence strategic decision making. Numerous governments encourage domestic investment from foreign MNEs by offering tax holidays and cash incentives to employ local workers. To take advantage of the opportunities and minimize the risks, managers must develop an understanding of the government sector, the political environment, and the legal framework of the countries where they conduct business. They must develop skills to interact effectively with local institutions.

Country risk Exposure to potential loss or adverse effects on company operations and profitability caused by developments in a country's political and/or legal environments.

The opening vignette alerts us to the risks of doing business in Russia. **Country risk** refers to exposure to potential loss or adverse effects on company operations and profitability caused by developments in a country's political and/or legal environments. Country risk is one of four major types of international business risks we introduced in Chapter 1. It is also referred to as *political risk*. Exhibit 6.1 identifies types of country risk prevalent in international business. While the immediate cause of country risk is a political or legal factor, underlying such factors may be economic, social, or technological developments.

Political or legislative actions can harm business interests, even when this is not their intent. Laws may be unexpectedly strict or may result in unintended consequences. Many laws favor host-country interests—that is, interests in foreign countries where the firm has direct operations. For example, Coca-Cola's business fell off in Germany when the government enacted a recycling plan. New laws required consumers to return nonreusable soda containers to stores for a refund of

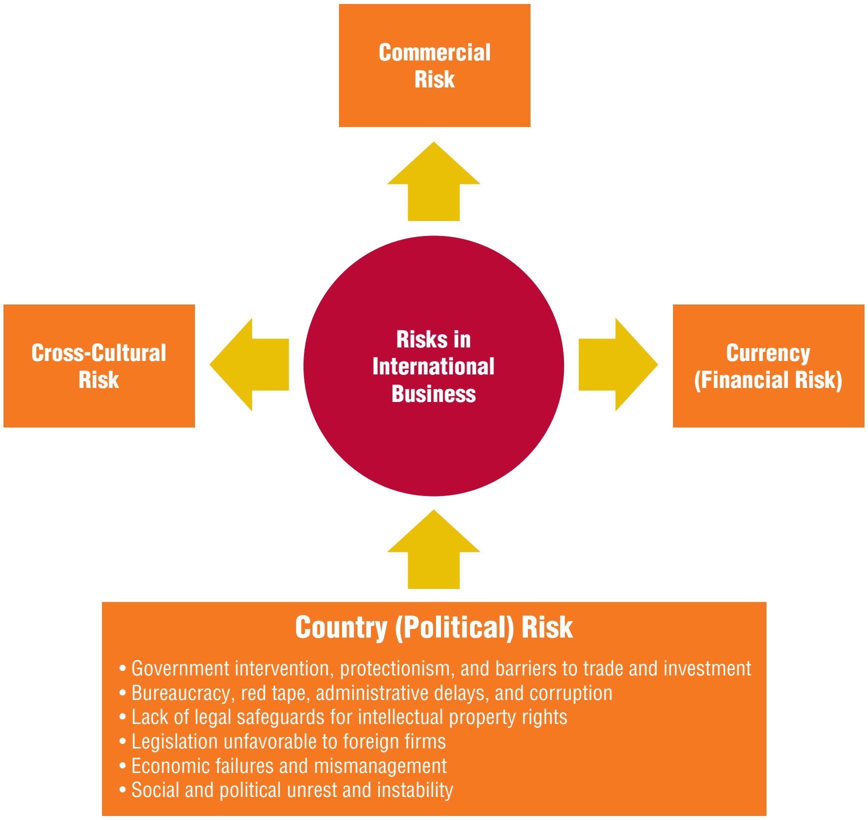


Exhibit 6.1

Country Risk as One of Four Major Risks in International Business

0.25 euros. Rather than cope with the unwanted returns, big supermarket chains responded by yanking Coke from their shelves, pushing their own store brands instead. In China, the government censors material that criticizes the government. Yahoo must monitor the information that appears on its Web site to prevent the Chinese government from shutting down its China operations.[1]

Just as laws and regulations can lead to country risk, their inadequate enforcement can pose challenges for the firm. Inadequate legal protection is particularly challenging in developing countries. Regulations to protect intellectual property may exist on paper but are not adequately enforced. **Intellectual property** refers to ideas or works created by people or firms, such as patents, trademarks, and copyrights. When an innovator invents a new product, produces a movie, or develops new computer software, another party can copy and sell the innovation without acknowledging or paying the inventor. As implied in the opening vignette, Russia's legal framework is relatively weak and inconsistent. Russian courts lack substantial experience ruling on commercial and international affairs. Owing to the unpredictable and potentially harmful legal environment, Western firms frequently abandon joint ventures and other business initiatives in Russia.[2]

Intellectual property Ideas or works created by people or firms, such as patents, trademarks, and copyrights.

How Prevalent Is Country Risk?

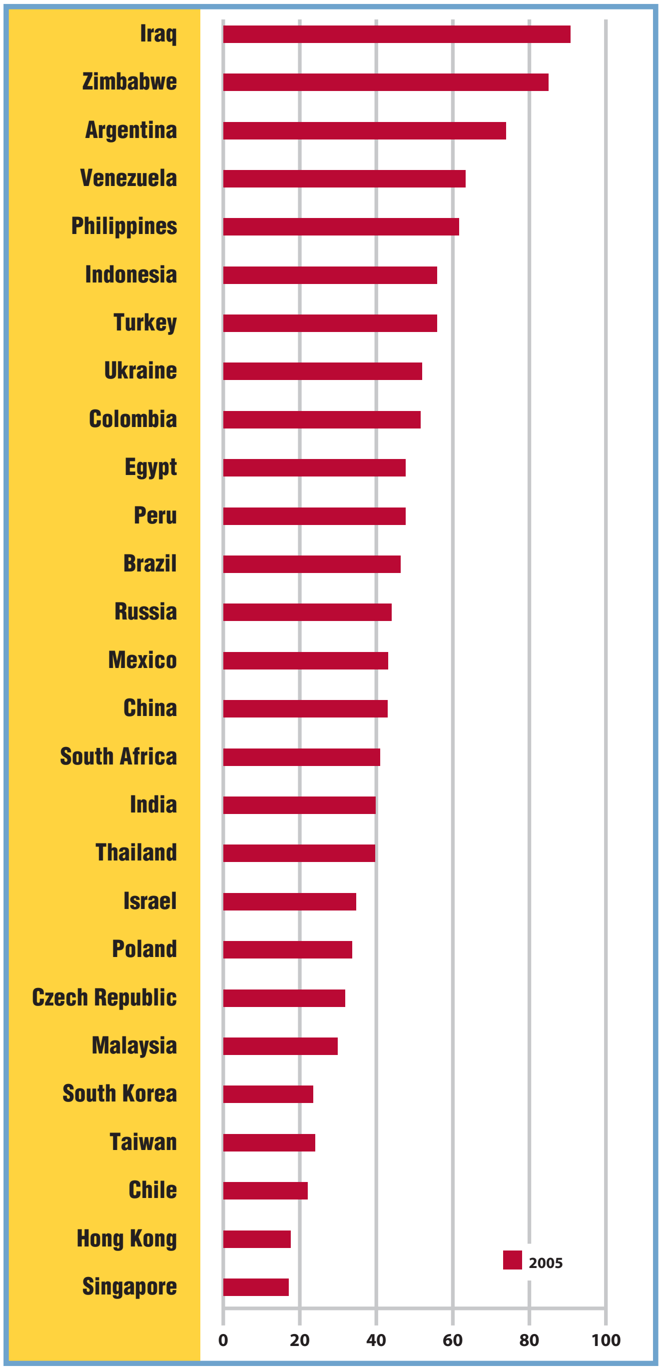
Exhibit 6.2 portrays the level of risk in various countries. Risk is measured using various indicators, such as government debt, fiscal and monetary policy, and political stability. In the wake of war and the emergence of a new political regime, Iraq is one of the riskiest countries. Zimbabwe is risky because of ongoing corruption (bribery and fraud) and political turmoil. By contrast, Singapore and Hong Kong are among the most politically stable countries.[3] Country risk may affect all

Exhibit 6.2

Country Risk in Selected Countries

On a scale of 0 to 100, the rankings combine measures of political risk (such as the threat of war) and economic risk (such as the size of fiscal deficits). They also include measures that affect a country's liquidity and solvency (for example, its debt structure and foreign-exchange reserves)

SOURCE: From *The Economist* (2005), "Country Risk, February 26, p. 102. Copyright © 2005 The Economist. Used with permission.



firms in a country equally, or it may affect only a subset. For instance, the civil war that occurred in the former Yugoslavia and several African countries in the 1990s tended to affect all firms. By contrast, despite the presence of several competitors in the Russian oil industry—Conoco-Phillips, Exxon Mobil, and Royal Dutch Shell—the Russian government targeted only Yukos with politically motivated persecution.[4]

India has often been characterized by high country risk. Hindu nationalists that came to political power in 1996 openly opposed foreign investment and foreign influence on Indian society. They enacted laws that targeted foreign firms for harassment. Some Indians are threatened by perceived cultural invasion from abroad. For example, the KFC restaurant chain was forced to step up security after threats by local political groups to destroy the firm's fast food outlets. About 100 farmers ransacked a KFC restaurant in Bangalore. In an earlier incident, the same restaurant was forced to close after health officials said its chicken contained excessive levels of monosodium glutamate, a flavor enhancer. KFC had long used the same ingredient abroad and won a court order to reopen the outlet.[5]

As countries develop stronger economic ties with foreign trading partners, and become better integrated with the global economy, they tend to liberalize their markets and eliminate restrictions on foreign business. This happened in India as well, with the introduction of a series of economic reforms and markets opening in 1991. Exhibit 6.2 suggests the relationship between country risk and the degree of legal and political freedom. The country risk ratings tend to be rather low in countries with a favorable legal climate and political stability. In contrast, country risk ratings are higher in countries with excessive regulatory burdens and political instability.

What Are Political and Legal Systems?

A **political system** refers to a set of formal institutions that constitute a government. It includes legislative bodies, political parties, lobbying groups, and trade unions. A political system also defines how these groups interact with each other.

Political system A set of formal institutions that constitute a government.

Legal system A system for interpreting and enforcing laws.

A **legal system** refers to a system for interpreting and enforcing laws. The laws, regulations, and rules establish norms for conduct. A legal system incorporates institutions and procedures for ensuring order and resolving disputes in commercial activities, as well as protecting intellectual property and taxing economic output. Political and legal systems are both dynamic and constantly changing. The two systems are interdependent—changes in one affect the other.

