Transformation in Saudi Arabia

opening case

The desert kingdom of Saudi Arabia is a rarity in the modern world, an absolute monarchy whose laws are based upon interpretations of a religious text, the Qur'an, the holy book of Islam. Despite its adherence to an archaic form of government, the Saudi economy has historically performed well, primarily due to the country's position as the world's largest oil exporter. In 2017, the country's GDP per capita on a purchasing power parity basis was $55,300, not far behind the $59,500 GDP per capita of the United States.

The oil sector accounts for around 87 percent of government revenues, 42 percent of GDP, and 90 percent of export earnings. In times of high oil prices, the Saudi government has used oil revenues to finance a sprawling government apparatus and to subsidize energy prices, which are among the lowest in the world. In 2014, however, oil prices collapsed, wiping out an annual government surplus. In 2015, the government deficit ballooned to 15 percent of GDP, and it hit 20 percent of GDP in 2016, forcing the country to issue more debt and draw down its foreign exchange reserves.

To compound matters, Saudi Arabia has a young population—some 70 percent of the population is under the age of 30—and unemployment is high at 12 percent, a combination of factors that many see as a recipe for social unrest. The high unemployment reflects the fact that while there are jobs available outside of the government sector, most of them are taken by low-paid foreign workers, who account for 80 percent of the labor force.

Following the death of his brother, in January 2015 Salman bin Abd al-Aziz Al Saud became King. Breaking with tradition, the aging King quickly devolved substantial power to his son, crown prince Muhammad bin Salman (commonly known as "MBS"). The young crown prince articulated a different vision for Saudi Arabia. Known as Vision 2030, this calls for reducing the kingdom's dependence on oil revenues, privatizing the state-owned oil company Saudi Aramco, cutting energy and water subsidies, growing the private sector, investing $500 billion in a new city called NEOM that will serve as a hub for private and foreign investment, and introducing a value-added tax in order to close the government deficit. At the same time, the crown prince is seeking to loosen the stifling moral codes that have limited cultural life and to promote a "moderate Islam open to the world and all religions."

Not surprisingly, this vision has met with resistance, particularly from members of the sprawling royal family and conservative clergy who have benefited from the status quo. To counter this, the crown prince consolidated his power, removing members of the royal family that disagreed with him and putting his allies in positions of power. This culminated in an unprecedented shake-up in November 2017 when scores of people, including some of the most powerful princes in the kingdom, were arrested in a massive anticorruption sweep and jailed in, of all places, Riyadh's opulent Ritz Carlton.

continued

Whether this power grab will help the crown prince achieve his goals for Saudi Arabia remains to be seen. The government has had to backtrack on plans to reduce subsidies after strong resistance from the population, but it did introduce a 5 percent value-added tax in January 2018. Plans for the privatization of Saudi Aramco are under way, and the government budget deficit has been cut in half since 2015—although stronger oil prices have had a lot to do with that. Some of the stricter laws have also been relaxed. Women are now allowed to drive and some banned cultural entertainments once seen as decadent, including going to the cinema, may soon be allowed. In the long run though, transforming the Saudi economy will require growth in the non-oil private sector, and that is a challenging task. Moreover, the scandal surrounding the murder of journalist Jamal Khoshoggi by Saudi operatives in Turkey in October 2018 has at the very least potentially weakened the power of the crown prince and the resulting fallout may constitute a significant setback to his reform efforts. ●

Sources: Asa Fitch, "Saudi Arabia Plans Record Spending in New Budget," *The Wall Street Journal*, December 19, 2017; Brittany De Lea, "Saudi Citizens Plagued by New Taxes, High Unemployment after Oil Price Collapse," *Fox Business*, October 26, 2017; and "Saudi Arabia's Unprecedented Shake-up," *The Economist*, November 5, 2017.

