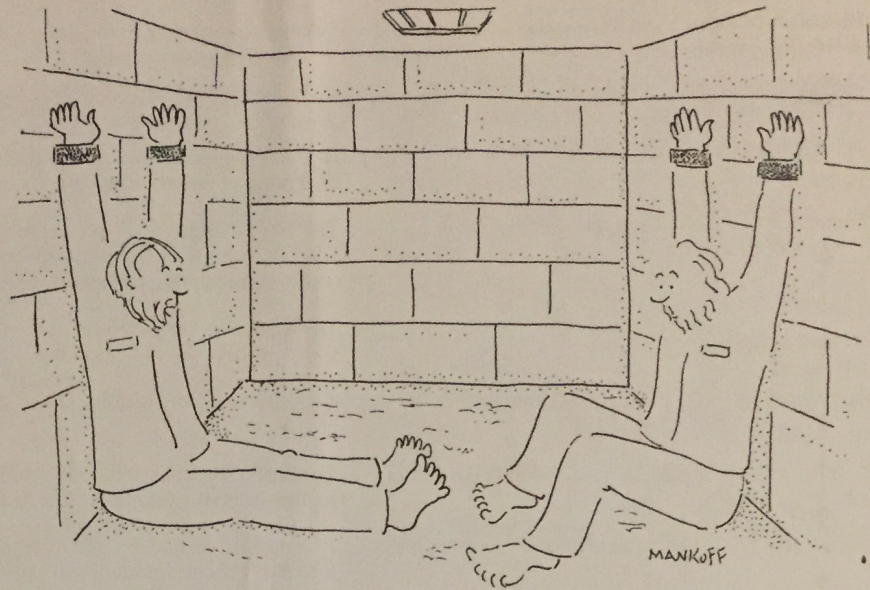


FIGURE 3.4 Today, a Question of Where Fiction Stops and Fact Starts

Source: Robert Mankoff/New Yorker Cartoon Bank/www.cartoonbank.com



"Look, you've got to accept some curtailment of your freedom in exchange for increased security."

unpredictably enforced laws, and freedom constraints will increase systemic political risk in many countries.

Systemic political risks, by influencing the macro business environment, affect the operation of all firms.

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Systemic risks do not necessarily reduce potential profits. In fact, elections and policy shifts can create opportunities for foreign investors. In the past few years, for example, newly elected governments in Vietnam, Malawi, Estonia, and Guinea deregulated and privatized their previously state-controlled economies. Investors who accepted the risk of a public policy reversal and pursued the emerging opportunities prospered as freer markets developed in these countries. Our opening case traces a similar market pattern in China. Political trends encouraged pro-market reforms that reduced risks and created opportunities. Still, taking advantage of such opportunities, whether in China or elsewhere, calls for tough-minded analysis of the risk-return relationship.

Procedural political risk institutes impediments that constrain the flexibility of local operations.

Procedural Political Risk Around the clock, people, products, and funds move from point to point in the global market. Each move creates a procedural transaction between subsidiaries, companies, or countries. Political actions sometimes impose frictions that slow or stop these transactions. The repercussions of, say, public fraud or a partisan judicial system can raise business costs. Corrupt officials might pressure a foreign firm to pay additional monies to clear goods through customs or obtain a permit to open a factory. For example, Nigeria's notoriously challenging business environment is rife with procedural risks. "The entire state machinery exists to siphon off cash," said one observer. "Many functions of government have been adapted for personal gain.... A universe of red tape engulfs the economy.... In some Nigerian states, governors must personally sign off on every property sale; many demand a fee."¹⁰³ Politically motivated interference escalates expenses, thereby lowering returns. Procedural political risk is a micro risk—that is, it affects some but not all companies. Monitoring industry developments, minding the relative contribution of their firms to the local economy, and promoting solid citizenship help MNEs manage their exposure.

The dynamic of distributive political risk is the gradual elimination of the local property rights of foreign companies.

Distributive Political Risk Countries see successful foreign investors as agents of innovation and sources of prosperity. Often, as MNEs generate greater profits in the local economy, the host government may question whether it is getting its "fair" share of the rewards. In some

situations, change is immediate. For example, rising silver prices led the Bolivian government to “dismantle the privatization model” governing its mining industry and expropriate all assets owned by private, largely foreign-owned mining companies.¹⁰⁴ Foreign MNEs, like Coeur d’Alene Mines and Pan American Silver, besides watching their share price plummet on the news, were given two weeks to prepare for state takeover of their Bolivian mines.

More often, officials launch programs of *creeping expropriation* whereby they slowly take a bigger share of the rewards. Methods vary, such as increasing barriers to transferring personnel into or profits out of the country. Gradually, through such techniques, the host government eliminates MNEs’ local property rights. Generally, vigilance helps MNEs minimize exposure. Many also fight back, building global supply chains that diversify operations.

Chrysler, for example, deterred creeping expropriation in Peru because its local factory made about half the parts needed to assemble a car; importing the rest meant the local facility was useless if the government interfered with operations. Likewise, Japan’s escalating tension with China (notably, consumer boycotts of Japanese products, anti-Japanese riots, and foreboding military confrontations) pushes Japanese MNEs to hedge their political risk. Some apply a “China-plus” approach whereby they backstop their supply chains, once anchored in China, with a shadow hub in another Asian market such as Thailand, Vietnam, or the Philippines. Although inefficient, alternative locations safeguard the Japanese firms’ Asian operations in the event political hostilities flare.¹⁰⁵

Sometimes the importance of the market leaves MNEs with few options. The United States, for instance, is not generally considered a hotbed of distributive political risk. If you’re in the cigarette business, however, you’re aware that the U.S. carries high degrees of political risk.¹⁰⁶ Its government battles cigarette makers (both domestic, like Philip Morris, and foreign, like British American Tobacco) on matters of taxation, regulation, business practice, and liability. Preserving market access requires that companies accept hard operational limits.

Catastrophic political risk devastates companies and countries.

Catastrophic Political Risk Catastrophic political risk includes political developments that adversely affect the operations of every firm in a country. It typically arises from macro flash-points—ethnic discord, illegal regime change, civil disorder, insurrection—that disrupt society. Anti-state activities in Egypt in early 2011, for example, paralyzed its economy. Foreign commerce and domestic business all but halted, markets seized up, and supplies of all sorts vanished. Auspiciously, Egypt pulled back from the brink. In other situations, such as in failed states like Chad, Afghanistan, or Zimbabwe, spiraling disruptions triggered political conflicts that devastated the business environment for all firms.¹⁰⁷ By the fall of 2013, however, Egypt fell into a similar downward spiral. MNEs responded by suspending operations.

Point



Point Yes Companies take politics seriously, fully aware that the actions of host governments affect the business environment. Consequently, MNEs face threats that demand political risk management strategies. All have a choice: They can apply a proactive or passive approach. Those who advocate active political risk management reason that the best defense is a good offense. In my opinion, they’re right. Taking charge, predicting political problems, and controlling risks is the ticket to success.

WHAT TO DO Seasoned managers pull this off through two battle-tested tactics. First, they apply state-of-the-art statistical modeling to quantify political risks. Second, they stress-test their models, consulting experts on the political

Proactive Political Risk Management: The Best Approach

maneuverings in a particular country. This two-pronged approach, like good management in general, applies hard analysis and objective interpretation. It begins with the thesis that neither positive nor negative political events in any country are independent or chance events. Civil strife, creeping expropriation, regime change, ethnic tension, terrorism, and the like do not happen randomly. They unfold in observable patterns that bright folks applying sharp analytics can study to estimate the odds of future outcomes. An objective model that detects, measures, and frames scenarios moves a company ahead of the curve, preparing it to manage its political risk exposure.

WHAT TO WATCH Measuring the right set of discrete events is the key precondition of modeling political risk.

Specifically, this approach requires identifying valid indicators that one can measure reliably. Research identifies useful indicators: the number of military officers holding political office, pace of urbanization, frequency of government crises, degree of literacy, ethno-lingual fractionalization, and so on. Evolving methods fortify analyses. For example, sentiment analysis identifies emotionally charged words and phrases used in online communications. Comparing the relative frequency of positive and negative words used in millions of exchanges, feeds, and posts on the Internet produces a national as well as global map of how people “feel.” Sentiment analysis, for example, indicated that people’s resentment of autocratic rule was crossing critical thresholds in Egypt and Libya weeks before violence erupted.¹⁰⁸ Moreover, sentiment analysis confirms that the challenge is not identifying individual measures, but rather identifying the right mix. Once done, skillful statistical modeling can objectively estimate risk exposure.