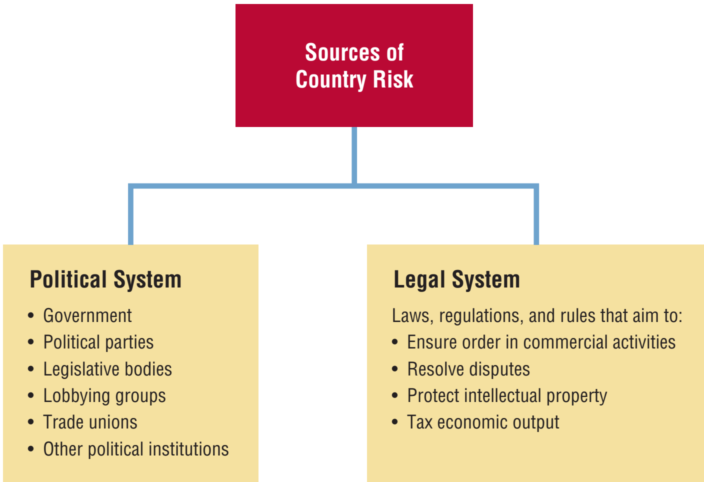
Exhibit 6.3 highlights the sources of political and legal systems that contribute to country risk. Adverse developments in political and legal systems give rise to country risk. These can result from installation of a new government, shifting values or priorities in political parties, new directions or initiatives devised by special interest groups, and the creation of new laws or regulations. Change may be gradual or sudden. Gradual change is usually easier for the firm to accommodate. By contrast, sudden change is harder to deal with and poses greater risk to the firm. Unfavorable developments give rise to new conditions that may threaten the firm's products, services, or business activities. For example, a new import tariff may increase the cost of an important component used in manufacturing a product. A modification in labor law may alter the hours that the firm's employees are allowed to work. The installation of a new political leader may lead to government takeover of corporate assets.

Country risk is *always* present, but its nature and intensity vary over time and from country to country. In China, for example, the government is in the process of overhauling the national legal system, making it increasingly consistent with Western systems. Reforms, however, have been carried out in a piecemeal manner. New regulations have been poorly formulated, confusing, or contradictory. For instance, at one point the Beijing government announced that foreign investments in China's Internet industry were illegal. By this time Western firms had already invested millions of dollars in the Chinese dot.com sector, without any indication that the investments were inappropriate. In disputes between local and foreign firms, governments are often inclined to protect local interests. Even where Western firms obtain favorable judgments in the courts, enforcement may be difficult to achieve.

Let's delve into political and legal systems in greater detail.

Exhibit 6.3

Sources of Country Risk



Political Systems

The principal functions of a political system are to establish stability based on laws, provide protection from external threats, and govern the allocation of valued resources among the members of a society. Each country's political system is relatively unique, having emerged within a particular historical, economic, and cultural context. Each political system evolves as a function of constituent demands and the evolution of the national and international environment. Constituents are the people and organizations that support the political regime and are the recipients of government resources.

In terms of regulating and controlling business, political systems run the gamut—from state ownership of economic enterprises and control of internal commerce to minimal government intervention in business activities. In recent history, three major types of political systems can be distinguished: totalitarianism, socialism, and democracy. Exhibit 6.4 highlights countries that exemplify these systems. Note, however, that these categories are not mutually exclusive. For example, most democracies also include some elements of socialism. Most of the totalitarian regimes of the twentieth century now embrace a mix of socialism and democracy.

Totalitarianism

Well-known totalitarian states from the past include China (1949–1980s), Germany (1933–1945), the Soviet Union (1918–1991), and Spain (1939–1975). Today, some states in the Middle East and Africa entail elements of totalitarianism. Under totalitarianism, the state attempts to regulate most aspects of public and private behavior. A totalitarian government seeks to control not only all economic and political matters but the attitudes, values, and beliefs of its citizenry. Often, the entire population is mobilized in support of the state and a political or religious ideology. Totalitarian states are generally either theocratic (religion-based) or secular (non-religion-based). Usually there is a state party led by a dictator, such as Kim Jong-il in North Korea. Party membership is mandatory for those who wish to advance within the social and economic hierarchy. Power is maintained by means of secret police, propaganda disseminated through state-controlled mass media, regulation of free discussion and criticism, and the use of terror tactics. Totalitarian states do not tolerate activities by individuals or groups such as churches, labor unions, or political parties that are not directed toward the state's goals.[6]

Elements of Totalitarianism Found in	Elements of Socialism Found in	Elements of Democracy Found in
Cuba North Korea Several countries in Africa (such as Eritrea, Libya, Sudan, Equatorial Guinea, Zimbabwe)	Bolivia China Egypt India Romania Russia Venezuela	Australia Canada Japan New Zealand United States Most European countries Most Latin American countries

Exhibit 6.4

Examples of Countries under Various Political Systems

Over time, most of the world's totalitarian states have either disappeared or shifted their political and economic systems toward democracy and capitalism. China initiated major reforms in the 1980s, and the Soviet Union collapsed in 1991. Agricultural lands and state enterprises were gradually sold to private interests, and entrepreneurs gained the right to establish their own businesses. However, the transition has not been easy, and former totalitarian states continue to maintain strong political control, including government intervention in business (as in the case of Russia in the opening vignette). Former Soviet states and China are still characterized by red tape that hinders the founding of new firms, bureaucratic accounting and tax regulations, inadequate legal systems to protect business interests, and weak infrastructure in transportation, communications, and information technology (see, for example, World Bank's www.doingbusiness.org).

Socialism

Socialism's fundamental tenet is that capital and wealth should be vested in the state and used primarily as a means of production for use rather than for profit. It is based on a collectivist ideology in which the collective welfare of people is believed to outweigh the welfare of the individual. Socialists argue that capitalists receive a disproportionate amount of society's wealth relative to workers. They believe that, because the pay of workers does not represent the full value of their labor, government should control the basic means of production, distribution, and commercial activity.

Socialism has manifested itself in much of the world as *social democracy,* and has been most successful in western Europe. It has also played a major role in the political systems of large countries such as Brazil and India, and today remains a viable system in much of the world. In social democratic regimes, such as France and Norway, government does intervene in the private sector and in business activities. Corporate income tax rates are also relatively higher in countries such as France and Sweden. Even robust economies like Germany have experienced net outflows of FDI as businesses seek to escape extensive regulation.

Democracy

Democracy has become the prevailing political system in much of the world's advanced economies. Democracy is characterized by two key features:

- *Private property rights:* The ability to own property and assets and to increase one's asset base by accumulating private wealth. *Property* includes tangibles, such as land and buildings, as well as intangibles, such as stocks, contracts, patent rights, and intellectual assets. Democratic governments devise laws that protect property rights. People and firms can acquire property, utilize it, buy or sell it, and bequeath it to whomever they want. These rights are important because they encourage individual

By protecting private property rights, democracies promote entrepreneurship. These women in Chetumal, Mexico, make tortillas in their small business.

initiative, ambition, and innovation, as well as thrift and the desire to accumulate wealth. People are less likely to have these qualities if there is any uncertainty about whether they can control their property or profit from it.

- *Limited government:* The government performs only essential functions that serve all citizens, such as national defense, maintaining law and order, diplomatic relations, and the construction and maintenance of infrastructure such as roads, schools, and public works. State control and intervention in the economic activities of private individuals or firms is minimal. By allowing market forces to determine economic activity, resources are allocated with maximal efficiency.[7]

Under democracy, individual pursuits of people and firms are sometimes at odds with equality and justice. Because people have differing levels of personal and financial resources, each performs with varying degrees of success, leading to inequalities. Critics of pure democracy argue that, when these inequalities become excessive, government should step in to level the playing field. In democracies such as Japan, Germany, and Sweden, the rights and freedoms associated with democracy are construed in larger societal terms rather than on behalf of individuals. Each society balances individual freedom with broader social goals.

Virtually all democracies include elements of socialism, such as government intervention in the affairs of individuals and firms. Socialistic tendencies emerge because of abuses or negative externalities that occur in purely democratic systems. For example, Japan has been striving to achieve the right balance between democracy and socialism. In the 1990s, poor management practices and an economic recession led to the bankruptcy of thousands of Japanese firms. To maintain jobs and economic stability, the Japanese government intervened to support numerous large firms and banks that, in a pure democracy, would have failed. But such policies have also led to inflexibility in the Japanese economy and a delay of needed structural improvements. Many countries, including Australia, Canada, the United States, and those in Europe, are best described as having a *mixed* political system—characterized by a strong private sector *and* a strong public sector (with considerable government regulation and control).

Democracy's Link to Economic Freedom

Compared to totalitarianism and socialism, democracy is associated with greater economic freedom and, usually, higher economic living standards. Economic freedom flourishes when governments support the institutions necessary for that freedom, such as freely operating markets and rule of law. Exhibit 6.5 reveals that the more political freedom in a nation, the more its citizens enjoy economic freedom. The extent of political freedom ranges from "free" to "not free." It is characterized by free and fair elections, the right to form political parties, fair electoral laws, existence of a parliament or other legislative body, freedom from domination by the military, foreign powers, or religious hierarchies, and self-determination for cultural, ethnic, and religious minorities. Economic freedom is related to the extent of government interference in business, the strictness of the regulatory environment, and the ease with which commercial activity is carried out according to market forces (www.freedomhouse.org).

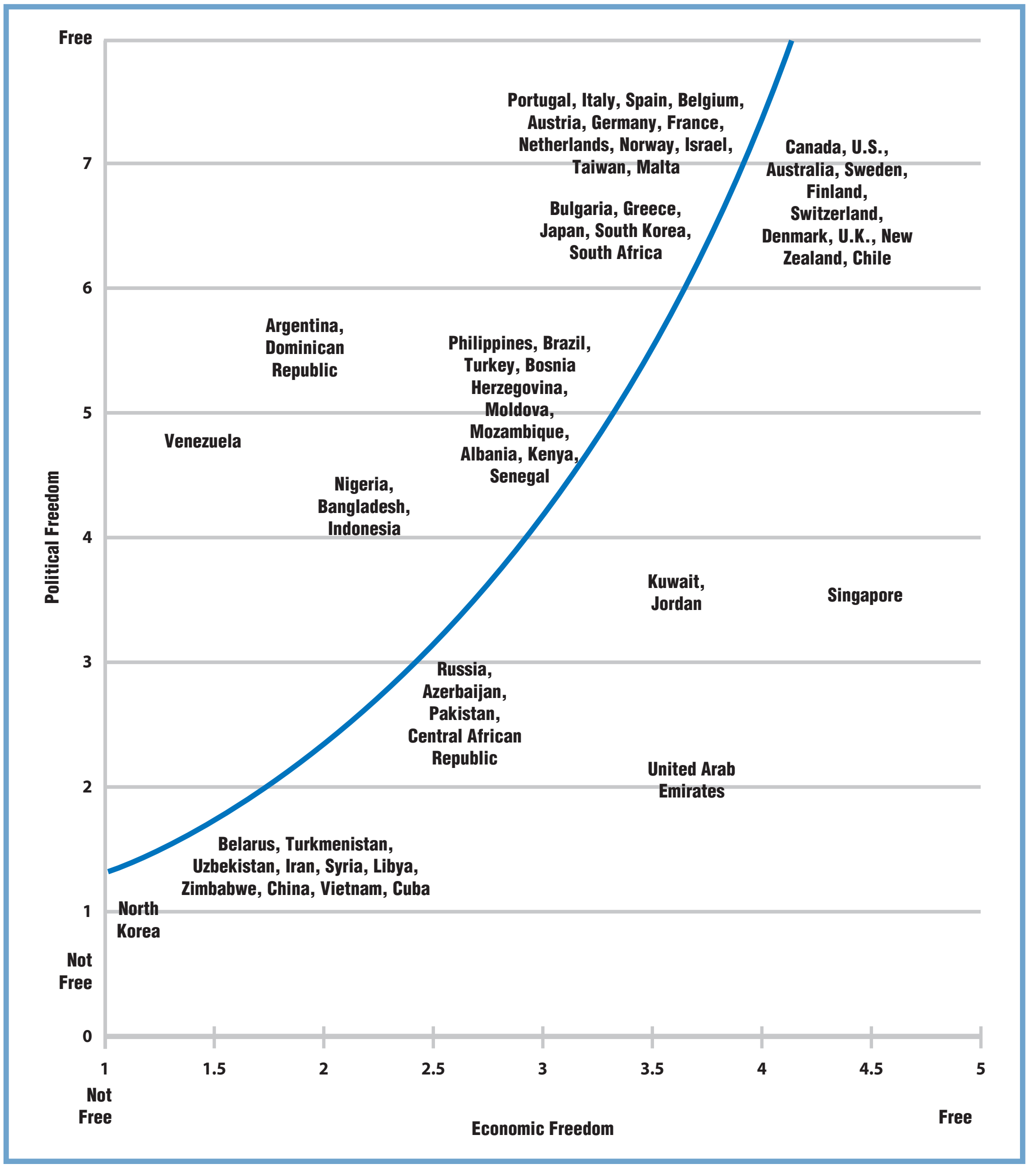


Exhibit 6.5

Relationship between Political Freedom and Economic Freedom for a Sample of Countries

SOURCE: Freedom House. Accessed at www.freedomhouse.org

How Political Systems Influence Economic Systems

Each political system tends to be associated with a particular type of economic system. Generally speaking, totalitarianism is associated with command economies, democracy is associated with market economies, and socialism is associated with mixed economies. Let's review these economic systems.