Introduction

International business is much more complicated than domestic business because countries differ in many ways. Countries have different political, economic, and legal systems. They vary significantly in their level of economic development and future economic growth trajectory. Cultural practices can vary dramatically, as can the education and skill levels of the population. All these differences can and do have major implications for the practice of international business. They have a profound impact on the benefits, costs, and risks associated with doing business in different countries; the way in which operations in different countries should be managed; and the strategy international firms should pursue in different countries. The main function of this chapter and the next two is to develop an awareness of and appreciation for the significance of country differences in political systems, economic systems, legal systems, economic development, and societal culture. Another function of the three chapters is to describe how the political, economic, legal, and cultural systems of many of the world's nation-states are evolving and to draw out the implications of these changes for the practice of international business.

political economy
The political, economic, and legal systems of a country.

This chapter focuses on how the political, economic, and legal systems of countries differ. Collectively, we refer to these systems as constituting the political economy of a country. We use the term **political economy** to stress that the political, economic, and legal systems of a country are interdependent; they interact with and influence each other, and in doing so, they affect the level of economic well-being. In Chapter 3, we build on the concepts discussed here to explore in detail how differences in political, economic, and legal systems influence the economic development of a nation-state and its likely future growth trajectory. In Chapter 4, we look at differences in societal culture and at how these differences influence the practice of international business. Moreover, as we will see in Chapter 4, societal culture has an influence on the political, economic, and legal systems in a nation and thus its level of economic well-being. We also discuss how the converse may occur: how political, economic, and legal systems may also shape societal culture.

The opening case illustrates some of the issues discussed in this chapter. Saudi Arabia is an absolute monarchy where the state controls large portions of economic activity and where laws are directly informed by religious teachings taken from the Qur'an. In this regard, the country could not be more different than an advanced Western nation such as the United States. At the same time, Saudi Arabia is now actively trying to change its economic system, diversifying activity away from oil, and in doing so seeks to attract more foreign investment, creating an opportunity for international business. To be successful in the country, however, international businesses need to understand the political economy and the culture of the Saudi nation. Moreover, the kind of transformation in political economy and culture that Saudi Arabia is embarking upon is risky, and failure is possible—a fact that anyone seeking to invest in the Kingdom needs to take into account.

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Political Systems

LO 2-1 Understand how the political systems of countries differ.

political system System of government in a nation.

The political system of a country shapes its economic and legal systems.[1] Thus, we need to understand the nature of different political systems before discussing economic and legal systems. By **political system**, we mean the system of government in a nation. Political systems can be assessed according to two dimensions. The first is the degree to which they emphasize collectivism as opposed to individualism. The second is the degree to which they are democratic or totalitarian. These dimensions are interrelated; systems that emphasize collectivism tend to lean toward totalitarianism, whereas those that place a high value on individualism tend to be democratic. However, a large gray area exists in the middle. It is possible to have democratic societies that emphasize a mix of collectivism and individualism. Similarly, it is possible to have totalitarian societies that are not collectivist.

collectivism A political system that emphasizes collective goals as opposed to individual goals.

COLLECTIVISM AND INDIVIDUALISM

Collectivism refers to a political system that stresses the primacy of collective goals over individual goals.[2] When collectivism is emphasized, the needs of society as a whole are generally viewed as being more important than individual freedoms. In such circumstances, an individual's right to do something may be restricted on the grounds that it runs counter to "the good of society" or to "the common good." Advocacy of collectivism can be traced to the ancient Greek philosopher Plato (427–347 B.C.), who, in *The Republic*, argued that individual rights should be sacrificed for the good of the majority and that property should be owned in common. Plato did not equate collectivism with equality; he believed that society should be stratified into classes, with those best suited to rule (which for Plato, naturally, were philosophers and soldiers) administering society for the benefit of all. In modern times, the collectivist mantle has been picked up by socialists.

socialists Those who believe in public ownership of the means of production for the common good of society.