WHAT TO ADD We concede a proactive approach has limits. Spreadsheet estimation, no matter how rigorous or extensive, carries analysis only so far. Reaching this limit

need not halt analysis, however. One can complement quantitative measures with in-depth, country-specific qualitative indicators. Enriching interpretation requires perspectives and perceptions that intuitively understand a country’s political drama in ways that numbers struggle to represent.

How do we apply this approach? A popular tactic is surveying country experts. Besides being mindful of quantitative factors, specialists add an understanding of the subtle intricacies of secondary data. They enhance analyses with their expertise on the subjective conditions in a country, adding a bit of wisdom to interpret what appears to others as idiosyncratic circumstances but, in their eyes, is a systematic pattern of political activities.

Integrating expert assessments into your political risk strategy is straightforward. Begin by running standardized interviews with experts to assess a country’s political environment. If stuck, a useful starting point is the Internet; searching “political risk management” generates resources. Collectively, they support projecting realistic scenarios and logically assigning probabilities to reasonable outcomes—the hallmarks of proactive political risk management.

Proactive Political Risk Management: The Best Approach

Counterpoint No Unquestionably, a proactive approach exhibits the hallmark of good management—enterprising, confident, and controlling. However, it fails to explain why many MNEs do the exact opposite, choosing to manage political risk passively by treating it as an unpredictable hazard of the business environment. They reason that no model, regardless of how brilliantly it has been conceptualized, how systematically it has been specified, and how precisely it has been administered, can consistently predict political risk. Granted, shrewd models extrapolate meaningful insights from economic, political, and social reports about who may take office, what policies may pass, and how these sorts of political events affect the business environment. Unquestionably, these insights make the political system and its risks understandable. They do not, however, make it predictable.

WHAT TO HEDGE Insights do not qualify as predictions precisely because of the intrinsic impossibility of reliably measuring messy, ill-structured situations. The political world is complex, its inalienable feature is ambiguity, and its tendency to change is absurdly high. Complicating matters are the innumerable variables and their interaction



Counterpoint

that shape a political system. This situation becomes more difficult as companies venture into emerging markets, each with its own political peculiarities. Going from the United States to Mexico may be a stretch, but that pales in comparison to expanding from the United States to, say, Saudi Arabia, Kazakhstan, Latvia, or Rwanda. No matter how powerful the spreadsheet or insightful the expert, the dimensions and dynamic of a political environment defy precise specification. Certainly, developing broad frameworks that anticipate unpredictable hazards makes good business sense. However, prudently managing political risk starts by rejecting the delusion that one can. The objective is protection, not prediction.

HOW TO HEDGE This, of course, raises the question: How do I hedge my company’s exposure? Typically, MNEs applying a passive approach outsource the political risk-management process. They reason the best shield is buying political risk insurance—essentially, the best offense is a good defense. Consider the flexibility they get through this approach. They can purchase coverage that protects operations from an array of political risks, including government expropriation, involuntary abandonment,

and damage from political violence. Furthermore, companies are not limited to a few carriers. A range of public agencies, international organizations, and private companies offer a variety of coverage options.

- Multilateral development banks (MDBs) are international financial institutions funded and owned by member governments that promote growth in member countries by providing financial incentives to potential investors. Reducing the capital at risk encourages firms to expand into otherwise unacceptably risky environments. Examples are the African Development Bank, the Asian Development Bank, and the World Bank Group.
- The Overseas Private Investment Corporation (OPIC) encourages U.S. investment projects overseas by protecting ventures against various forms of risk, including civil strife, expropriation, and currency inconvertibility. Increasingly, OPIC promotes investments in emerging markets that support U.S. foreign policy priorities.
- Private insurance companies underwrite political risk protection. Many cover "routine" distributive and procedural risks that involve property and income, such

as contract repudiation and currency inconvertibility. Private insurers are reluctant to cover catastrophic risks that result from civil strife, insurrection, or war.

WHAT TO REALIZE Ultimately, we have no quarrel with the notion that prediction and control are touchstones of professional management. Still, politics are anything but predictable and controllable. Indeed, few, if any, predicted the political turmoil of the Arab Spring and the surprisingly swift collapse of the Mubarak regime in Egypt. And who would have called democracy's retreat a decade ago, especially when leading analysts were celebrating the "end of history?" Not to put too sharp an edge on it, but if one cannot predict these mega-events, then exactly what can one predict? Therefore, it just makes more sense—and, we might add, more cents—to resist the delusion of proactive management and opt for the practicality of passively managing political risk.

1. Given the choice between a proactive versus a passive risk management strategy, which approach would you recommend? Specify three reasons to justify your recommendation.

THE LEGAL ENVIRONMENT

As political ideologies differ among countries, so do legal systems. Thus, a key aspect of the international business environment is how a country develops, interprets, and enforces its laws. Businesspeople, understandably, champion consistency in laws from country to country. Uniform, transparent laws make it easier to plan where to invest and, once there, how to compete on competencies, not connections.

In theory, legitimate rules that apply without prejudice to individual or institutional behavior, regardless of political, cultural, or economic status, anchor an effective legal environment. Done justly, individuals and companies can make lawful decisions that support peace and prosperity; done arbitrarily, all suffer. "To distrust the judiciary," reasoned Honoré de Balzac, "marks the beginning of the end of society."

The **legal system** specifies the rules that regulate behavior, the processes by which laws are enforced, and the procedures used to resolve grievances. Legal systems differ across countries due to variations in tradition, precedent, usage, custom, or religious precepts. Moreover, with the exception of the members of the European Union, countries rarely recognize the legitimacy of legal practices or court judgments from other nations. Concluded a legal scholar, "Products move very easily across borders. Legal judgments, not so much."¹⁰⁹

All things being equal, every legal system institutes rules that support business formation, regulate transactions, and stabilize relationships. Successfully doing so ensures that a society can pursue economic development and, when disagreements arise, resolve them without resorting to lawlessness. Modern legal systems share three components: (1) **constitutional law**, which translates the country's constitution into an open and just legal system, setting the framework for government and defining the authority and procedure of political bodies to establish laws; (2) **criminal law**, which safeguards society by specifying what conduct is criminal, and prescribing punishment to those who breach those standards; and (3) **civil and commercial laws**, which ensure fairness and efficiency in business transactions by stipulating private rights and specific remedies in order to regulate conduct between individuals

The legal system is the mechanism for conceiving, stipulating, interpreting, and enforcing the law in a formal jurisdiction.

Modern legal systems evidence three components:

- Constitutional Law
- Criminal Law
- Civil and Commercial Law

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and/or organizations. No single legal component in and of itself guarantees a functioning legal system. Success depends on the collective effectiveness of all in promoting philosophical integrity, procedural justice, and personal security.

Aspects of each type of law bear upon MNEs' actions in a host country.¹¹⁰ Our opening case, for example, shows how China's legal traditions and practices attract, retain, and deter foreign investment. Whereas Western investors are accustomed to transparent bankruptcy laws that protect creditors, Chinese law presently protects debtors. Likewise, one in six business practitioners in Russia has been prosecuted for alleged economic crime over the past decade; most cases have no plaintiff, acquittals are rare, and company assets are often expropriated by the state.¹¹¹ Russian law, contends critics, "is the property of those who enforce it, and written exclusively for them."¹¹²

TYPES OF LEGAL SYSTEMS

Managers face five types of legal systems in the world today:

- Common law
- Civil law
- Theocratic law
- Customary law
- Mixed

The type of legal system in a country determines the conduct of business transactions, the rights and obligations of those doing business, and the legal redress open to those who believe they have been wronged. Understanding the nuances of the system pushes executives to assess a variety of issues: Are laws based on abstractions or practicality? Do judges or juries pass judgment? Is justice based on objective principle or seen as the province of divinity? Do personal connections trump case facts? Peculiar as these questions sound, international business puts managers into different situations wherein different interpretations of these issues result in different standards that regulate the legality of their actions.