Command economy Also known as a centrally planned economy, the state is responsible for making all decisions in a command economy with respect to what goods and services the country produces, the quantity of their production, the prices at which they are sold, and the manner of their distribution. The state owns all productive wealth, land, and capital. The government allocates resources based on which industries it wants to develop. A large bureaucracy with central planners is created to manage the nation's affairs. While command economies were common in the twentieth century, they proved so inefficient that most have gradually died out. Central planning is less efficient than market forces in synchronizing supply and demand. For example, shortages were so common in the

Soviet Union that people often waited in lines for hours to buy basic goods like sugar and bread. Today many countries, especially those that embrace socialism, exhibit some characteristics of command economies. The leading examples are China, India, Russia, and certain countries in Central Asia, Eastern Europe, and the Middle East.

Market economy Decision making on levels of production, consumption, investment, and savings results from the interaction of supply and demand—that is, *market forces.* Economic decisions are left to individuals and firms. Government intervention in the marketplace is limited. Market economies are closely associated with capitalism, according to which the means of production are privately owned and operated. Participants typically exhibit a market-oriented mentality and entrepreneurial spirit. The task of the state is to establish a legal system that protects private property and contractual agreements within which people and firms can carry out their economic activity. However, the government may also intervene to address the inequalities that market economies sometimes produce.

Mixed economy A mixed economy exhibits the features of both a market economy and a command economy. It combines state intervention *and* market mechanisms for achieving production and distribution. Most industries are under private ownership, and entrepreneurs freely establish, own, and operate corporations. But the government also controls certain functions, such as pension programs, labor regulation, minimum wage levels, and environmental regulation. The state usually funds public education, health care, and other vital services. There are usually state-owned enterprises in key sectors such as transportation, telecommunications, and energy. For example, in France, the government owns key banks and some key industries, such as aluminum refining. One car company, Renault, is partially state owned, but another, Peugeot, is not. In Germany, Japan, Norway, Singapore, and Sweden, government often works closely with business and labor interests to determine industrial policy, regulate wage rates, and/or provide subsidies to support specific industries.

The last century saw a substantial increase in the number of mixed economies and a concurrent rise in government involvement in economic matters. For example, in the United States, combined government spending increased from about 3 percent of GDP in the 1930s to roughly 20 percent by the 1980s. During the same period in most other developed economies, average government spending as a percent of GDP rose from 8 to over 40 percent. Governments in Europe, Japan, and North America imposed many new regulations on private firms.[8] Regulations were adopted for workplace safety, minimum wages, pension benefits, and environmental protection.

Legal Systems

Legal systems provide a framework of rules and norms of conduct that mandate, limit, or permit specified relationships among people and organizations, and provide punishments for those who violate these rules and norms. Laws require or limit specific actions, while empowering citizens to engage in certain activities, such as entering into contracts and seeking remedies for contract violations. Regulations mandate what procedures citizens and firms follow in a given context. Legal systems are dynamic; They evolve over time to represent each nation's changing social values and the evolution of their social, political, economic, and technological environments.

Prevailing political systems—totalitarianism, socialism, and democracy—tend to influence their respective legal systems as well. Democracies tend to encourage market forces and free trade. In well-developed legal systems, such as in Australia, Canada, Japan, the United States, and most European countries, laws are widely known and understood. They are effective and legitimate because they are applied to all citizens equally, issued by means of formal procedures applied by recognized government authorities, and enforced systematically and fairly by police forces and formally organized judicial bodies.

In these countries, a culture of law exists, where citizens consistently respect and follow the rule of law. **Rule of law** refers to the existence of a legal system where rules are clear, publicly disclosed, fairly enforced, and widely respected by individuals, organizations, and the government. International business flourishes in those societies where the rule of law prevails. For example, in the United States, the Securities and Exchange Act encourages confidence in business transactions by requiring public companies to frequently disclose their financial indicators to investors. Legal systems can be eroded by declining respect for the law, weak government authority, or burdensome restrictions that attempt to forbid behavior prevalent in the society. In the absence of the rule of law, economic activity can be impeded and firms have to contend with great uncertainty.

Rule of law The existence of a legal system where rules are clear, publicly disclosed, fairly enforced, and widely respected by individuals, organizations, and the government.

Five Types of Legal Systems

Nations can be characterized by one of five basic legal systems. These are: common law, civil law, religious law, socialist law, and mixed systems. These legal systems are the foundation for laws and regulations. Exhibit 6.6 provides examples of countries where these legal systems tend to prevail.

Common law (also known as case law) is a legal system that originated in England and spread to Australia, Canada, the United States, and former

Primarily Common Law	*Primarily Civil Law*	*Primarily Religious Law*	*Primarily Socialist Law*	*Mixed Systems*
Australia	Much of western Europe and Latin America	Middle East, North Africa, and a few countries in Asia	Russia	Much of eastern Europe,
Ireland	Turkey		China	Philippines
New Zealand	Japan		Cuba	Puerto Rico
United Kingdom	Mexico		North Korea	South Africa
Canada			Kazakhstan	Thailand
United States			Uzbekistan	Sri Lanka
India			Ukraine	Ethiopia
Pakistan			Azerbaijan	Hong Kong
Ghana			Moldova	Bahrain
Nigeria			Tajikistan	Qatar
Zimbabwe			Kyrgyzstan	Singapore
Malaysia				Morocco
				Tunisia
				Vietnam
				Egypt

Exhibit 6.6 Dominant Legal Systems in Selected Countries

SOURCES: Accessed at wikipedia.org/wiki/Legal_systems of the world and www.droitcivil.uottawa.ca/world-legal-systems/eng-tableau.php.

members of the British Commonwealth. The basis of common law is tradition, past practices, and legal precedents set by the nation's courts through interpretation of statutes, legislation, and past rulings. The national legislature in common-law countries (such as the House of Lords in Britain and Congress in the United States) holds ultimate power in passing or amending laws. In the United States, because the U.S. Constitution is very difficult to amend, the Supreme Court and even lower courts enjoy considerable flexibility in interpreting the law. Accordingly, because common law is more open to interpretation by courts, it is more flexible than other legal systems. Thus, judges in a common-law system have substantial power to *interpret* laws based on the unique circumstances of individual cases, including commercial disputes and other business situations.

Civil law (also known as code law) is found in France, Germany, Italy, Japan, Turkey, Mexico, and in Latin America. Its origins go back to Roman law and the Napoleonic Code. Civil law is based on an all-inclusive system of laws that have been "codified"—clearly written and accessible. Civil law divides the legal system into three separate codes: commercial, civil, and criminal. Code law is considered complete as a result of catchall provisions found in most code-law systems. Rules and principles form the starting point for legal reasoning and administering justice. The codified rules emerge as specific laws and codes of conduct produced by a legislative body or some other supreme authority.

Both common law and civil law systems originated in western Europe and both represent the common values of western Europeans. A key difference between the two systems is that common law is primarily judicial in origin and based on court decisions, whereas civil law is primarily legislative in origin and is based on laws passed by national and local legislatures. Common law and civil law pose various differences for international business. These are highlighted in Exhibit 6.7. In reality, common-law systems generally contain elements of civil law, and vice versa. The two systems complement each other, and countries that employ one also tend to employ some elements of the other.

Legal Issues	*Civil Law*	*Common Law*
Ownership of intellectual property	Determined by registration.	Determined by prior use.
Enforcing agreements	Commercial agreements become enforceable only if properly notarized or registered.	Proof of agreement is sufficient for enforcing contracts.
Specificity of contracts	Contracts tend to be brief because many potential problems are already covered in the civil code.	Contracts tend to be very detailed, with all possible contingencies spelled out. Usually more costly to draft a contract.
Compliance with contracts	Noncompliance is extended to include unforeseeable human acts such as labor strikes and riots.	Acts of God (floods, lightning, hurricanes, etc.) are the only justifiable excuses for noncompliance with the provisions of contracts.

Exhibit 6.7 Examples of Differences between Common Law and Civil Law

Religious law is a legal system strongly influenced by religious beliefs, ethical codes, and moral values viewed as mandated by a supreme being. The most important religious legal systems are based on Hindu, Jewish, and Islamic law. Among these, the most widespread is Islamic law, which is found mainly in the Middle East, North Africa, and Indonesia. Islamic law is derived from interpretations of the Qur'an, the holy book of Muslims, and the teachings of the Prophet Mohammed. Also known as the *shariah*, Islamic law is nonsecular—that is, adherents generally do not differentiate between religious and secular life. Islamic law spells out norms of behavior regarding politics, economics, banking, contracts, marriage, and many other social issues. Islamic law governs relationships among people, between people and the state, and between people and a supreme being. Thus, Islamic law might be said to encompass all possible human relationships. Because it is seen as divinely ordained, Islamic law is relatively static and absolute. Unlike other legal systems, it evolves very little over time.

Saleh Nikbakht, a lawyer for university professor Hashem Aghajari, holds a copy of the court's 2004 death sentence on his client for speaking out against Iran's hardline clerical leaders.

Most Muslim countries currently maintain a dual system, where both religious and secular courts coexist. Other countries with large Muslim populations, such as Indonesia, Bangladesh, and Pakistan, now have secular constitutions and laws. Turkey, another country with a majority Muslim population, has a strongly secular constitution. Saudi Arabia and Iran are unusual in the sense that religious courts have authority over all aspects of jurisprudence.

Traditional views of religious law are opposed by modern liberal movements within Islam. For example, strict interpretation of Islamic law prohibits the giving and receiving of interest on loans or investments. Thus, to comply with Islamic law, banks charge administrative fees or take equity positions in the projects that they finance. Many Western banks—for example, Citibank, JP Morgan, and Deutsche Bank—have subsidiaries in Muslim countries that comply with shariah laws. Muslim countries such as Malaysia have issued Islamic-compliant bonds that offer revenue from an asset, such as a rental property, rather than interest.[9]

Socialist law is a legal system found mainly in the independent states of the former Soviet Union, China, and a few states in Africa. It is based on civil law, with elements of socialist principles that emphasize state ownership of property. The rights of the state are emphasized over those of the individual. Countries that adhere to socialist law tend to view property and intellectual property rights more loosely than those that apply civil or common law. With the collapse of the Soviet Union and the transition of China toward capitalism, socialist law is gradually becoming westernized. As these countries adopt free-market principles, their legal systems increasingly incorporate additional elements of civil law.