Socialism

Modern **socialists** trace their intellectual roots to Karl Marx (1818–1883), although socialist thought clearly predates Marx (elements of it can be traced to Plato). Marx argued that the few benefit at the expense of the many in a capitalist society where individual freedoms are not restricted. While successful capitalists accumulate considerable wealth, Marx postulated that the wages earned by the majority of workers in a capitalist society would be forced down to subsistence levels. He argued that capitalists expropriate for their own use the value created by workers, while paying workers only subsistence wages in return. According to Marx, the pay of workers does not reflect the full value of their labor. To correct this perceived wrong, Marx advocated state ownership of the basic means of production, distribution, and exchange (i.e., businesses). His logic was that if the state owned the means of production, the state could ensure that workers were fully compensated for their labor. Thus, the idea is to manage state-owned enterprise to benefit society as a whole, rather than individual capitalists.[3]

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

social democrats Those committed to achieving socialism by democratic means.

In the early twentieth century, the socialist ideology split into two broad camps. The **communists** believed that socialism could be achieved only through violent revolution and totalitarian dictatorship, whereas the **social democrats** committed themselves to achieving socialism by democratic means, turning their backs on violent revolution and dictatorship. Both versions of socialism waxed and waned during the twentieth century.

The communist version of socialism reached its high point in the late 1970s, when the majority of the world's population lived in communist states. The countries under Communist Party rule at that time included the former Soviet Union; its eastern European client nations (e.g., Poland, Czechoslovakia, Hungary); China; the southeast Asian nations of Cambodia, Laos, and Vietnam; various African nations (e.g., Angola and Mozambique); and the Latin American nations of Cuba and Nicaragua. By the mid-1990s, however, communism was in retreat worldwide. The Soviet Union had collapsed and had been replaced by a collection of 15 republics, many of which were at least nominally structured as democracies. Communism was swept out of eastern Europe by the largely bloodless revolutions of 1989. Although China is still nominally a communist state with substantial limits to individual political freedom, in the economic sphere, the country has moved sharply away from strict adherence to communist ideology. Old-style communism, with state control over all economic activity, hangs on in only a handful of small fringe states, most notably North Korea.

Social democracy also seems to have passed a high-water mark, although the ideology may prove to be more enduring than communism. Social democracy has had perhaps its greatest influence in a number of democratic Western nations, including Australia, Denmark, Finland, France, Germany, Great Britain, Norway, Spain, and Sweden, where social democratic parties have often held political power. Other countries where social democracy has had an important influence include India and Brazil. Consistent with their Marxist roots, after World War II social democratic government in some nations nationalized some private companies, transforming them into state-owned enterprises to be run for the "public good rather than private profit." This trend was most marked in Great Britain where by the end of the 1970s state-owned companies had a monopoly in the telecommunications, electricity, gas, coal, railway, and shipbuilding industries, as well as substantial interests in the oil, airline, auto, and steel industries.

However, experience demonstrated that state ownership of the means of production ran counter to the public interest. In many countries, state-owned companies performed poorly. Protected from competition by their monopoly position and guaranteed government financial support, many became increasingly inefficient. Individuals paid for the luxury of state ownership through higher prices and higher taxes. As a consequence, a number of Western democracies voted many social democratic parties out of office in the late 1970s and early 1980s. They were succeeded by political parties, such as Britain's Conservative Party and Germany's Christian Democratic Party, that were more committed to free market economics. These parties sold state-owned enterprises to private investors (a process referred to as **privatization**). Even where social democratic parties regained the levers of power, as in Great Britain in 1997 when the left-leaning Labor Party won control of the government, they too were now committed to continued private ownership.

privatization
The sale of state-owned enterprises to private investors.

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

Individualism

The opposite of collectivism, **individualism** refers to a philosophy that an individual should have freedom in his or her economic and political pursuits. In contrast to collectivism, individualism stresses that the interests of the individual should take precedence over the interests of the state. Like collectivism, individualism can be traced to an ancient Greek philosopher, in this case Plato's disciple Aristotle (384–322 B.C.). In contrast to Plato, Aristotle argued that individual diversity and private ownership are desirable. In a passage that might have been taken from a speech by contemporary politicians who adhere to a free market ideology, he argued that private property is more highly productive than communal property and will thus stimulate progress. According to Aristotle, communal property receives little care, whereas property that is owned by an individual will receive the greatest care and therefore be most productive.