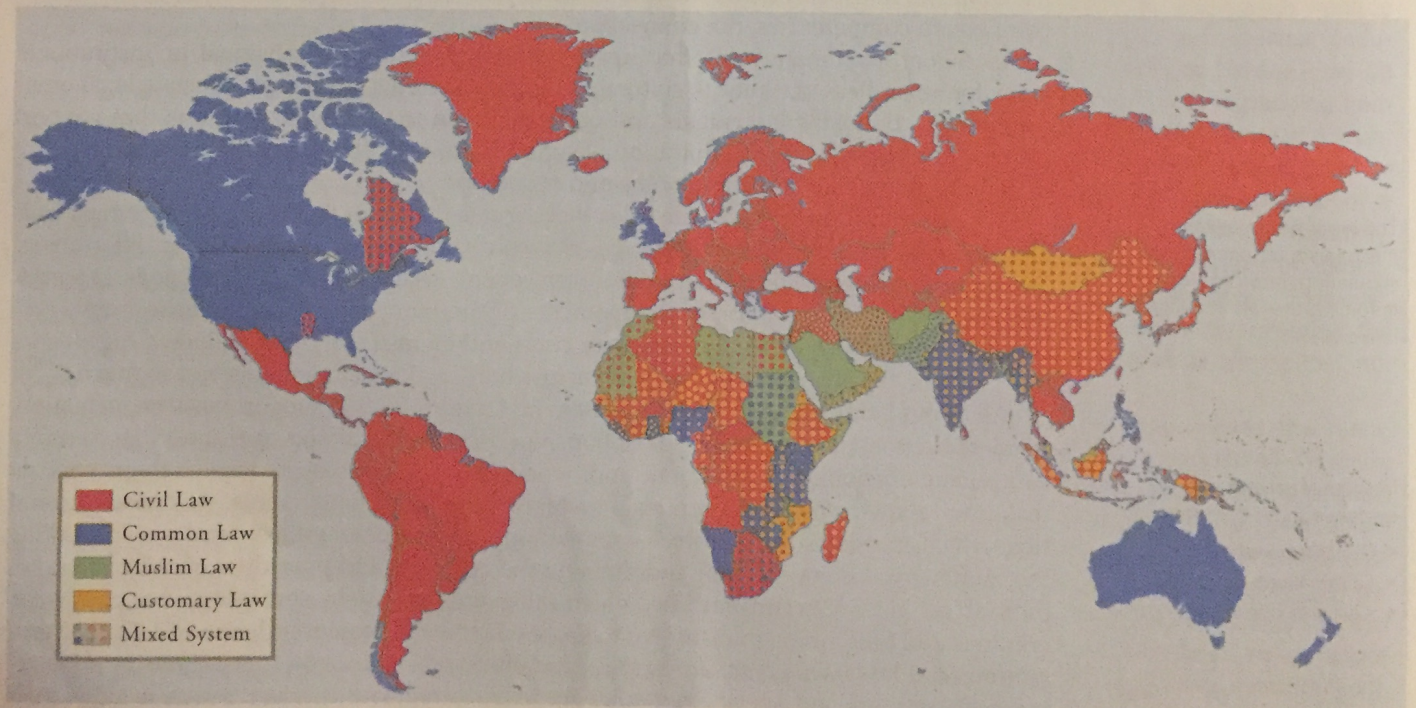
The globalization of business drives the standardization of laws across countries. Still, enduring philosophical outlooks and practical orientations result in different types of legal systems around the world. Map 3.3 identifies the primary types that prevail worldwide, namely: *common law*, *civil law*, *theocratic law*, *customary law*, and *mixed systems*.¹¹³

MAP 3.3 The Wide World of Legal Systems

Managers operating internationally face legal environments anchored in a variety of philosophies and principles. Here we see the world organized by predominant types of legal systems.

Source: University of Ottawa, "World Legal Systems," retrieved 4/15/2013 from <http://www.juriglobe.ca/eng/index.php>.

Note: Given that this is a Mercator projection, the scale approximates east-west distance at the equator; however, the farther you move from the equator, the more the east-west distance is distorted.



Common law is developed by judges through the decisions of courts.

Civil law is based on strict application of statutory laws.

Theocratic law is based on the inspirations and instructions of religious teachings.

Customary law is based on norms of behavior that gain legitimacy through long-term practice.

CONCEPT CHECK

As we saw in Chapter 1, business environments vary. Granted, there are points of convergence, but conducting international business calls for recognizing the existence of fundamental differences across countries. Here, we stress that legal systems differ on a variety of principles and practices.

Common Law A **common law** system relies on tradition, judge-made precedent, and usage. It respects established case law in resolving disputes. Judicial officials refer to statutory codes and legislation, but only after considering the rules of the court, custom, judicial reasoning, prior court decisions, and principles of equity. The doctrine of *stare decisis* is a distinguishing feature of the common law system—it obliges judges to respect the precedent established by prior court rulings.¹¹⁴ The common law system has Anglo-American legacies; it prevails in, among others, Canada, the United States, India, Hong Kong, England, New Zealand, and Australia.

Civil Law A **civil law** system relies on the systematic codification of accessible, detailed laws. It assigns political officials, rather than government-employed judges, the responsibility to translate legal principles into a compendium of regulatory statutes. Rather than create law, as they do in the common law system, judges apply the relevant statutes to resolve disputes. In contrast to *stare decisis*, judicial officers in a civil law system are not bound by precedent. Precisely stipulated statutory codes, however, constrain their authority to interpret the law. Similarly, notaries public play minor roles in common law countries but are important gatekeepers as well as regulators of contracts and certificates in civil law systems. Civil law is the most widespread type of legal system in the world. It is used in various forms in approximately 150 countries, including Germany, France, Mexico, and Japan.

Theocratic Law A **theocratic law** system relies on religious doctrine, precepts, and beliefs. Ultimate legal authority is vested in religious leaders, who regulate business transactions and social relations based on their interpretation of a sacred text. For instance, Iran's president, Hassan Rouhani, defers to the final say of Iran's supreme leader, Ayatollah Ali Khamenei. Theocratic laws see no separation of church and state; government, law, and religion are one. The most prevalent theocratic system, Muslim or Islamic law (or *Shari'a*), is based on the Qur'an, the *Sunnah* (decisions and sayings of the Prophet Muhammad), the writings of Islamic scholars, and the consensus of legal communities in Muslim countries.¹¹⁵ Muslim law prevails in the Middle East and northern Africa. However, modernists (e.g., Turkey, Indonesia), traditionalists (e.g., Kuwait, Malaysia), and fundamentalists (e.g., Iran, Saudi Arabia) advocate different interpretations of *Shari'a*.

Customary Law A **customary law** system reflects the wisdom of daily experience or, more formally, enduring spiritual legacies and time-honored philosophical outlooks. It anchors legal systems in many indigenous communities, defining the rights and responsibilities of members. Legitimacy follows not from the stamp of a powerful person or sanctification by an institution, but from individuals recognizing the benefits of complying with community standards. Offenses are treated as torts—i.e., private wrongs or injuries rather than crimes against the state or society. Customary law prevails in many developing countries, particularly those in Africa.¹¹⁶ Few nations operate under a wholly customary legal system. Instead, this type often plays a role in countries that have a mixed legal system.

Mixed System A **mixed legal system** emerges when a nation uses two or more of the preceding types. In a sense, legal pluralism results when two or more legal systems apply cumulatively or interactively. Map 3.3 shows that one finds most mixed legal systems in Africa and Asia. The Philippines, South Africa, and Guyana, for instance, follow a blend of civil and common law. Nigeria, Malaysia, and Kenya mix common, theocratic, and customary law. Bangladesh, Singapore, and Pakistan blend common and theocratic law. Indonesia, Djibouti, and Oman, conversely, blend theocratic law with civil codes.

TRENDS IN LEGAL SYSTEMS

As the Third Wave of Democratization spread, the philosophy of individualism supplanted that of collectivism. Legally, this change promoted individual legal rights and instituted practices of due process. The law became more transparent, courts became more impartial,

and officials became more accountable in many countries. Presently, democracy's retreat, by signaling the rise of strong states advocating collectivism, pushes managers to pinpoint likely changes in legal systems. Managers begin by accepting that authoritarian governments use the legal system to regulate business activity so that it unconditionally supports and sustains the state. There is no separation of law and state; the state uses the law to control public and private matters. Bluntly put, justice is not blind but arbitrary, oppressive, and state-serving.