Mixed systems refers to a variation of two or more legal systems operating together. In most countries, legal systems evolve over time, adopting elements of one system or another that reflect their unique needs. The contrast between civil law and common law has become particularly blurred as many countries combine both systems. Alternatively, legal systems in Eastern Europe mix elements of civil law and socialist law. Legal systems in Lebanon, Morocco, and Tunisia share elements of civil law and Islamic law.

What about the linkage between legal systems and political systems? Socialism is most associated with socialist law, but may include elements of common law and civil law. Totalitarianism is most associated with religious law and socialist law. Democracy is associated with common law, civil law, mixed systems, and, occasionally, socialist law. Accordingly, democracy tends to be viewed as a flexible political system.

Actors in Political and Legal Systems

Political and legal systems evolve from the interplay among various societal institutions, at both the national and international levels. Five types of actors are active in transforming political and legal systems.

Government

The government, or the public sector, is the most important actor, operating at national, state, and local levels. Governments have the power to enact and enforce laws. They are particularly influential in how firms enter host countries and how they conduct business there. Governments regulate international business activity through the exercise of complex systems of institutions, agencies, and public officials. Agencies that possess such powers in the United States include the U.S. Trade Representative and the International Trade Administration. In Canada, such functions are handled by the Ministry of Foreign Affairs, the Ministry of Finance, and the Export and Import Controls Bureau. Similar agencies operate in Australia, Britain, and virtually all other countries.

International Organizations

Supranational agencies such as the World Trade Organization (www.wto.org), United Nations (www.un.org), and the World Bank (www.worldbank.org) have a strong influence on international business activities. For instance, the United Nations Conference on Trade and Development (UNCTAD) helps oversee international trade and development in the areas of investment, finance, technology, and enterprise development. Such organizations help facilitate free and fair trade by providing administrative guidance, governing frameworks, and, occasionally, financial support.

Regional Economic Blocs

Regional trade organizations, such as the European Union (EU), the North American Free Trade Agreement (NAFTA), and the Association of Southeast Asian Nations (ASEAN), aim to advance the economic and political interests of their members. The EU organization is especially well developed, with its own executive, legislative, and bureaucratic bodies. The EU enacts and enforces laws and regulations that directly affect business. For example, following new regulations forced by Lithuania's entry into the EU, the supermarket chain IKI had to spend millions to build separate entrances for fresh meat delivery in each of its 136 stores.[10]

Special Interest Groups

These organizations are formed to serve the interests of particular countries, industries, or causes. For example, the Organization for Economic Cooperation and Development (OECD) supports the economic developmental and business goals of advanced economies. The Organization of Petroleum Exporting Countries (OPEC) is a powerful cartel that controls global oil prices, which, in turn, affect the cost of doing business and consumer prices. OPEC emerged in the 1970s as a collective and powerful voice for oil-producing countries, including Saudi Arabia, Kuwait, Iran, Venezuela, Nigeria, and Indonesia. Other groups exercise similar control over the production and allocation of commodities such as sugar, coffee, and iron ore.

Special interest groups engage in political activity to advance specific causes, ranging from labor rights to environmental protection. They often influence national political processes and produce outcomes with far-reaching conse-

Organization or Group	*Issues of Concern*
Organized religious groups	Perceive moral violations by foreign firms
Labor organizations	Oppose imported goods and offshoring
Competing businesses	Concerned about local resource consumption
Customers	Perceived price gouging by firms
Minority groups	Perceived discrimination/sexual harassment
Conservationists	Concerned about environmental degradation
General public	Concerned about the impact of foreign firms on national culture

Exhibit 6.8

Issues of Concern to Special Interest Organizations and Groups

quences for business. Many groups target particular industries and affect individual firms accordingly. Special interest groups operate not only in host countries but also in the home country. For example, well-orchestrated U.S. interest groups forced U.S.-owned firms to reduce their investments in South Africa because of its apartheid policies.[11] Greenpeace and the Save the Waves Coalition are two environmental groups that oppose the plan of Sempra Energy, a California gas and electric utility, to build a liquefied natural gas terminal and pipeline in Mexico. They argue that Sempra's planned natural gas facility in Baja California will pollute the ocean and wipe out lobster and tuna stocks in the area. Protestors have disrupted Sempra's construction progress.[12] Exhibit 6.8 lists major interest groups and their likely stance toward various business issues.

Competing Firms

Rival domestic firms with a strong presence in the host country naturally have an interest in opposing the entry of foreign firms into the local market and may lobby their government for protection. For example, host-country competitors often complain when foreign firms receive financial support from the parent or host-country governments. This was exemplified when Asterix, a French theme park, opposed French government support for the U.S.-based Disney when the latter established Disneyland Paris. Similarly, U.S. automakers in Detroit opposed BMW's construction of a factory in South Carolina. However, the local government of South Carolina supported the BMW facility on the grounds that it would generate jobs and increase tax revenues.

Types of Country Risk Produced by the Political System

Political systems influence the activities of business in numerous ways, giving rise to various types of country risk. We discuss specific risks brought about by political systems next.

Government Takeover of Corporate Assets

Governments seize corporate assets in two major ways: confiscation and expropriation. *Confiscation* refers to the seizure of foreign assets *without* compensation. For example, in Venezuela, President Hugo Chavez confiscated a major oil field owned by the French petroleum firm Total. *Expropriation* refers to the seizure of corporate assets *with* compensation.

French farmers block the main entrance of a McDonald's fast food restaurant in Auch, southwestern France during a 1999 protest. The banner translates, "No to American Orders."

A third term, *nationalization*, is also used, and it denotes government takeover of not a firm but an entire industry, with or without compensation. In 2006, the government of Bolivia nationalized much of the oil and gas industry in that country.[13] By contrast, in recent decades, numerous governments have engaged in *privatization*, the selling of state-owned enterprises to private interests. The trend has been especially notable in China and Eastern Europe, which have privatized countless state enterprises since the 1980s.

Embargoes and Sanctions

Most countries are signatories to international treaties and agreements that specify rules, principles, and standards of behavior in international business. Nevertheless, governments may unilaterally resort to sanctions and embargoes to respond to offensive activities of foreign countries. *Sanctions* are a type of ban on international trade, usually undertaken by a country, or a group of countries, against another judged to have jeopardized peace and security. *Embargoes* are official bans on exports or imports of specific products or specific modes of transport with particular countries. They are often issued during wartime or in the wake of tensions between nations. Embargoes amount to regulations that forbid trade in specific goods with specific countries. For example, the United States has enforced embargoes against Cuba, Iran, and North Korea, all at times labeled as state sponsors of terrorism. The European Union has enacted embargoes against Belarus, Sudan, and China in certain areas, such as foreign travel, to protest human rights and weapon-trading violations.

Boycotts against Firms or Nations

Consumers and special interest groups occasionally target particular firms perceived to have harmed local interests. Consumers may refuse to patronize firms that behave inappropriately. A boycott is a voluntary refusal to engage in commercial dealings with a nation or a company. Boycotts and public protests result in lost sales and increased costs related to public relations in order to improve the firm's image. Disneyland Paris and McDonald's have been the targets of boycotts by French farmers, who view these firms as symbols for venting their anger against U.S. agricultural policies and globalization. Many U.S. citizens boycotted French products following France's decision not to support the American-led invasion of Iraq in the early 2000s.

War, Insurrection, and Revolution

War, insurrection, and revolution pose big problems for business operations. While such events usually do not affect companies directly, their indirect effects can be disastrous. For example, in Mexico in the 1990s, peasants in the state of Chiapas took up arms against the government, claiming governmental oppression and indifference to poverty. Later, a presidential candidate and another political leader were assassinated. These events stimulated many firms and financiers to withdraw their investments from Mexico because they perceived heightened political instability. In order to minimize losses from warlike acts, firms can purchase war risk insurance.

Terrorism

Terrorism is the threat or actual use of force or violence to attain a political goal through fear, coercion, or intimidation.[14] In recent years, much terrorism is sponsored by national governments, making it a particularly hazardous form of country risk. Terrorism has escalated in much of the world, as exemplified by the September 11, 2001 attacks on the United States. In addition to causing tremendous loss of life, these acts severely damaged the New York financial community and disrupted the business activities of countless firms. Terrorism induces fear in consumers, who reduce their purchasing, potentially leading to economic recession. The hospitality, aviation, entertainment, and retailing industries may be particularly affected. Terrorism also affects financial markets. In the days following the 9/11 attacks, the value of the United States stock market dropped some 14 percent.[15]

Types of Country Risk Produced by the Legal System

Country risk also arises due to peculiarities of national legal systems. Particularly relevant to international business are *commercial law,* which specifically covers business transactions, and *private law,* which regulates relationships between persons and organizations, including contracts, and liabilities that may arise due to negligent behavior. In many countries, the legal system favors home-country nationals. Laws are designed to promote the interests of local businesses and the local economy.

Legal systems in both the host country and the home country pose various challenges to firms.

Country Risk Arising from the Host Country Legal Environment

The host country government can impose a variety of legal stipulations on foreign companies doing business there.

Foreign investment laws These laws affect the type of entry strategy firms choose, as well as their operations and performance. Many nations impose restrictions on inward foreign direct investment (FDI). For example, Japan's *daitenhoo* (large-scale retail store law) restricted foreigners from opening warehouse-style stores such as Wal-Mart or Toys "Я" Us. The law protected smaller shops by restricting the operations of retail giants. It requires large-scale retailers to obtain the approval of local retailers, a painstaking and time-consuming process. In Malaysia, firms that want to invest in local businesses must obtain permission from the Malaysian Industrial Development Authority, which screens proposed investments to ensure they fit with national policy goals. The United States restricts foreign investments that are seen to affect national security. Major investments may be reviewed by the U.S. Committee on Investments. In 2006, the U.S. Congress fiercely opposed a pending deal granting operational control at several U.S. ports to Dubai Ports World, a firm based in the United Arab Emirates. Under strong opposition from the U.S. public and Congress, the firm eventually abandoned its investment plans.

Controls on operating forms and practices Governments impose laws and regulations on how firms should conduct production, marketing, and distribution activities within their borders. Such restrictions may reduce firms' efficiency, effectiveness, or both. For example, host countries may require companies to obtain permits to import or export. They may devise complex regulations that complicate transportation and logistical activities or limit the options for entry

In Japan, foreign-owned large-scale retail stores such as Toys "Я" Us face restrictive laws designed to protect smaller shops.

strategies. In China's huge telecommunications market, the government requires foreign investors to seek joint ventures with local firms; local operations cannot be wholly owned by foreigners. The government's goal is to ensure that China maintains control of its telecommunications industry and obtains inward transfer of technology, knowledge, and capital.