Individualism was reborn as an influential political philosophy in the Protestant trading nations of England and the Netherlands during the sixteenth century. The philosophy was refined in the work of a number of British philosophers, including David Hume (1711–1776), Adam Smith (1723–1790), and John Stuart Mill (1806–1873). Individualism exercised a profound influence on those in the American colonies that sought independence from Great Britain. Indeed, the concept underlies the ideas expressed in the Declaration of Independence. In the twentieth century, several Nobel Prize–winning economists—including Milton Friedman, Friedrich von Hayek, and James Buchanan—championed the philosophy.

Individualism is built on two central tenets. The first is an emphasis on the importance of guaranteeing individual freedom and self-expression. The second tenet of individualism is that the welfare of society is best served by letting people pursue their own economic self-interest, as opposed to some collective body (such as government) dictating what is in society's best interest. Or, as Adam Smith put it in a famous passage from *The Wealth of Nations*, "an individual who intends his own gain is led by an invisible hand to promote an end that was no part of his intention. Nor is it always worse for the society that it was no part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it. This author has never known much good done by those who effect to trade for the public good."[4]

What About People's Future Rights?

Individualism versus collectivism is a centuries-old debate topic and an inherently interesting issue. For example, does an individual's life belong to him or her or to the community, society, or country in which he or she resides? Most people have a direct and immediate answer, but there is no consensus on which answer, depending on which country you reside in or which personal "compass" you subscribe to. Everyone has tendencies toward being both individualistic and collectivistic but prefers one way more than the other. So, which of these ideas—individualism or collectivism—do you think is correct, and which cultural belief do you prefer and why?

Source: *Objective Standard*, March 3, 2014. www.theobjectivestandard.com.

The central message of individualism, therefore, is that individual economic and political freedoms are the ground rules on which a society should be based. This puts individualism in conflict with collectivism. Collectivism asserts the primacy of the collective over the individual; individualism asserts the opposite. This underlying ideological conflict shaped much of the recent history of the world. The Cold War, for example, was in many respects a war between collectivism, championed by the former Soviet Union, and individualism, championed by the United States. From the late 1980s until about 2005, the waning of collectivism was matched by the ascendancy of individualism. Democratic ideals and market economics replaced socialism and communism in many states. Since 2005, there have been some signs of a small swing back toward left-leaning socialist ideas in several countries, including several Latin America nations such as Venezuela, Bolivia, and Paraguay, along with Russia (see the Country Focus for details). Also, the global financial crisis of 2008–2009 caused some reevaluation of the trends toward individualism, and it remains possible that the pendulum might tilt back the other way.

DEMOCRACY AND TOTALITARIANISM

Democracy and totalitarianism are at different ends of a political dimension. **Democracy** refers to a political system in which government is by the people, exercised either directly or through elected representatives. **Totalitarianism** is a form of government in which one person or political party exercises absolute control over all spheres of human life and prohibits opposing political parties. The democratic–totalitarian dimension is not independent of the individualism–collectivism dimension. Democracy and individualism go hand in hand, as do the communist version of collectivism and totalitarianism. However, gray areas exist; it is possible to have a democratic state in which collective values predominate, and it is possible to have a totalitarian state that is hostile to collectivism and in which some degree of individualism—particularly in the economic sphere—is encouraged. For example, China and Vietnam have seen a move toward greater individual freedom in the economic sphere, but those countries are stilled ruled by parties that have a monopoly on political power and constrain political freedom.

democracy
Political system in which government is by the people, exercised either directly o[r] through elected representatives.

totalitarianism
Form of government in which one pers[on] or political party exercises absolute control over all spheres of human life a[nd] opposing political parties are prohibite[d].