Recall earlier observations on legal affairs in China. Doing business there, said an observer, means dealing with "a society that had... plenty of rules, but they were seldom enforced. China appeared to be run by masterful showmen: appearances mattered more than substance, rules were there to be distorted."¹¹⁷ Moreover, the CCP's official status above the law further complicates determining what is right and what is wrong. China is not the exception. The Russian legal code is laced with ambiguities. Businesses, caution legal analysts, "cannot even keep track of the law, let alone decide whether to follow it."¹¹⁸ Besides confusion, ambiguity renders the law as less about protecting the citizenry and more a tool of arbitrary and abusive state power.

CONCEPT CHECK

As developed in Chapter 2, a country's cultural orientation toward standards of accountability, equity, and fairness influences the prevailing principles in its legal environment.

The rule of man holds that the ruler, in whatever form, commands authority that is above the law.

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The rule of man anchors the legal system in totalitarian states.

The rule of law holds that no individual is above laws that are clearly specified, commonly understood, and fairly enforced.

The Basis of Rule Once relegated to the periphery of the global economy, emerging markets steadily command center stage. Their expanding markets increasingly frame managers' interpretation of legal trends. Most notably, the strong performance of emerging economies pushes managers to reassess the prevailing philosophical basis of law in order to understand how local officials will regulate the business environment. Specifically, the rise of emerging economies, along with their dissimilar conceptions of legality, requires that managers ask, "What is the *basis of rule* in a given country?" This question inevitably directs attention to the rule of man versus the rule of law.

The Rule of Man The **rule of man** holds that ultimate authority resides in a person whose word and whim, no matter how unfair or unjust, is law. For much of history, rulers and law were one and the same—the law was the will of the ruler, whether that ruler was called king, queen, lord, emperor, empress, shogun, czar, raj, chief, caliph, etc.¹¹⁹ Today, these titles have largely given way to others, such as chairman, emir, comandante, generalissimo, dictator, supreme leader, or, in the case of North Korea, "Dear Leader." In whatever form and with whatever title, the rule of man defines a legal system in which the sovereign leader's actions are not restricted by a constitution, regulated by criminal codes, or open to opposition. For example, Saddam Hussein, former President of Iraq, imperiously declared that the "law is anything I write on a scrap of paper."¹²⁰ In China, furthermore, top-ranked party members accused of wrongdoing answer to the CCP first, not to the law of the land, precisely because "the Party sits outside, and above the law."¹²¹

The rule of man is an instrumental device of totalitarianism. In effect, the sovereign leader creates the law, officials are the followers of the law, and the citizens its subjects. In such systems, the state uses the legal system to suppress threats to, and reward support for, its authority. Constitutional issues are discretionary, criminal law is arbitrary, and opportunism taints commercial and civil matters. The law is an apparatus of the state. Rather than deficient, justice is absent.

The Rule of Law The **rule of law** holds that no one, whether a public official or private citizen, is above the law. Thomas Jefferson, for instance, wrote in the Declaration of Independence that "all men are created equal" to hold forth that everyone, from kings to peasants, is subject to the same laws.¹²² More symbolically, in front of courthouses worldwide stands a statue of a woman, carrying a sword and measuring balances, sometimes wearing a blindfold, sometimes with eyes closed. Her sword stands for the power of the court, her scales for the competing claims of the petitioners, and her blindfold signifies that justice is meted out objectively, without fear or favor, regardless of identity, power, or weakness. Justice is blind so that justice is impartial.

The rule of law holds that governmental authority is legitimately exercised in accordance with written, publicly disclosed laws. In such a system, citizens regard constitutional principles as legitimate, criminal codes as fair, and commercial/civil matters as just. Operationally, laws are clear, publicized, and protective of fundamental rights; they are developed, administered, and enforced transparently; all citizens have access to a competent, independent, and ethical judiciary; and all officials are accountable to the law of the land.¹²³ Rather than absent, justice is omnipresent.

Absent the rule of law, democracy struggles.¹²⁴ Operationally, it constrains state power and safeguards lives, liberty, and property. Instituting objective legal standards creates stability that encourages investment and growth. Finally, the rule of law defines the core of a just society and fortifies liberty. Protecting people from abusive and arbitrary government is vital, given that, as John Locke warned some three centuries ago, “Wherever law ends, tyranny begins.”

IMPLICATIONS FOR MANAGERS

Originating in the Magna Carta of 1215, the concept of the rule of law anchored the legal evolution of many developed economies, most notably Great Britain, the United States, France, and Germany. Besides instituting a just political environment, the rule of law guarantees the enforceability of commercial contracts and business transactions while safeguarding property rights. Investors and companies rely on it to validate laws, codes, and statutes.

For example, in the West, property rights—namely, the exclusive authority to determine how one’s property is used—are so taken for granted that they rarely cross our minds. We cannot say the same for many countries in Asia, Africa, the Middle East, and South America. There, the historic centrality of the rule of man makes the principles and practices of the rule of law odd abstractions. It has, at best, a negligible legacy in the legal traditions of many long-developing, now-emerging countries. As a result, property rights in countries like China, Venezuela, Saudi Arabia, Russia, and Vietnam are so arbitrarily protected that they are an enduring concern.¹²⁵ The rule of thumb for MNEs is straightforward: In countries where the rule of man is the basis of law, acceptable marketplace behavior is unpredictable. Managers stay alert to trumped-up charges, solicitation of bribes, and favoritism of local rivals.

Map 3.4 indicates that the rule of law prevails in wealthier, westernized countries—i.e., the United States, Canada, Japan, New Zealand, Australia, and most of Europe.¹²⁶ In contrast, the countries that fall in the long crescent that starts in northern Russia, cuts southward through China, circles down to South East Asia, moves on toward the Middle East, and extends through Africa over to South America show the far greater pervasiveness of the rule of man. Conclusion? The rule of man anchors the legal systems of many of today’s emerging countries. Managers, eyeing these fast-growing markets, realize that where there is no formal law officially in place, society typically defaults to the rule of man.

THE CONFOUND OF DEMOCRACY’S RETREAT

The tendency toward totalitarianism in many developing countries complicates legal circumstances. Again, look at Map 3.4. Every country that Freedom House rates as “Partly Free” or “Not Free” lies along the “rule of man crescent.” The same goes for countries rated as Hybrid or Authoritarian states by the EIU. Uncertainty about the basis of law and the goals of government in much of the world creates a disconcerting situation for managers. Operating in Western economies grants them the benefit of a consistent application of legitimate laws. Few developing countries offer such safeguards.

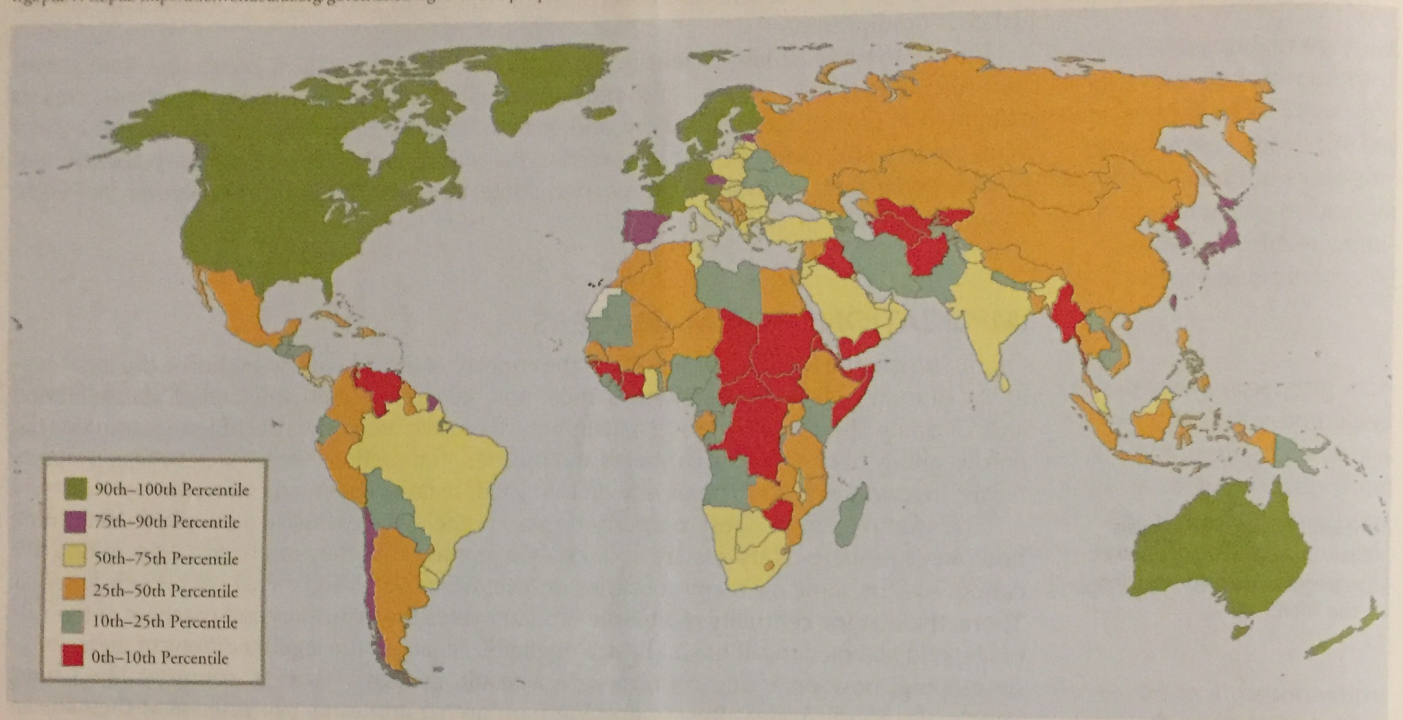
In Germany, for example, action taken by foreign firms against local companies that counterfeit their products consistently proves decisive. Violators are restrained and punished. In Belarus or Kazakhstan, however, the same sorts of legal actions typically prove pointless. There, as in other rule-of-man systems, writs, injunctions, and lawsuits are trapped in a slow-grinding legal machine that answers to the leader, not to legitimate legal standards.¹²⁷