Marketing and distribution laws These laws determine which practices are allowed in advertising, promotion, and distribution. For example, Finland, France, Norway, and New Zealand prohibit cigarette advertising on television. Germany largely prohibits comparative advertising, in which one brand is touted as superior to a specific competitor. Many countries cap the pricing of critical goods and services, such as food and health care. Such constraints affect firms' marketing and profitability. Product safety and liability laws hold manufacturers and sellers responsible for damage, injury, or death caused by defective products. In the case of violations, firms and company executives are subject to legal penalties such as fines or imprisonment, as well as civil lawsuits. In contrast to advanced economies, product liability laws are generally weak in developing countries. Some firms take advantage of these weaknesses. For example, as litigants pursued tobacco companies in Europe and the United States, these companies shifted much of their marketing of cigarettes to developing countries.

Laws regarding income repatriation MNEs earn profits in various countries and typically seek ways to transfer these funds back to their home country. However, in some countries, governments devise laws that restrict such transfers. The action is often taken to preserve hard currencies, such as euros, U.S. dollars, or Japanese yen. Repatriation restrictions limit the amount of net income or dividends that firms can remit to their home-country headquarters. While such constraints often discourage inward FDI, they are common in countries experiencing shortage of hard currencies.

Environmental laws Governments also enact laws to preserve natural resources, to combat pollution and the abuse of air, earth, and water resources, and to ensure health and safety. In Germany, for example, companies must follow strict recycling regulations. The burden of recycling product packaging is placed on manufacturers and distributors. Nevertheless, governments attempt to balance environmental laws against the impact that such regulations may have on employment, entrepreneurship, and economic development. For instance, environmental standards in Mexico are looser or less well-enforced than in other countries, but the Mexican government is reluctant to strengthen these standards for fear that foreign MNEs will reduce their investment.

Contract laws International contracts attach rights, duties, and obligations to the contracting parties. Contracts are used in five main types of business transactions: (1) the sale of goods or services, especially large sales, (2) distribution of the firm's products through foreign distributors, (3) licensing and franchising—that is, a contractual relationship that allows a firm to use another company's intellectual property, marketing tools, or other assets, (4) FDI, especially where this is done in collaboration with a foreign entity, in order to create and operate a foreign subsidiary, and (5) joint ventures and other types of cross-border collaborations.

Some convergence is occurring toward an international standard for international sales contracts. In 1980, the United Nations instituted the Convention on Contracts for the International Sale of Goods (CISG), a uniform text of law for international sales contracts. More than 70 countries are now party to the CISG, covering about three-quarters of all world trade. Unless excluded by the express terms of a contract, the CISG is deemed to supersede any otherwise applicable domestic law(s) regarding an international sales transaction.

Internet and e-commerce regulations These regulations are now the new frontier in legal systems. As highlighted in this chapter's *Global Trend* feature. Internet and e-commerce laws are still evolving. Firms that undertake e-commerce in countries with weak laws face considerable risk. For example, in China, the government has developed legislation to ensure security and privacy due to the rapid spread of the Internet and e-commerce. Many consumer-privacy laws have yet to be enacted, and progress has been delayed on the development of methods to protect private data from criminal or competitive eyes. Protections for online contracting methods have been implemented with the recent adoption of e-signature laws. However, enforcement of e-commerce laws in China remains inconsistent.

Country Risk Arising from the Home-Country Legal Environment

In addition to complying with the laws of host countries, managers must adhere to the laws of their home country. Let's discuss these legal considerations. **Extraterritoriality** refers to the application of home-country laws to persons or conduct outside of national borders. In most cases, the laws are applied in an attempt to prosecute individuals or firms located abroad for some type of wrongdoing.

Extraterritoriality Application of home-country laws to persons or conduct outside of national borders.

Examples of extraterritoriality in international business abound. For example, a French court recently ordered Yahoo! to bar access to Nazi-related items on its website in France and to remove related messages, images, and literature from its sites accessible in France and the United States.[16] In 2001, the United States enacted the Patriot Act authorizing the U.S. government to seize funds held by non-U.S. banks in the United States. The European Union has pursued Microsoft for perceived monopolistic practices in the development and sale of its operating system software. Monopolies are considered harmful because they can unfairly restrain trade.

Businesses generally oppose extraterritorialty because it increases transaction costs and compliance and regulatory costs, and causes considerable uncertainty.

The Foreign Corrupt Practices Act (FCPA) Passed by the U.S. government in 1977, the FCPA made it illegal for a firm to offer bribes to foreign parties for the purpose of securing or retaining business. The FCPA came about in an era when over 400 U.S. companies admitted paying bribes to foreign government officials and politicians. The FCPA was strengthened in 1998 with additional antibribery conventions for foreign firms and managers who act in furtherance of corrupt payments while in the United States. The FCPA also requires firms with securities listed in the United States to meet its accounting provisions. All such firms must devise and maintain an accounting system that tightly controls and records all company expenditures.[17] However, the definition of a "bribe" is not clearly specified in the FCPA. For example, the act draws a distinction between bribery and "facilitation" payments, which may be permissible if they do not violate local laws.[18]

Many countries do not have antibribery laws for international transactions. Some U.S. managers have argued that the FCPA harms their interests

GLOBAL TREND

E-Commerce and the International Legal Environment

While still a small fraction of world trade, international e-commerce is growing fast. E-commerce operates in an electronic space not bound by geography or national borders. E-commerce reduces traditional barriers of distance from markets and the lack of information about market opportunities. The World Wide Web remains a "wild west" of international business, as most countries lack adequate legal protections. E-commerce is fraught with thorny legal issues. For example, individuals or firms that place information, photographs, or music online may be violating intellectual property laws. Although electronic contracts are in digital format, existing contract law typically covers only paper documents. Consumers who use the Internet to make purchases with credit cards may risk identity theft and fraud.

Taxation of transnational e-commerce is complex because it is often difficult to define merchandise sold online. Do software, books, and music constitute products—or services? For tax purposes, the two categories are usually treated differently. E-commerce can circumvent tariffs and other trade barriers. Most e-commerce is currently free from customs duties, largely because of the technical difficulties of applying duties to these flows. A related issue concerns the location of a sale. When a customer in Japan buys software from Microsoft's Web site—based in the United States—does the sale originate in Japan or the United States? Such questions affect not only taxation, but also legal jurisdiction, in the event of disputes between buyers and sellers.

Inadequate legal frameworks are hindering the growth of global e-commerce, and therefore international organizations are driving efforts to devise internationally appropriate laws. For example, the United Nations Commission on International Trade Law (UNCITRAL) developed the *Model Law on Electronic Commerce*. The law ensures that electronic transactions are legally recognized and that a course of action is available to enforce them. The law also provides guidelines for treating electronic legal documents (such as contracts) as equivalent to paper documents.

The UNCITRAL model is only a guide, and national governments are not bound by it. E-commerce laws are evolving differently in different countries. Individual regulations represent the values and distinctive approaches of each nation. The resultant lack of consistency creates conflicts between national jurisdictions. When creating e-commerce law, some governments favor strong control and regulation. Other governments opt for a more liberal, hands-off approach. Those who favor government intervention argue, for example, that the Internet can bring their citizens face to face with pornography, gambling, or fraud. Many want to tax e-commerce and subject it to international trade controls. By contrast, those who favor a more liberal approach argue that the Internet has the potential to transform national economies and ease global poverty. They oppose strong government intervention because it runs the risk of slowing the pace of global e-commerce and economic development.

Experts argue that evolving regulatory frameworks should be governed by consistent principles that lead to predictable results, regardless of where buyers and sellers reside. Law enforcement authorities need to cooperate cross-nationally to reduce online crime. Trust is the basis for successful e-commerce transactions, and strong legal frameworks are required to promote trustworthy online commerce. Governments must devise legal frameworks that recognize and ensure the security of electronic payment systems and the privacy of online data. Legal frameworks need to strike the right balance to ensure that international trade flourishes, but not to be so restrictive as to hinder its promise.

Sources: Primo Braga, C. (2005). "E-commerce Regulation: New Game, New Rules?," *Quarterly Review of Economics and Finance* 45(2/3): 541–58; WTO. (1999). *Seminar on Electronic Commerce and Development: Summary Report*, February 19, Geneva: World Trade Organization; United Nations. (1999). *UNCITRAL Model Law on Electronic Commerce Guide to Enactment*, New York: United Nations.

because foreign competitors often are not constrained by such laws. FCPA criminal and civil penalties have become increasingly harsh. Firms can be fined up to $2 million, while individuals can be fined up to $100,000 and face imprisonment.

Antiboycott regulations These home-country regulations prevent companies from participating in restrictive trade practices or boycotts imposed by foreign countries against other countries. Firms are not allowed to participate in boycotts to the extent they discriminate against others on the basis of race, religion, gender, or national origin. For example, some Arab nations have long boycotted trading with the state of Israel because of political disagreements, and made it a requirement for any foreign company that wishes to do business with the Arab countries to also observe this boycott. The antiboycott regulations passed by the United States Congress in 1977 effectively prohibit U.S. firms from participating in the boycott of Israel when operating in these Arab nations.

Accounting and reporting laws Accounting practices and standards differ greatly around the world. Differing standards pose difficulties for firms, but can create opportunities as well. For example, when assigning value to stocks and other securities, most countries use the lower of cost or market value. However, Brazil encourages firms to adjust their portfolio valuations because of historically high inflation there. When valuing physical assets such as plant and equipment, Canada and the United States use historical costs. Numerous countries in Latin America use inflation-adjusted market value. In the United States, firms can write off uncollectible accounts. This allowance is not permitted in France, Spain, and South Africa. Research and development costs are expensed as incurred in most of the world, but are capitalized in South Korea and Spain. Belgium, Malaysia, and Italy use both conventions.

Transparency in financial reporting The timing and transparency of financial reporting vary widely around the world. **Transparency** is the degree to which firms regularly reveal substantial information about their financial condition and accounting practices. For example, in the United States, public firms are required to report financial results to stockholders and to the Securities and Exchange Commission every quarter. In much of the world, however, financial statements may come out once a year or less often, and they often lack transparency. Not only does greater transparency improve the environment for business decision making, it also improves the ability of citizens to hold companies accountable.

Transparency The degree to which firms regularly reveal substantial information about their financial condition and accounting practices.

In an effort to curb corruption by its firms, the United States Congress passed the 2002 Sarbanes-Oxley Act to promote greater transparency in accounting practices. This comprehensive legislation was passed to deter accounting and managerial abuses. It emerged in the wake of accounting-fraud scandals at firms such as Enron and Worldcom. The act makes corporate CEOs and CFOs personally responsible for the accuracy of annual reports and other financial data. Foreign affiliates of U.S. firms, and foreign firms with significant U.S. operations, are required to comply with the Sarbanes-Oxley provisions. European firms like Royal Dutch Shell (Netherlands and United Kingdom), Royal Ahold (Netherlands), Parmalat (Italy), and Vivendi (France) have also been accused of managerial and accounting irregularities in recent years.

However, a major drawback of the Sarbanes-Oxley reforms is the cost of compliance—estimated at tens of billions of dollars and millions of work-hours—to change or install systems for internal accounting controls. In an effort to avoid these rigid financial requirements, some European firms are reducing their business investments in the United States, and several have deregistered from U.S. stock markets.[19] In the meantime, some governments in Europe have called for stricter standards in European accounting practices.