Democracy

The pure form of democracy, as originally practiced by several city-states in ancient Greece, is based on a belief that citizens should be directly involved in decision making. In complex, advanced societies with populations in the tens or hundreds of millions, this is impractical. Most modern democratic states practice **representative democracy**. The United States, for example, is a constitutional republic that operates as a representative democracy. In a representative democracy, citizens periodically elect individuals to represent them. These elected representatives then form a government whose function is to make decisions on behalf of the electorate. In a representative democracy, elected representatives who fail to perform this job adequately will be voted out of office at the next election.

representative democracy
A political system in which citizens periodically elect individuals to repr[esent] them in government.

country FOCUS

Putin's Russia

The modern Russian state was born in 1991 after the dramatic collapse of the Soviet Union. Early in the post-Soviet era, Russia embraced ambitious policies designed to transform a communist dictatorship with a centrally planned economy into a democratic state with a market-based economic system. The policies, however, were imperfectly implemented. Political reform left Russia with a strong presidency that—in hindsight—had the ability to subvert the democratic process. On the economic front, the privatization of many state-owned enterprises was done in such a way as to leave large shareholdings in the hands of the politically connected, many of whom were party officials and factory managers under the old Soviet system. Corruption was also endemic, and organized crime was able to seize control of some newly privatized enterprises. In 1998, the poorly managed Russian economy went through a financial crisis that nearly bought the country to its knees.

Fast-forward to 2018, and Russia still is a long way from being a modern democracy with a functioning free market–based economic system. On the positive side, the economy grew at a healthy clip during most of the 2000s, helped in large part by high prices for oil and gas, Russia's largest exports (in 2013 oil and gas accounted for 75 percent of all Russian exports). Between 2000 and 2013, Russia's gross domestic product (GDP) per capita more than doubled when measured by purchasing power parity. The country now boasts the world's 12th-largest economy. Thanks to government oil revenues, public debt is also low by international standards—at just 12 percent of GDP in 2017 (in the United States, by comparison, public debt amounts to 70 percent of GDP). Indeed, Russia has run a healthy trade surplus on the back of strong oil and gas exports for the last decade.

On the other hand, the economy is overly dependent on commodities, particularly oil and gas. This was exposed in mid-2014 when the price of oil started to tumble as a result of rapidly increasing supply from the United States. Between mid-2014 and early 2016, the price of oil fell from $110 a barrel to a low of around $27 before rebounding to $50. This drove a freight train through Russia's public finances. Much of Russia's oil and gas production remains in the hands of enterprises in which the state still has a significant ownership stake. The government has a controlling ownership position in Gazprom and Rosneft, two of the country's largest oil and gas companies. The government used the rise in oil and gas revenues between 2004 and 2014 to increase public spending through state-led investment projects and increases in wages and pensions for government workers. While this boosted private consumption, there has been a dearth of private investment, and productivity growth remains low. This is particularly true among many state-owned enterprises that collectively still account for about half of the Russian economy. Now with lower oil prices, Russia is having to issue more debt to finance public spending.

Russian private enterprises are also hamstrung by bureaucratic red tape and endemic corruption. The World Bank ranks Russia 92nd in the world in terms of the ease of doing business and 88th when it comes to starting a business (for comparison, the United States is ranked 4th and 20th, respectively). Transparency International, which ranks countries by the extent of corruption, ranked Russia 135 out of 176 nations in 2017. The state and state-owned enterprises are famous for pushing work to private enterprises that are owned by political allies, which further subverts market-based processes.