Uncertainty about the basis of law in a particular country complicates decision making in the MNE.

MAP 3.4 The Worldwide Practice of the Rule of Law

The *rule of law* holds that government authority is legitimate only when it is exercised according to written laws and established enforcement procedures. The coding of this map is based on the degree a country does so. Therefore, for example, the United States at the 90th percentile indicates the pervasiveness of the rule of law. Conversely, Venezuela's classification below the 10th percentile indicates the pervasiveness of the rule of man.

Source: Based on World Bank, *Governance Matters VI: Governance Indicators for 1996–2011*, retrieved April 15, 2013 from <http://info.worldbank.org/governance/wgi/worldmap.asp> See also Kaufmann D., A. Kraay, and M. Mastruzzi (2010), *The Worldwide Governance Indicators: Methodology and Analytical Issues*, retrieved April 15, 2013 from <http://info.worldbank.org/governance/wgi/pdf/WGI.pdf> <http://info.worldbank.org/governance/wgi/worldmap.asp>



Violators in the good graces of the “man,” whether Alexander Lukashenko of Belarus or Nursultan Nazarbayev of Kazakhstan, flourish.¹²⁸

Certainly, a prudent MNE could opt to avoid such markets. In fact, this strategy had long been the case. Until 2000 or so, the question of the basis of law in developing countries was largely inconsequential. Markets in the West provided a wealth of opportunities for productive, profitable activity. Developing markets were on the periphery of the global economy, serving mainly as sources of raw materials. The occasional dispute between the adventurous Western company and the locals was typically resolved in the favor of the former. Now, slowing growth in the West, aggravated by the aftermath of the financial crisis, moves the fast-growing emerging economies to the center of the global market. Their supply of inexpensive, productive resources along with accelerating local demand is a siren call few MNEs can resist. As GE’s CEO reasoned, “We’ve globalized around markets... Today we go to Brazil, we go to China, we go to India because that’s where the customers are.”¹²⁹ Going forward, the McKinsey Global Institute reports that 400 midsize emerging-market cities—many unfamiliar in the West—such as Sanaa, Ibadan, Ouagadougou, Chittagong, Kinshasa, and Bamako, will generate nearly 40 percent of global growth over the next 15 years. As a result, and as suggested in our opening profile of China, MNEs long accustomed to the rule of law increasingly operate in markets anchored in the rule of man.

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WHICH RULE WHEN?

Some hypothesize that developing countries, especially fast-growing emerging economies like China, Argentina, Russia, Nigeria, Peru, Saudi Arabia, Thailand, and Malaysia, will follow the precedent of developed countries and eventually accept the legitimacy of the rule of law.



Lady Justice, here seen at Römer Square in Frankfurt, Germany, is an allegorical personification of the moral force of the rule of law.

Source: clickable/Fotolia

As Western countries moved from agrarian to industrial economies, their societies increasingly saw the need to sanction and protect property rights. Ongoing economic development, in turn, required a legal system that no longer appealed to the “man” in power but to the written law for guidance and resolution. Therefore, extrapolating from Western history, some presume that the shift from agrarianism to industrialism in developing countries will accelerate their adoption of the rule of law. The Third Wave of Democracy, with ideological change anchored in the Washington Consensus, bolstered this scenario.

CONCEPT CHECK

Chapter 1 suggests that democratic political systems grant MNEs the freedom to engage in their preferred modes of international business. Note, however, that democracy’s retreat creates uncertainty about operating in particular countries. Nations use their legal systems to encourage, regulate, or prohibit certain modes.

Recent circumstances, however, complicate the projected progression. Democracy’s retreat has slowed, if not reversed, progress precisely because the rule of law is antithetical to totalitarianism—one cannot be the “man” if one must answer to the law. More practically, China’s economic performance tests the thesis that a positive relationship exists between the rule of law, economic growth, and prosperity.¹³⁰ China’s status as the world’s largest recipient of foreign investment over the past few decades, notwithstanding corruption within a system of crony capitalism administered by the absolute authority of the CCP, questions the necessity of the rule of law. Similar situations in Russia, Venezuela, Saudi Arabia, and Turkmenistan, among others, require foreign investors to qualify their forecasts. Now, the more plausible scenario is one in which emerging economies will arguably migrate from one basis of rule to another—that is, from rule of man to “rule by law” and its implicit notion that even the ruler is subject to the law. Growing cries from expanding middle class for stronger property rights, by improving the accountability of public officials, will then lay the foundation for society to accept the legitimacy of the rule of law.

Then again, in order to advise folks in emerging economies, one must qualify this interpretation in light of national legacies. The forecast of the rule of law as the inevitable end-state presumes that the particular legal philosophies of the West apply to countries throughout the world. Instead, some argue that the “West does not know best,” reasoning that the

The growing confidence of emerging economies increasingly questions the long-running presumption that “the West knows best.”

efficiency and stability of a progressive, autocratic ruler are often more important than the liberty and freedom of a messy democracy. Said one Western analyst, “One-party autocracy certainly has its drawbacks. But when it is led by a reasonably enlightened group of people, as China is today, it can also have great advantages.”¹³¹ Indeed, throughout its storied 5000-year history, Chinese civilization has never practiced democratic governance based on the rule of law. Instead, while dynasties periodically changed, each adopted authoritarian governance that imposed the rule of man. Consequently, managers watch and learn as changing economic environments, which we profile more precisely in Chapter 4, influence the basis of law.

LEGAL ISSUES IN INTERNATIONAL BUSINESS

Differences in political ideologies often pose operating problems. The fact that countries use diverse legal principles to regulate the business environment aggravates this situation. Moreover, new forms of business activity along with changing patterns of trade and investment put MNEs in uncertain legal situations. In the following, we profile legal aspects of day-to-day decision-making in the MNE.

OPERATIONAL CONCERNS

Operational concerns that managers face worldwide include

- Starting a business.
- Entering and enforcing contracts.
- Hiring and firing workers.
- Closing a business.

MNEs obey local laws on starting, running, and closing a business. Activities such as hiring workers, obtaining credit, protecting investors, paying taxes, trading across borders, and enforcing contracts must comply with applicable laws. In theory, business regulations are efficiently designed, easily accessible, and straightforwardly administered. Moreover, simple, well-designed work rules discourage corruption by removing the incentive to bribe regulators. The World Bank, along with the World Economic Forum, concludes that better business conditions consistently boost economic growth, job creation, and trade.