Ethical values and practices *Ethics* refers to the moral behavior of people, firms, or governments. Ethical issues often arise, or may be exacerbated, by deficiencies in legal systems. *Corruption* is an extreme form of unethical behavior. It involves the use of illegal or unethical practices, especially bribery and fraud, to achieve business objectives. Bribes may be offered to gain access to important markets and to achieve other business objectives abroad. In this chapter's opening vignette, you saw that rampant corruption has raised doubts about Russia's evolving legal system. In Germany, business managers paid $13 million in bribes during the construction of a waste incineration plant. The Yacyretá hydropower project on the border of Argentina and Paraguay, built with World Bank support, failed to meet energy-production goals, and much of the $1.87 billion in expenditures was used fraudulently.[20] Corporate corruption occurs in every society, but is particularly common in developing economies.

One study found that over 30 percent of MNEs believe that corruption is a major or very severe concern to them in their worldwide investment decisions. The United Nations estimates that the total amount of bribes paid every year is approximately $1 trillion.[21] In an effort to fight international corruption, the United States passed the Foreign Corrupt Practices Act, described earlier. In addition, in 1996 the International Chamber of Commerce adopted "Rules of Conduct to Combat Extortion and Bribery," and the United Nations issued a "Declaration against Corruption and Bribery in International Commercial Transactions." In 1998 the Organization for Economic Cooperation and Development (OECD) unveiled its own antibribery agreement. The 30 OECD members (essentially, all the advanced economies), plus several Latin American countries, have signed the accord. Finally, international organizations such as the United Nations, the World Bank, and the International Monetary Fund have launched programs to combat international corruption.

Exhibit 6.9 on pages 182–183 shows the level of corruption worldwide as perceived by executives engaged in international business. The Corruption Perceptions Index is provided by Transparency International (www.transparency.org), an organization that tracks illicit behavior worldwide. Countries with the highest scores have the lowest levels of corruption, such as Canada, Finland, New Zealand, and Denmark. Countries with the lowest scores have the highest levels of corruption, such as most countries in Africa and former Soviet Union states. Note that corruption tends to be correlated with economic development. The less economically developed a nation, the more likely it will suffer from corruption. This relationship points to a key dilemma in economic development—trade and investment can help reduce poverty, but MNEs are reluctant to do business with countries that exhibit high levels of corruption.

Corruption poses a threat to national development and internal stability and is more prevalent where transparency is lacking. Corruption harms the poorest within societies, those who may be forced to pay bribes to gain access to various products and services, such as water, electricity, and phone service. High levels of corruption are associated with low levels of inward FDI. In other words, firms tend not to invest in highly corrupt countries.[22] Corruption has been a big factor in recent construction projects in Iraq and Afghanistan and in countries devastated by the Indian Ocean tsunami disaster. Roughly 10 percent of the $4 trillion spent annually on construction procurement is wasted through bribery and corruption.[23]

Studies indicate that corruption tends to be lower in countries that are strongly integrated into the global economy, have highly transparent accounting and information systems, have consistently enforced anticorruption laws, and have governments that are committed to reducing unethical practices.[24]

Managing Country Risk

While country risk is more common in nations with substantial government intervention, in reality, country risk can occur anywhere. Thus, managers are regularly faced with the challenge of developing strategies to minimize country risk. Seasoned managers attempt to anticipate and systematically manage country risk. They take proactive measures to minimize harmful exposure and adverse effects. In the discussion that follows, we highlight five specific strategies that managers can employ to manage country risk.

Proactive Environmental Scanning

Anticipating country risk requires advance research. Initially, managers develop a comprehensive understanding of the political and legal environment in target countries. They then engage in *scanning* to assess potential risks and threats to the firm. Scanning allows the firm to improve practices in ways that conform with the goals and standards of local laws and political entities, and to create a positive environment for business success.

One of the best sources of intelligence in the scanning process is employees working in the host country. They are usually plugged in to evolving events and can evaluate them in the context of local history, culture, and politics. Embassy and trade association officials may also regularly develop and analyze intelligence on the local political scene. Some consulting firms, such as PRS Group (www.prsgroup.com) and Business Entrepreneurial Risk Intelligence (www.beri.com), specialize in country-risk assessment and provide guidelines for appropriate strategic responses. Once the firm has researched the political climate and contingencies of the target environment, it then develops and implements strategies to facilitate effective management of relations with policymakers and other helpful contacts in the host country. The firm then takes steps to minimize its exposure to country risks that threaten its performance.

Strict Adherence to Ethical Standards

Ethical behavior is essential not only for its own sake, but also because it helps insulate the firm from some country risks that other firms otherwise encounter. Those companies that engage in questionable practices, or operate outside the law, naturally invite redress from the governments of the host countries where they do business.

The trend toward corporate social responsibility (CSR) aims at improving ethical business standards. **Corporate social responsibility** refers to operating a business in a manner that meets or exceeds the ethical, legal, commercial, and public expectations of stakeholders (customers, shareholders, employees, and communities). The idea that corporations can and should be good citizens, and that good citizenship requires more than simply providing secure jobs and paying taxes, is spreading throughout the world. CSR implies that firms should behave not just to maximize their profits but in ways that benefit society.

Corporate social responsibility (CSR)
Operating a business in a manner that meets or exceeds the ethical, legal, commercial, and public expectations of stakeholders (customers, shareholders, employees, and communities).

Increasingly, companies devise business strategies that simultaneously enhance the public good and safeguard the environment.[25] There are numerous ways in which transnational firms behave responsibly. Examples of such behavior include: complying with local and international laws, not discriminating in hiring or promoting, providing fair and adequate wages, ensuring health and safety in the workplace, instituting a fair system of regular and overtime work hours, avoiding the use of child labor, and providing adequate protection of the environment.[26]

Exhibit 6.9

Corruption Perceptions Index, CPI 2006

SOURCES: Transparency International, Corruption Perceptions Index, accessed at www.transparency.org


OCEAN
SWEDEN
FINLAND
ESTONIA
LATVIA
LITHUANIA
RUSSIA
BELARUS
POLAND
CZECH REP.
SLOVAKIA
UKRAINE
AUSTRIA
HUNGARY
MOLDOVA
ROMANIA
SERBIA AND MONTENEGRO
BOSNIA-
BULGARIA
MACEDONIA
ALBANIA
GREECE
TURKEY
CYPRUS
GEORGIA
ARMENIA
AZERBAIJAN
R U S S I A
KAZAKHSTAN
MONGOLIA
UZBEKISTAN
KYRGYZSTAN
TURKMENISTAN
TAJIKISTAN
NORTH KOREA
SOUTH KOREA
JAPAN
SYRIA
LEBANON
IRAQ
ISRAEL
JORDAN
IRAN
AFGHANISTAN
C H I N A
KUWAIT
PAKISTAN
NEPAL
BHUTAN
QATAR
UNITED ARAB EMIRATES
BANGLADESH
TAIWAN
PACIFIC OCEAN
LIBYA
EGYPT
SAUDI ARABIA
OMAN
INDIA
MYANMAR (BURMA)
LAOS
CHAD
SUDAN
ERITREA
YEMEN
THAILAND
VIETNAM
CAMBODIA
PHILIPPINES
DJIBOUTI
SOMALIA
CENTRAL AFRICAN REPUBLIC
ETHIOPIA
SRI LANKA
BRUNEI
MALAYSIA
SINGAPORE
CONGO REPUBLIC
UGANDA
KENYA
CONGO DEMOCRATIC REPUBLIC (ZAIRE)
RWANDA
BURUNDI
TANZANIA
INDIAN OCEAN
I N D O N E S I A
PAPUA NEW GUINEA
SOLOMON ISLANDS
ANGOLA
ZAMBIA
MALAWI
MOZAMBIQUE
VANUATU
FIJI
NAMIBIA
ZIMBABWE
MADAGASCAR
MAURITIUS
RÉUNION
BOTSWANA
NEW CALEDONIA
AUSTRALIA
SWAZILAND
SOUTH AFRICA
LESOTHO
NEW ZEALAND
CPI 2006
9.0 to 10.0
8.0 to 8.9
7.0 to 7.9
6.0 to 6.9
5.0 to 5.9
4.0 to 4.9
3.0 to 3.9
2.0 to 2.9
1.0 to 1.9
no data available

Allying with Qualified Local Partners

A practical approach to reducing country risk is to enter target markets in collaboration with a knowledgeable and reliable local partner. Qualified local partners are better informed about local conditions and better situated to establish stable relations with the local government. For instance, because of various challenges in China and Russia, Western firms often enter these countries by partnering with local firms who assist in navigating the complex legal and political landscape.

Protection through Legal Contracts

A legal contract spells out the rights and obligations of each party and is especially important when relationships go awry. Contract law varies widely from country to country, and firms must adhere to local standards. For example, a Canadian firm doing business in Belgium must comply with the laws of both Belgium and Canada, as well as the evolving laws of the European Union, some of which may override Belgian law.

International contractual disputes arise from time to time, and firms generally employ any of three approaches for resolving them: conciliation, arbitration, and litigation. *Conciliation* is the least adversarial method. It is a formal process of negotiation whose objective is to resolve differences in a friendly manner. The parties in a dispute employ a conciliator, who meets separately with each in an attempt to resolve their differences. Parties can also employ mediation committees—groups of informed citizens—to resolve civil disputes. *Arbitration* is a process in which a neutral third party hears both sides of a case and decides in favor of one party or the other, based on an objective assessment of the facts. Compared to litigation, arbitration saves time and expense, while maintaining the confidentiality of proceedings. Arbitration is often handled by supranational organizations, such as the International Chamber of Commerce in Paris or the Stockholm Chamber of Commerce. *Litigation* is the most adversarial approach, and occurs when one party files a lawsuit against another in order to achieve desired ends. Litigation is most common in the United States, but is eschewed in most other countries, typically in favor of arbitration or conciliation.

Safeguarding Intellectual Property Rights

Intellectual property consists of *industrial property*—that is, patents, inventions, trademarks, and industrial designs. It also includes *copyrights,* such as works of literature, music, and art, as well as books, films, and TV shows. Intellectual property is often the basis of firms' competitive advantage and long-term performance. Companies go to great expense to protect their intellectual assets in order to maintain their ability to develop and offer competitive products to customers.

Governments implement safeguards to protect intellectual property. Patents confer the exclusive right to manufacture, use, and sell products or processes. Copyright laws protect music, published works, and certain types of software. Trademarks remain in force for many years from their date of registration. International organizations such as the World Trade Organization (WTO) have devised strict standards for intellectual property protections. Other standards have been established by the World Intellectual Property Organization (WIPO) and various international treaties, such as the International Convention for the Protection of Industrial Property Rights and the Burton Convention for the Protection of Literary and Artistic Works.

Intellectual property rights
The legal claim through which the proprietary assets of firms and individuals are protected from unauthorized use by other parties.

Despite these protections, however, the protection of **intellectual property rights**—the legal claim that firms and individuals hold on their proprietary assets—is not guaranteed in much of the world. For one, laws enacted in one country are enforceable only within that country, conferring no protection abroad. Many countries are not members of WIPO or other treaty organizations. Practical mechanisms for ensuring protection may be lacking or poorly enforced. Individual country laws and practices differ widely. As a result, firms risk local loss of their property and a decline in the value that such holdings provide. For example, widely recognized global brands—Rolex, Louis Vuitton, and Tommy Hilfiger, among others—are often victims of counterfeiting, eroding the firm's competitive advantage and brand equity.

Exhibit 6.10 summarizes losses, in millions of U.S. dollars, from illegal copying or pirating of movies, music, software, and books in various countries (see the Losses columns) and the proportion of pirated items sold as a percentage of total items sold (see the Levels columns). For example, Disney has struggled to launch its DVD movie business in China, due to rampant local counterfeiting. Legitimate Disney DVDs of films like *Finding Nemo* and *The Lion King* cost up to 10 times as much as knockoffs, restricting sales to a trickle.[27] In Russia, illicit Web sites sell popular music downloads for as little as 5 cents apiece, or less than one U.S. dollar for an entire CD. The illegal sites are popular with music fans worldwide looking for cheap downloads. The sites are easily accessed by online shoppers in countries where they are otherwise outlawed under intellectual property laws. Russia's laws regarding counterfeiting are often insufficient to thwart such crimes, and enforcement is weak.[28]

Protection of intellectual property rights is a perennial problem, especially for companies that internationalize through FDI, licensing, and collaborative modes. Particularly susceptible are firms in the pharmaceuticals, software, publishing, and music industries. Companies may file for protection under the Paris Convention for the Protection of Industrial Property, an international agreement intended to protect proprietary assets in many countries simultaneously, but the protection is limited. Ultimately, firms must apply for protection on a country-by-country basis, although patent, trademark, and copyright laws vary substantially around the world. In each country, their nature and enforcement depend on national laws, administrative practices, and treaty obligations. Enforcement is a big challenge and depends on the attitude of local courts and law enforcement agencies.

Country	Records and Music		Business Software		Entertainment Software		Books	Totals
	Losses	Levels	Losses	Levels	Losses	Levels	Losses	Loss
Brazil	$177	40%	$497	62%	$159	88%	$18	$851
China	203	85%	1.488	90%	510	90%	50	2,251
India	53	55%	318	70%	86	82%	40	497
Italy	48	27%	716	50%	648	40%	20	1,432
Mexico	487	67%	296	63%	182	85%	41	1,006
Philippines	50	62%	35	72%	NA	NA	49	134
Poland	24	35%	264	58%	NA	75%	NA	288
Russia	423	65%	1433	83%	282	72%	42	2,180
Saudi Arabia	20	50%	112	51%	NA	NA	8	140
Ukraine	30	60%	290	85%	NA	NA	NA	320

Exhibit 6.10

Estimated Losses from Copyright Piracy (Millions of U.S. Dollars) and Piracy Levels (Percentages) in Selected Countries, 2005

Losses: Illegal copying or pirating of movies, music, software, and books

Level: the proportion of pirated items sold as a percentage of total items sold

SOURCE: International Intellectual Property Alliance (IIPA), Special 301 Data Estimates, February 2007.

CLOSING CASE

Pillaging Patents: The New War on Pharmaceutical Drugs

AACSB: Reflective Thinking, Ethical Reasoning

The $600 billion global pharmaceutical industry is dominated by about 10 firms; five are headquartered in Europe and five in the United States. Examples include GlaxoSmithKline (United Kingdom), Novartis AG (Switzerland), Merck (United States), Pfizer (United States), and Sanofi Aventis (France). Europe and the United States account for roughly 25 and 50 percent of worldwide pharmaceutical sales, respectively. This global industry is confronted with several major challenges.

High Cost of R&D Expenses

Pharmaceutical firms engage in large-scale, intensive research and development (R&D) to create and market drugs meant to treat everything from cancer to hair loss. Thousands of pharmaceutical drugs allow people to live longer and healthier lives. Europe and the United States are home to the major pharmaceutical firms and to industry R&D. They benefit from strong patent protection laws and abundant investment capital. According to industry statistics, it takes 12 to 15 years, and over $800 million in R&D expense, to successfully bring a new pharmaceutical compound to market. Only 1 in 10,000 investigated and tested compounds is approved for patient use. Only 3 out of every 10 new, approved compounds are successful enough to recover their R&D costs. For their successful products, pharmaceutical firms must charge prices high enough to recover not only the high costs of product development, but also to recover the cost of products that never achieve profitability.

Limited Protection for Intellectual Property

Governments grant patents and provide other types of protections for intellectual property. In practice, such protection is inadequate, especially in developing countries. India is one of the world's poorest countries, and very few of its citizens can afford health care or medications. The country has a history of weak intellectual property protection, which has discouraged R&D and innovation. In 1972, a major revision to the Indian Patent Act revoked all patents for medicines. Following this dramatic shift, foreign-branded pharmaceutical manufacturers abandoned India, and numerous pharmaceutical "chop shops" emerged. The new firms freely infringed on drug patents and engaged in a sort of selling free-for-all in the huge Indian pharmaceutical market. They reverse-engineered patented compounds developed by European and U.S. companies and began selling the pirated generics at drastically lower prices. The foreign pharmaceuticals launched legal actions against these violations but, in the absence of strict patent protection and with little local competition, the Indian generic drug manufacturers flourished.

The Challenge from Generic Brands

Under World Trade Organization (WTO) rules, a patent protects a drug inventor from competition for up to 20 years. In reality, when the lengthy testing and approval phase is factored in, the effective life of a drug patent is often less than 12 years. The manufacturer typically has only five to eight years of patent protection in which to recover its investment before generic manufacturers can legally enter the market. Once a patent expires, generic manufacturers have the right to produce medications originally invented by major pharmaceuticals. Generic manufacturers typically sell the medications that they produce at very low prices. Patent protections are important because they encourage innovation by allowing inventors a limited opportunity to recover their R&D investments. However, patent protection laws governing pharmaceuticals differ substantially around the world.

A *branded compound* is produced under patent protection by a pharmaceutical manufacturer that has undertaken expensive R&D to invent the drug. Each year, pharmaceutical firms typically invest some 20 percent of revenues into R&D to invent new compounds. "Approved generic compounds," manufactured in countries with strict bio-equivalency regulations, are comparable to branded compounds in safety, efficacy, and intended use. The main reason that generic manufacturers can charge lower prices is that they do not incur the high costs of R&D to develop new drugs. Because the medications are already established in the marketplace, generic manufacturers also incur substantially lower marketing and sales expenses.

In the world of generic drugs, Israel-based Teva Pharmaceutical is the largest manufacturer, holding about 12 percent of worldwide market share. Teva makes generic versions of about 150 brand name compounds. Teva and other generic producers have greatly increased their world market share in recent years. In the United States alone, generic medications now account for over half of all prescribed compounds. Once a branded compound's patent expires, generic manufacturers begin producing generic versions almost immediately.

Subsequently, retail prices for the compound can fall by as much as 90 percent within 12 months. The generic pharmaceutical industry is growing rapidly, partly due to rising demand for medications in developing economies and countries with weak patent protection.

Counterfeit Drugs

Many developing-country governments fail to ensure the bioequivalence of generics manufactured in their countries. As a result, a growing industry of counterfeit and bioinequivalent medications has emerged in such countries as Argentina, Brazil, China, and India. Because of the threats posed by counterfeit manufacturers, branded pharmaceutical firms spend significant resources to protect their patents and intellectual property rights around the world. Branded pharmaceutical manufacturers have pursued legal actions at the WTO and against individual nations. In 1995, the WTO's agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) was approved by approximately 150 WTO member countries.

Neglected Therapeutic Areas

A large portion of pharmaceutical research is focused on developing treatments for diseases that can return the cost of capital and generate profits. For these reasons, pharmaceutical firms tend to target the most attractive markets. For example, these firms are much more likely to develop a drug for cancer and central nervous system diseases (such as psychiatric ailments) than for ailments common to poor countries (such as tuberculosis). Some in the pharmaceutical industry believe that R&D is too costly and risky to invest in diseases common to poor countries.

At the same time, governmental and private initiatives have begun to address these market realities by providing incentive packages and public-private partnerships. For example, the Bill and Melinda Gates Foundation is investing billions of dollars to fight AIDS, tuberculosis, and various infectious diseases that affect developing countries.

Closer to Public Scrutiny

The pharmaceutical industry's actions are often subject to public scrutiny. For example, the government of South Africa got into a tussle with several manufacturers of branded AIDS drugs. Because of high prices, the government sanctioned the importation of nonapproved generics. The reaction from branded pharmaceutical manufacturers was to sue South Africa, which created an international backlash against the firms. Not only did the episode generate much negative publicity for the branded pharmaceutical firms, it made people more aware of the generic drug industry and its potential for helping those affected by the AIDS pandemic. In the wake of the South African debacle, Brazil and several other countries threatened to break patents if pharmaceutical firms did not make their drugs more affordable. In the interest of good public relations, several branded pharmaceutical firms began to offer their AIDS drugs at lower prices in Africa. In all, the pharmaceutical firms have developed at least 88 medicines to treat AIDS and related conditions. The United States and various European governments have provided billions of dollars in subsidies to support AIDS treatment in Africa.

The Future

Without adequate protection of intellectual property rights, the pharmaceutical industry has fewer incentives to pursue drug discovery. At the same time, consumers in poor countries need access to drugs but can't afford them. Lax intellectual property laws facilitate the production of cheap generic drugs, but without these protections major pharmaceutical firms have fewer incentives to fund the R&D that results in new treatments for the diseases that plague the world.

Case Questions

1. Specify the types of country risks that pharmaceutical firms face in international business. How do the political and legal systems of countries affect the global pharmaceutical industry?
2. People need medications, but the poor often cannot afford them. Governments may not provide subsidies for health care and medications. Meanwhile, pharmaceutical firms focus their R&D on compounds likely to provide the best returns. What is the proper role of the following groups in addressing these dilemmas: national governments, branded pharmaceutical firms, and generic manufacturers?
3. Consult www.PhRMA.org, The Pharmaceutical Research and Manufacturers of America. What steps is the branded industry taking to address the various ethical issues that it faces, such as providing affordable drugs to poor countries?
4. Consult the TRIPS agreement at the WTO portal (www.wto.org). What are the latest developments regarding this treaty? What types of protection does this treaty provide to pharmaceutical firms? What enforcement mechanisms does TRIPS provide for ensuring that these protections will be carried out?
5. Recommend a strategy that management at a large pharmaceutical firm should employ in order to reduce the likelihood of political and legal risks that such firms face. What steps should management take to minimize its exposure to such risks?

Sources: Grabowski, H., H. Vernon, and J. DiMasi. (2002). "Returns on Research and Development for 1990s New Drug Introductions." *Pharmacoeconomics* 20, suppl. 3, 11–29; Trouiller, P., et al. (2002). "Drug Development for Neglected Diseases: A Deficient Market and a Public-Health Policy Failure." *The Lancet* 359 (June), 2188–94; Lofgren, H., and P. Malhotra. (2004). "India's Pharmaceutical Industry: Hype or High Tech Take-Off." *Australian Health Review* 28 (2): 182–93; Slater, J. (2003). "Indian Pirates Turned Partners; Once Copycats, Its Medication-makers Emerge As Industry Powerhouses." *Wall Street Journal*, Nov 13, 2003; Glass, G. (2005). "Patent Attack." *Pharmaceutical Executive* 25 (4): 76–81; *The Economist.* (2005). "Survey: Prescription for Change." June 18, 2005; *The Economist.* (2005). "Business: Big Generic Pharma; Pharmaceuticals." July 30, 2005; *The Economist.* (2005). *The Economist.* (2005). "Business: Corrupted; Medications and Intellectual Property." July 23, 2005; *World Trade Organization.* (1994). "Agreement on Trade-Related Aspects of Intellectual Property Rights." Retrieved from www.PhRMA.org "What Goes Into the Cost of Prescription Drugs?"