Despite these virtues, big companies and individuals often experience the opposite. Wal-Mart has run into a firestorm of controversy over its bribery practices in Mexico. In defense, Wal-Mart held that the convoluted, often contradictory Mexican legal code pushed it to protect its competitiveness with well-placed bribes.¹³² Similarly, at the micro level, a Brazilian entrepreneur recalled his experience in starting up his first company in his home country, where obtaining authorizations, licenses, and permits to start a new business—from seven different ministries—took about 150 days. When he started a U.S.-based business, however, “within a week I had formed an LLC (limited liability corporation), incorporated in Delaware, and set up bank accounts.”¹³³

The globalization of markets progressively standardizes legal systems. Attracting foreign investors requires positive reputations and records. Memberships in international organizations accelerate this trend. The European Union requires all member countries to satisfy standards for the rule of law; the World Bank requires borrowers to agree to legal reforms; the WTO imposes a raft of legal obligations. Despite this convergence, enduring variability differentiates how countries regulate basic business operations. The World Bank evaluates several features of the business environment, studying how the role of regulation influences economic performance. Table 3.3 provides a cross-country snapshot of some of the variation involved in starting, running, and closing a business.

Getting Started Starting a business involves activities such as registering a name, choosing the appropriate tax structure, obtaining licenses and permits, arranging credit, and securing insurance. Some countries expedite this process; others do not. For example, start-up is a straightforward process in Australia, requiring one registration procedure that encompasses tax, labor, and administrative declarations. Conversely, India imposes 13 procedural requirements, including regulations for bank deposits, court registration, health benefits, and so on. The upshot: it takes about two days to start a business in Australia but about 30 days in India.

CONCEPT CHECK

A theme of the text is the linkages among individuals, companies, countries, and institutions. Here, we emphasize the importance of relationships between ideas and ideals, namely the interplay among a country's type of political system, its organizing legal philosophy, and its prevailing doctrine of law. Making these connections helps managers assess the systemic nature of the country's business environment.

TABLE 3.3 The Rules of the Game

The World Bank tracks micro-level characteristics of the regulatory frameworks in 185 economies. Comparative information on the rules of the game encourages officials to streamline their legal systems, thereby improving the efficiency of national business environments. Here we highlight data for a subsample of countries in terms of opening, running, and closing a business.

Economy	Starting a Business			Enforcing Contracts			Closing a Business		
	Number of Procedures ¹	Time (Days)	Cost (% of income per capita)	Number of Procedures ²	Time ³ (Days)	Cost* (% of Claim)	Recovery rate (C on the \$)	Time (Years)	Cost ⁵ (% of Estate)
Australia	2	2	0.7	28	395	21.8	80.8	1	8
Brazil	13	119	5.4	45	731	16.5	17.1	4	12
Canada	1	5	0.4	36	570	22.3	90.7	.8	4
Chad	11	55	175.5	41	743	45.7	0	4	6
China	14	38	3.6	37	406	11.1	36.1	1.7	22
France	5	7	0.9	29	390	17.4	45.0	1.9	9
Germany	9	15	6	30	394	14.4	82.7	1.2	8
Guatemala	12	37	52.5	31	1459	26.5	27.5	3	15
India	12	29	46.8	46	1420	39.6	27.6	4.3	9
Japan	8	23	7.5	30	360	32.2	92.7	.6	4
Korea, Rep.	8	14	7.5	35	230	10.3	82.3	1.5	4
Russian	8	29	2.3	36	281	13.4	41.5	2	9
United States	6	6	1.4	32	300	14.4	81.5	1.5	7
United Kingdom	6	13	0.7	28	399	24.8	88.5	1	6

Source: Compiled from "Doing Business 2012," The World Bank.

Notes

¹ Number of procedures to complete before starting a business.

² Number of procedures that require interaction between the parties to the dispute or between them and the judge or court officer.

³ Average number of days from when the plaintiff files the lawsuit in court until settlement.

⁴ Average cost incurred during dispute resolution, including court fees and attorney fees.

⁵ Average cost of bankruptcy process, including court costs, insolvency practitioners' costs, and associated expenses.

At least one can take comfort in avoiding the same in Suriname—starting up there involves 13 procedures spanning 694 days.

For the sake of clarity, we restrict our discussion primarily to first-order effects of day-to-day operations for a small to medium-size enterprise. Keep in mind that activities, such as a business start-up, can be quite complicated for large MNEs. For instance, when entering India, multi-brand foreign chains, such as Wal-Mart, Carrefour, IKEA, and Tesco, face a battery of regulations. Notably, they must operate as joint ventures, have no higher than a 51 percent ownership share, direct at least half of their capital investments into processing infrastructure, and open outlets only in cities that have at least 1 million residents.¹³⁴

Making and Enforcing Contracts Once up and running, companies enter and enforce contracts with buyers and sellers.¹³⁵ The sanctity of a contract is vital to business transactions. The United Nations Convention on Contracts for the International Sale of Goods sets guidelines for negotiating and enforcing contracts. Still, standards vary across different legal systems. Countries using a common law system, for instance, encourage precise, detailed contracts, whereas those with a civil law system encourage less specific agreements.

Similar tendencies show up in contract-enforcement policies. Australia, Norway, and the United Kingdom impose the fewest number of enforcement procedures. Burundi, Angola, Bolivia, Cameroon, El Salvador, Mexico, and Panama require many procedures. Singapore needs 150 days to enforce a contract, the United States about 300 days, and Timor-Leste some 1,800 days. On average, across 185 countries, a firm is looking at 615 days to settle a contract dispute.

Hiring and Firing No matter where you are operating, you will have to hire and, when necessary, fire workers. One would think that common sense would guide legally appropriate

decisions. Legal standards around the world, however, are rarely straightforward. Moreover, local laws cover virtually every aspect of employment—how workers are hired, what they are paid, how many hours they can work, and whether they can be fired.

Singapore, New Zealand, and the United States are among the countries with the most flexible labor-regulation statutes. China provides the most flexibility in hiring and firing and the greatest discretion in setting employment conditions (work hours, minimum wages, and benefits). In contrast, Angola, Belarus, and Paraguay restrict firing employees and impose generous severance payments.

Slow-moving bureaucracies often complicate business regulation. Mexico last overhauled its labor law in the 1970s; hence, sacking a worker after a year of employment costs three times as much as in Chile, and eight times more than in Brazil. Mexico's higher severance costs further constrain firms' flexibility.¹³⁶ Regarding bureaucracy, India's national government imposes 55 labor laws while its various states add another 150 or so. Its Industrial Disputes Act, for example, requires any company employing 100 or more workers to obtain state permission before firing anyone, even if it has hit hard times.¹³⁷

Getting Out or Going Under Closing a business involves more than padlocking the doors. In the United States, for example, the Internal Revenue Service requires reporting the sale of assets, payments to subcontractors, and termination of retirement plans. In the West, the bankruptcy process is anchored in the English bankruptcy law of 1732, the first modern law to address this issue, and its progressive revision, beginning in 1800, by the United States.

Ireland, Japan, Canada, and Hong Kong make closing the doors both fast (between four to eight months) and cheap (between 1 and 10 percent of the estate). The situation differs in developing countries. India's lack of a comprehensive bankruptcy code complicates dealing with creditors, officials, and courts, which in turn discourages bankruptcy. Consequently, only four of every 10,000 firms go bankrupt in India, compared with 350 per 10,000 firms in the United States.¹³⁸ Bankruptcy in Indonesia, Vietnam, and Ecuador is slow (between five to eight years) and expensive (between 10 and 30 percent of the estate). Several countries, including Burundi, Sudan, Cambodia, Afghanistan, Guinea-Bissau, and Dominica, stipulate no standards to govern dissolution.

CONCEPT CHECK

Chapters 1 and 2 note that income and wealth influence the actions that countries, both rich and poor, take to develop their business environments. Correspondingly, these factors also influence countries' approach to regulating MNEs local operations.

Richer countries typically regulate business activities less. Poorer countries typically regulate more.

A KEY RELATIONSHIP: WEALTH AND REGULATION

Data indicate an inverse relationship between a nation's general wealth and its regulation of business activity. In a nutshell, richer countries regulate less and poorer countries regulate more. In high-income countries (e.g., the United States, France, Japan), starting a business requires an average of 6.28 procedures, spans 18 days, and costs 7 percent of per capita income. Doing the same in middle-income countries (e.g., Mexico, Poland, Malaysia, China, India, South Africa), requires an average of 7.8 procedures, spans 36 days, and costs 28 percent of per capita income. Lastly, in low-income countries (e.g., Bangladesh, Ethiopia, Nepal), one is facing 7.5 procedures, a 90-day span, and 37 percent of per capita income. Furthermore, legal systems in wealthier nations tend to regulate operational activities more consistently than do those in poorer countries—as one would expect, given the prevalence of the rule of law in the former and the rule of man in the latter.¹³⁹

Table 3.4 identifies the top-ranked and bottom-ranked countries whose legal policies enact the most or least supportive business environments. In terms of the former, Singapore has developed a comprehensive legal code that fosters the most favorable business environment in the world. Conversely, the Central African Republic's legal shortcomings create the world's least favorable business environment. These rankings confirm an important relationship: most of the top-ranked countries in Table 3.4 have a democratic political system and a common or civil law legal system anchored in the rule of law. In contrast, most of the bottom-ranked countries exhibit authoritarian politics and a mixed legal system anchored in the rule of man.