This case was written by Kevin McGarry, John Riesenberger, and Gary Knight for classroom discussion only.

CHAPTER ESSENTIALS

Key Terms

corporate social responsibility, p. 181
country risk, p. 160
extraterritoriality, p. 177
intellectual property, p. 161
intellectual property rights, p. 184
legal system, p. 163
political system, p. 163
rule of law, p. 169
transparency, p. 179

Summary

In this chapter, you learned about:

1. What is country risk?

International business is influenced by political and legal systems. **Country risk** refers to exposure to potential loss or to adverse effects on company operations and profitability caused by developments in a country's political and legal environments. Inadequate enforcement of laws can lead to loss of **intellectual property rights**. A **political system** is a set of formal institutions that constitute a government. A **legal system** is a system for interpreting and enforcing laws. Adverse developments in political and legal systems increase country risk. These can result from events such as a change in government or the creation of new laws or regulations.

2. What are political and legal systems?

A **political system** is a set of formal institutions that constitute a government. A **legal system** is a system for interpreting and enforcing laws. Adverse developments in political and legal systems increase country risk. These can result from events such as a change in government or the creation of new laws or regulations.

3. Political systems

The three existing major political systems are *totalitarianism, socialism,* and *democracy*. These systems are the frameworks within which laws are established and nations are governed. Most countries today employ some combination of democracy and socialism. Democracy is characterized by *private property rights* and *limited government*. Socialism occurs mainly as *communism* or *social democracy*. Communism proved to be ineffective for allocating resources and declined sharply with the collapse of the Soviet Union in 1991. Today, most governments combine elements of socialism and democracy. In general, totalitarianism is associated with *command economies,* socialism with *mixed economies,* and democracy with *market economies*.

4. Legal systems

There are five major legal systems: *Common Law*, *Civil Law*, *Religious Law*, *Socialist Law*, and *Mixed Systems*. The **rule of law** implies a legal system in which laws are clear, understood, respected, and fairly enforced.

5. Actors in political and legal systems

Actors include *government*, which exists at the national, state, and municipal levels. The World Trade Organization and the United Nations are typical of *international organizations* that influence international business. *Special interest groups* serve the interests of particular industries or country groupings, usually in pursuit of economic development. Groups exist at various levels and include labor unions, environmental organizations, and consumers that promote particular points of view. Companies deal with *competing firms* in foreign markets, who may undertake political activities aimed at influencing international entry and performance.

6. Types of country risk produced by the political system

Governments impose constraints on corporate operating methods in areas such as production, marketing, and distribution. Governments may expropriate or confiscate the assets of foreign firms. Governments or groups of countries also impose *embargoes* and *sanctions,* which restrict trade with certain countries. *Boycotts* are an attempt to halt trade or prevent business activities and are usually pursued for political reasons. War and revolution have serious consequences for international firms. *Terrorism* has become more salient recently, and reflects the use of force or violence to attain political goals via fear, coercion, and intimidation.

7. Types of country risk produced by the legal system

Foreign investment laws may restrict FDI that harm the natural environment. Controls on operating forms and practices affect firms' production, marketing, and distribution activities. Marketing and distribution laws influence the nature of international firms' promotion, and advertising. Laws regarding income repatriation restrict the transfer of profits back to the home country. Environmental laws are devised to combat practices that harm the natural environment. International contracts vary around the world in both substance and enforcement. Internet and e-commerce regulations are relatively underdeveloped in most countries. **Extraterritoriality** is the application of home-country laws to persons or conduct outside of national borders. *Antiboycott regulations* prevent companies from participating in restrictive trade practices. Accounting and reporting laws vary around the world. **Transparency** is the degree to which firms reveal substantial and regular information about their financial condition and their accounting practices. Ethical values and practices relate to the moral behavior of people, companies, and governments. Corruption involves the use of illegal or unethical practices, such as bribery and fraud, to achieve business goals. Corruption varies internationally, and may be severe in some countries.

8. Managing country risk

Successful management requires developing an understanding of the political and legal context abroad. The firm should scan the environment proactively. It should strictly adhere to ethical standards. **Corporate social responsibility (CSR)** is operating a business in a manner that meets or exceeds the ethical, legal, commercial, and public expectations of stakeholders. Country risk is also managed by allying with qualified local partners abroad. The firm should seek protection through legal contracts. To be successful, international businesses must safeguard their **intellectual property rights**.

Test Your Comprehension AACSB: Reflective Thinking

1. What are the components of political systems? What are the components of legal systems? How do these systems lead to country risk?
2. Distinguish between totalitarianism, socialism, and democracy. What are the implications of each for internationalizing firms?
3. What are the specific characteristics of democracy? How do these characteristics facilitate international business?
4. What is the relationship between political freedom and economic freedom?
5. Describe the major types of legal systems. Which systems are most widely encountered?
6. Who are the major actors in political and legal systems? Which participant do you believe is most influential in international business?
7. Summarize how political and legal systems affect international business.
8. What are some proactive actions firms can take to minimize country risk while conducting cross-border business?
9. What are intellectual property rights? How do firms safeguard these rights?

Apply Your Understanding

AACSB: Reflective Thinking, Communication, Ethical Reasoning

1. For business enterprises to thrive, some minimum conditions must be present: recognition of private property rights and limited government intervention. To what extent may totalitarianism, socialism, and democracy interfere with the ideal commercial environment for firms?
2. Suppose you get a job at Aoki Corporation, a large firm that manufactures glass for industrial and consumer markets. Aoki is a large firm, but has little international experience. Senior managers are considering a plan to move Aoki's manufacturing to China, Mexico, or Eastern Europe, and to begin selling its glass in Latin America and Europe. However, they know little about the country risks that Aoki may encounter. How relevant are the following factors in contributing to potential country risk: foreign investment laws, controls on operating forms and practices, and laws regarding repatriation of income, environment, and contracts.
3. Royal Dutch Shell has been doing business in Nigeria since the 1920s, and has announced new plans to develop oil and gas projects there. However, over the years Shell has confronted a series of episodes involving country risk. Shell's operations are centered in Nigeria's Ogoni region, where the local citizens have protested Shell's drilling and refining activities, which are said to spoil the natural environment and reduce the amount of available farmland. Protestors also accuse Shell of extracting wealth from the region without adequately compensating local residents. Ogonis sabotaged Shell's operations to such an extent that the firm suspended parts of its Nigerian operations. Shell also came under pressure to divest its Nigerian operations and to pay reparations to the locals. Despite these problems, Shell has persisted in Nigeria. Management instituted various community development programs in the region, budgeted at $50 million per year. Describe the various types of country risk that Shell appears to face in Nigeria. What proactive steps can Shell take to anticipate future country risk? What should Shell do to deal more effectively with country risk? What steps can Shell take to be a better corporate citizen in Nigeria?

AACSB: Reflective Thinking, Communication, Use of Information Technology, Ethical Reasoning

Refer to Chapter 1, page 27, for instructions on how to access and use globalEDGE™.

1. Supranational organizations such as the World Bank (www.worldbank.org) and the World Trade Organization (www.wto.org) oversee much of the legal framework within which the world trading system operates. The political frameworks for specific industries or groupings of countries are strongly influenced by other organizations, such as the Organization of Petroleum Exporting Countries (www.opec.org) and the Organization for Economic Cooperation and Development (www.oecd.org). Using globalEDGE™ and the above online portals, address the following question: What is the goal of each organization and how does it go about achieving its goal? By viewing the news and press releases at each Web site, summarize the latest initiatives of each organization.

2. When companies venture abroad, managers need information on the nature of the legal and political environment in each country. This information is provided on various Web sources, as illustrated in the following exercises: (a) Suppose you want to sign up distributors in the European Union (EU) and want to learn about EU contract law. What would you do? Consult the globalEDGE portal to learn about trade and contract laws in Europe. Try the following: From the globalEDGE™ Resource Desk, click on Trade Law. Describe the resources there for learning about contract law in Europe. (b) The Central Intelligence Agency's portal provides up-to-date information about national governments and political environments. Go to www.cia.gov, click on "The World Factbook," and summarize the political environment in China, Colombia, France, and Russia.

3. Various organizations have devised international standards for ethical corporate behavior. These include the United Nations "Universal Declaration for Human Rights" (available at www.un.org), the OECD's "Guidelines for Multinational Enterprise" (www.oecd.org), the International Labor Organization's " Minimum Labor Standards" (www.ilo.org) and the U.S. Department of Commerce's "Model Business Principles" (www.commerce.gov). Visit these online portals and prepare a set of guidelines firms can follow in pursuing acceptable ethical standards in international business.

4. Freedom House is a nonprofit organization that monitors the state of freedom worldwide. It conducts an annual "Freedom in the World Survey," which you can view at www.freedom house.org/research. The survey compares the state of political rights and civil liberties in nearly 200 countries over time. Visit the site and answer the following questions: (a) What is the role of political rights and civil liberties in the Freedom House rankings? (b) What can governments in these countries do to facilitate more rapid social and political development? (c) What are the implications of the rankings for companies doing international business?

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Management Skill Builder©

Performing a Preliminary Country Risk Analysis

Country risk refers to potentially adverse effects on company operations and performance caused by changes in a country's political and legal environments. Managers use country risk analysis to identify potential threats to the firm's trade and investment activities.

AACSB: Reflective Thinking, Analytic Skills

Managerial Challenge

Before venturing into any country, managers determine the likelihood and nature of country risk, and its probable effect on the operations and performance of the firm. Finding out about country risks is a task performed in MNEs and other firms with substantial international operations. As a future manager, you need to acquire market research skills that will help you understand country risk.

Background

Country risk arises primarily from government intervention. Governments may impose legal and regulatory burdens that increase business costs, delays, or lost opportunities. Governments may restrict access to important markets, impose complex bureaucratic procedures, or limit the amount of profits realizable from foreign operations. Country risk impacts management decision making regarding the strategies for entering foreign markets. By entering a market via exporting, the firm's level of market commitment and risk are relatively low, and management can rapidly withdraw or reduce its operations in the market in the event of substantial risk. By contrast, the level of risk is heightened for firms that internationalize via FDI, which results in establishing a production facility or a subsidiary in the target country.

Managerial Skills You Will Gain

In this C/K/R Management Skill Builder©, as a prospective manager, you will:

1. Learn the factors that determine country risk.
2. Learn the variables to consider when locating company operations abroad.
3. Develop market research skills for acquiring knowledge concerning country risk for planning company operations abroad.
4. Research the types of country risk that firms encounter.

Your Task

Assume you are an employee with a company that plans to build a factory abroad. Management is considering each of three countries as possible locations to build the factory. You must decide which location is best. Management prefers the country with the lowest risk. Your task is to conduct market research to investigate the degree of country risk in each of China, Mexico, and Poland. Then prepare a brief report that includes an estimate of the level of country risk in each of these countries by examining corruption, political rights, civil liberties, freedom status, and economic freedom.

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