TABLE 3.4 Easy Here, Hard There: Doing Business in Various Countries

The World Bank ranks 185 countries on their respective ease of doing business—the higher the score, the more favorable the business environment. Technically, the ease of business index averages the country's percentile rankings on ten dimensions: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, paying taxes, trading across borders, and enforcing contracts. Here we see the best and worst performers.

Country	Ranking	Country	Ranking
Singapore	1	Niger	176
Hong Kong SAR, China	2	Côte d'Ivoire	177
New Zealand	3	Guinea	178
United States	4	Guinea-Bissau	179
Denmark	5	Venezuela	180
Norway	6	Congo, Dem. Rep.	181
United Kingdom	7	Eritrea	182
South Korea	8	Congo, Republic	183
Georgia	9	Chad	184
Australia	10	Central African Republic	185

Source: Doing Business 2013, The World Bank, Retrieved August 15, 2013.

STRATEGIC CONCERNS

Strategic concerns that managers face worldwide include

- Product origin and local content.
- Marketplace behavior.
- Legal jurisdiction.
- Product safety and liability.
- Intellectual property protection.

Routine concerns focus managers' attention on the day-to-day operations of opening, running, and closing a business. Strategic concerns direct their attention to long-term issues that shape the competitiveness, profitability, and sustainability of the firm. A country's legal environment influences each aspect, shaping an MNE's strategic decisions on making a product, marketing it, and safeguarding its proprietary features. Let's inspect some key concerns.

COUNTRY CHARACTERISTICS

National laws affect the flow of products across borders. To determine charges for the right to import a product, host governments devise laws that consider the product's **country of origin**—the country where it was grown, produced, or manufactured. Some countries apply this policy to product labels, under the title COOL (country-of-origin labeling), to inform consumers and support local producers. National security concerns also shape country-of-origin regulations. Suspicion about the espionage capabilities of their communication products dog Huawei and ZTE. Both China-headquartered companies are marked by opaque governance and tight linkages with the Communist Party of China. National security concerns have led Australia, Canada, and US authorities to exclude their network equipment products from public contracts.¹⁴⁰

Politicians also enact regulations to protect jobs, appease voters, placate special interests, and preserve tax revenue. Not surprisingly, host governments prefer that MNEs make the greatest possible portion of their product(s) locally. Besides boosting local enterprise, technology transfers and knowledge spillovers support domestic innovation. To spur reluctant companies, governments enforce **local content** regulations. Brazil, for instance, levies a 30 percent tax increase on imported cars with less than 65 percent local content.¹⁴¹ Likewise, Brazil requires foreign energy firms to spend 1 percent of gross revenue on local R&D.

CONCEPT CHECK

Recall from Chapter 2 that culture influences attitudes toward the development and ownership of ideas. Certain attitudes, particularly those toward workplace motivation and relationships, influence entrepreneurial behavior in a country. Likewise, attitudes toward collective and individual priorities shape a nation's competitive environment.

PRODUCT SAFETY AND LIABILITY

Countries regularly impose product-safety and liability laws that require an MNE to adapt a product or else forsake market access. As a rule, wealthier countries impose stringent standards, whereas poorer countries, reflecting developing legal codes and rule-of-man legacies, apply inconsistent ones. The European Union's product-liability directive shapes global standards.¹⁴² It outlines the legal responsibility of manufacturers and stipulates the process of product-liability compensation claims. Then again, some MNEs proactively preempt the risk. The Danish toy maker Lego, for instance, noted consumers' fear of the possible toxicity of plastic toys made in China and did not open a factory there. Instead, Lego opted for factories in comparatively more expensive but less worrisome Mexico and Eastern Europe.¹⁴³

LEGAL JURISDICTION

Countries stipulate the criteria for litigation when agents—whether legal residents of the same or of different countries—are unable to resolve a dispute. Usually, in the face of a cross-national dispute, each company petitions its home-country court to claim jurisdiction in the belief that it will likely receive more favorable treatment. This situation is especially pressing when a MNE from a rule-of-law system has legal difficulties in a rule-of-man environment. Worry about legal proceedings in certain legal systems leads MNEs to specify a **choice-of-law clause** in contracts that stipulates whose laws, if necessary, govern dispute resolution. Importantly, it obliges both parties to negotiate a compromise in the event the law changes. Without binding arbitration agreements, companies and consumers travel in legal limbo. Unless the foreign company has local operations, determining legal jurisdiction does not hold it accountable to a nation's legal system.

INTELLECTUAL PROPERTY

In Adam Smith's time, countries drew strength from their agricultural prowess. Later, smokestack industries defined a nation's prosperity and power. Now countries look to their brainpower to create might, prestige, and wealth. We call the output of this brainpower **intellectual property (IP)**—the creative ideas, innovative expertise, or intangible insights that create a competitive advantage for an individual, company, or country. The growing power of ideas in the global economy has made the protection of intellectual property a flashpoint of controversy.

Mainstream thought holds that the right to claim ownership of intellectual property stimulates innovation. Transnational institutions—notably, the World Intellectual Property Organization (WIPO), along with governments and industry associations—push for stronger protection. The primary safeguard is an **intellectual property right (IPR)** that grants the registered owners of inventions, literary and artistic works, and symbols, names, images, or designs the right to determine the use of their property. In other words, an IPR grants the registered owner of a copyright the legal authority to decide who may use the property and under what circumstances. Essentially, an IPR constitutes a legally enforceable but limited monopoly granted by a country to the innovator. It specifies a period during which other parties may not copy an idea so that the innovator can commercialize it. MNEs invest great effort to safeguard intellectual property, relying on tools like patents, trademark registrations, and copyrights.

The pervasiveness of piracy worldwide testifies to the difficulty of enforcing IPRs. Our closing case, "It's a Knockoff World," profiles these problems. Weak enforcement in some countries, particularly those marked by a rule of man bias and authoritarian politics, impose obstacles. Other problems arise because not all countries support the various agreements that

Product safety regulations set by the European Union shape standards worldwide.

The addition of a choice-of-law clause to contracts between different parties in different countries is an effective legal safeguard.

Intellectual property is the general term for creative ideas, expertise, or intangible insights that grant its owner a competitive advantage.

Intellectual property rights refer to the right to control and derive the benefits from writing (copyright), inventions (patents), processes (trade secrets), and identifiers (trademarks).

The predominant share of counterfeit products is made in countries in which the rule of man prevails.

protect IPRs—primarily, the Paris Convention for the Protection of Industrial Property and the Berne Convention for the Protection of Literary and Artistic Works, both created in the 1880s and updated periodically. The WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) broadens protection while, more recently, the EU is moving toward a "unitary patent" recognized automatically in all member countries.

Matters of jurisdiction complicate protection. A U.S. patent, for example, establishes IPR only in the United States and its territories and possessions; it does not extend to foreign markets. Further, there's no shortcut to worldwide protection; companies cannot register a "global" patent, trademark, or copyright. Although an IPR sounds secure, enforcing it often proves difficult. For example, in the United States, companies can go after the makers and sellers, not users, of counterfeit goods.¹⁴⁴ Worldwide, governments claim to abide by these agreements and enforce IPRs. However, piracy increasingly threatens popular or pricey products.

THE BASIS OF POLITICAL AND LEGAL DIFFERENCES

A key theme of this chapter is that inalienable differences exist between countries regarding political practice and legal regulation. Students new to the study of international business often find it helpful to understand the historical, economic, and cognitive basis for these differences. As we just saw, IP is a critical component of the development of any economy, no matter how rich or poor. Whereas some countries steadfastly affirm strong protection, others are less inclined. Still others turn a blind eye, informally sanctioning piracy. Making sense of the differences in attitudes and outlooks, as would be the case for other political or legal issues, follows from making sense of the effects of *historical legacies*, *economic conditions*, and *cultural orientations*.

HISTORICAL LEGACIES

Most counterfeit goods are made in markets in which the rule of man is the *de facto* legal system. A return trip to China, given its legal tradition, its influence, and its sluggishness in protecting IP, highlights the scope of the problem. Officially, China has a battery of laws that comply with international standards for market access, nondiscrimination, and transparency. However, many Chinese citizens and officials question the legitimacy of laws passed by foreign governments. Hence, foreign-made laws are inconsistently enforced in the local marketplace. This gap between domestic traditions and foreign standards, explained a Chinese jurist, means that its IP laws "exist to protect Chinese IP from foreign IP."¹⁴⁵ This situation is not unique to China. The Asian Development Bank evaluated the performance of Indonesia, Malaysia, the Philippines, South Korea, and Thailand relative to the rest of the world on measures of good governance: accountability, political stability, government effectiveness, regulatory quality, control of corruption, and rule of law. Over the past decade, their performance has deteriorated on nearly every dimension.¹⁴⁶

Calls for China (as well as Vietnam, Russia, Chad, India, Malaysia, to name just a few of the many with similar records) to protect IP in the context of the rule of law may eventually prove successful. Still, few anticipate quick progress. Advised a partner of Jones Day Shanghai, the "trend in China is toward more transparency, but it's likely to be a 20-year process.... even then, it will be far from the standards in the United States."¹⁴⁷ For China, the legal legacy of two millennia of the rule of man—or, in its current form, the rule of the CCP—suggests that such a change may be "one of the largest social infrastructure projects in the history of mankind."¹⁴⁸

CRN
Case Review Note

Countries that observe the rule of law, as opposed to the rule of man, more aggressively protect intellectual property rights.

ECONOMIC CIRCUMSTANCES

The vigor of IP protection often reflects a country's stage of economic development. Just as poorer countries regulate less rigorously than richer countries, so too do they more weakly protect IP.¹⁴⁹ In the case of developed countries, folks reason that protecting IP is the best way to energize innovation. "If the stuff you create can be misappropriated," noted an analyst, "your incentive for continuing to create valuable IP diminishes significantly."¹⁵⁰ Strong protection has created extensive IP in the West. Individuals and companies from developed countries control virtually all IP rights: Presently, they hold nearly 95 percent of all patents worldwide. In addition, 80 percent of patents granted in developing countries belong to residents of wealthy countries.¹⁵¹

The evolving world economy, especially the market moves powered by emerging economies, alters transnational institutional structures and legal outlooks.¹⁵² Popular perspectives in developing countries advocate less-stringent protection, arguing that IP rights are better interpreted as predatory, monopoly privileges that impose costs by:

- stifling the creativity, innovation, and emulation that support technological and cultural advance.
- inhibiting local development and lowering global welfare by constraining the use of existing knowledge.
- creating intellectual monopolies that protect business interests, bestow monopoly profits, and lessen the efficiency gains of free trade.
- inflating the prices that poor nations pay for products and processes that are available only from wealthy nations.
- stipulating licensing fees and regulatory burdens that increase the cost of idea creation and slow the diffusion of innovations.

In sum, goes this reasoning, property rights are a state-created privilege that impoverishes the majority in order to concentrate wealth and power among the privileged.¹⁵³ For example, in practical terms, critics in poor countries charge their rich counterparts with promoting strong IP protection to camouflage their intent to dismantle their generic drug industries.

This debate will twist and turn for many years. In the meantime, hard economics is likely the key determinant of a country's protection of IPRs. Poor people have little money to spend on necessities, let alone for expensive branded goods sold by foreign companies. In Kenya, where the average annual income is about \$1,800, it should not come as a surprise that many Kenyans "think you have to cheat to survive."¹⁵⁴ One means of survival is buying pirated copies of products that improve productivity (i.e., software), fight illness (medicines), or provide relief (consumer products).

CULTURAL ORIENTATION

Different attitudes toward IP protection reflect cultural orientations. Individualist countries such as the United States and Australia regard personal property rights as intrinsically legitimate: if you create something, you should have the right to say who can use it or copy it for any given purpose. In contrast, collectivist countries such as South Korea, Thailand, and China extol the virtue of sharing over individual ownership: if you create something, it should improve the welfare of society. Asked about piracy in his country, for example, a South Korean diplomat explained, "Historically, Koreans have not viewed intellectual discoveries or scientific inventions as the private property of the discoverers or inventors. New ideas or technologies [are] 'public goods' for everybody to share freely. Cultural esteem rather than material gain [is] the incentive for creativity."¹⁵⁵

Similarly, countries often interpret and enforce intellectual protection differently. For example, 2013 saw India's Supreme Court reaffirm Indian drug makers' right to apply a

Generally, poorer countries protect intellectual property less vigilantly than do wealthier countries.

Critics of intellectual property protection argue that granting monopoly rights imposes hardships, creates inefficiencies, and slows innovation.

process that differed from that recorded by the registered owner to produce and sell drugs patented in other countries; in other words, Indian patent law protects only the “processes” by which drugs are made, not the drugs themselves.¹⁵⁶ Hence, Indian drug companies make copycat versions of many of the world’s best medicines and sell them for far less. For example, leukemia treatment Gleevec, developed by Switzerland-based Novartis, costs patients up to \$70,000 per year; the Indian generic versions run about \$2,500 annually. Not surprisingly, India is the world’s leading exporter of generic medicine. It, along with China, makes more than 80 percent of the active ingredients of all drugs used in the United States.¹⁵⁷

Today, technologies challenge the influence of individualism and collectivism in the use and abuse of IP. Among some demographics, whether in collectivist China or individualist United States, piracy is an increasingly mainstream behavior. On one hand, hard economics spurs theft; more poor people seek affordable options, equality notwithstanding. Alternatively, the prevalence of piracy among teenagers and young adults in rich and poor countries alike reflects evolving attitudes and technological opportunism. Said the general counsel for NBC Universal, speaking of illegal file downloading, “Young people, in particular, conclude that if it’s so easy, it can’t be wrong.”¹⁵⁸ Improving technologies, by making piracy cheaper and easier, accelerate the violation of IP rights.

Cultural attitudes influence the protection of intellectual property rights. Individualist societies are more vigilant than collectivist societies.

THE POTENTIAL FOR CROSS-NATIONAL CONVERGENCE

Convincing countries to protect IP confronts a potent mix of legal legacies, economic conditions, and cultural orientations. Institutional initiatives try to expedite stronger enforcement. The WTO, for example, gives wealthy countries a year to comply with its latest rules on IP but grants poorer countries five- to 10-year grace periods. Longer grace periods, the thinking goes, acknowledges economic realities while building awareness of the benefits of protecting IP. Rising piracy rates suggest these programs struggle to make a difference.

Ironically, calls for stronger protection hinge on the future success of companies in currently lax countries. History shows that countries that create IP—no matter their legal legacy, economic status, or cultural orientation—ultimately enforce property rights.¹⁵⁹ As countries evolve from idea consumers to idea creators, they invent products based on their own IP. At some point, countries cross the threshold where the benefits of protection exceed the gains from piracy. Observers note that the United States, today a staunch defender of IPRs, copied other countries’ intellectual property when it was a developing country in the eighteenth century. Said one analyst, “American political independence was founded on the notion of economic self-sufficiency. And technology piracy became the premier tool to industrial development.”¹⁶⁰ Inventing its own IP eventually led the United States to endorse the Paris and Berne Conventions, both of which originated in the 1880s. From then on, the U.S. has steadfastly advocated strong IP rights.

Trends in China signal the start of this process. Long the factory floor of the world, China aims to be the new product lab. Presently, its patent office leads the world in patent applications; of the 2.14 million patent applications filed worldwide in 2011, 526,000 were filed in China, followed by the U.S. with 504,000, Japan with 343,000, and South Korea at 179,000. Although many Chinese patents file minor modifications, a growing share registers significant “invention” patents that grant the holder 20 years of protection (the same as in the West). Going forward, the Chinese government has a goal of 2 million domestic patent applications annually by 2015, with the aim of being one of the top two patent-owning countries by 2020.¹⁶¹ Already, we see Chinese firms such as Huawei and ZTE battling each other over patent violations. Tension will likely escalate as Chinese firms, intent on protecting their expanding IP, demand the legal system police pirates. Right now, the signals from Chinese officials and companies are confusing—increasing piracy yet increasing patent activity.¹⁶² The resolution of this conundrum—will China stay a pirate’s paradise or become a property protector?—will shape IP practices throughout the world.¹⁶³

Countries that generate intellectual property are strong advocates of ownership rights.