On the political front, Russia is becoming less democratic with every passing year. Since 1999, Vladimir Putin has exerted increasingly tight control over Russian politics, either as president or as prime minister. Under Putin, potential opponents have been sidelined, civil liberties have been progressively reduced, and the freedom of the press has been diminished. For example, in response to opposition protests in 2011 and 2012, the Russian government passed laws increasing its control over the Internet, dramatically raising fines for participating in "unsanctioned" street protests, and expanded the definition of treason to further limit opposition activities. Vocal opponents of the régime—from business executives who do not toe the state line to protest groups such as the punk rock protest band Pussy Riot—have found themselves jailed on dubious charges. To make matters worse, Putin has recently been tightening his grip on the legal system. In late 2013, Russia's parliament, which is dominated by Putin supporters, gave the president more power to appoint and fire prosecutors, thereby diminishing the independence of the legal system.

Freedom House, which produces an annual ranking tracking freedom in the world, classifies Russia as "not free" and gives it low scores for political and civil liberties. Freedom House notes that in the March 2012 presidential elections, Putin benefited from preferential treatment by state-owned media, numerous abuses of incumbency, and procedural "irregularities" during the vote count. Putin won 63.6 percent of the vote against a field of weak, hand-chosen opponents, led by Communist Party leader Gennadiy Zyuganove, with 17.2 percent of the vote. Under a Putin-inspired 2008 constitutional amendment, the term of the presidency was expanded from four years to six. Putin was elected to another six-year term in 2018 in an election that many observers thought was a sham.

In 2014, Putin burnished his growing reputation for authoritarianism when he took advantage of unrest in the neighboring country of Ukraine to annex the Crimea region and to support armed revolt by Russian-speaking separatists in eastern Ukraine. Western powers responded to this aggression by imposing economic sanctions on Russia. Taken together with the rapid fall in oil prices, this pushed the once-booming Russian economy into a recession. In 2014, the economy grew by just 0.6 percent, while the Russian ruble tumbled, losing half of its value against other major currencies. The economy contracted by 2.8 percent in 2015 and another 0.2 percent in 2016 before growing by 1.8 percent in 2017. Despite economic weaknesses, there is no sign that Putin's hold on power has been diminished; in fact, quite the opposite seems to have occurred.

Sources: "Putin's Russia: Sochi or Bust," *The Economist*, February 1, 2014; "Russia's Economy: The S Word," *The Economist*, November 9, 2013; Freedom House, "Freedom in the World 2017: Russia," www.freedomhouse.org; and K. Hille, "Putin Tightens Grip on Legal System," *Financial Times*, November 27, 2013.

To guarantee that elected representatives can be held accountable for their actions by the electorate, an ideal representative democracy has a number of safeguards that are typically enshrined in constitutional law. These include (1) an individual's right to freedom of expression, opinion, and organization; (2) a free media; (3) regular elections in which all eligible citizens are allowed to vote; (4) universal adult suffrage; (5) limited terms for elected representatives; (6) a fair court system that is independent from the political system; (7) a nonpolitical state bureaucracy; (8) a nonpolitical police force and armed service; and (9) relatively free access to state information.[5]

Totalitarianism

In a totalitarian country, all the constitutional guarantees on which representative democracies are built—an individual's right to freedom of expression and organization, a free media, and regular elections—are denied to the citizens. In most totalitarian states, political repression is widespread, free and fair elections are lacking, media are heavily censored, basic civil liberties are denied, and those who question the right of the rulers to rule find themselves imprisoned or worse.

Four major forms of totalitarianism exist in the world today. Until recently, the most widespread was **communist totalitarianism**. Communism, however, is in decline worldwide, and most of the Communist Party dictatorships have collapsed since 1989. Exceptions to this trend (so far) are China, Vietnam, Laos, North Korea, and Cuba, although most of these states exhibit clear signs that the Communist Party's monopoly on political power is eroding. In many respects, the governments of China, Vietnam, and Laos are communist in name only because those nations have adopted wide-ranging, market-based economic reforms. They remain, however, totalitarian states that deny many basic civil liberties to their populations. On the other hand, there are signs of a swing back toward communist totalitarian ideas in some states, such as Venezuela, where the government of the late Hugo Chávez displayed totalitarian tendencies. The same is true in Russia, where the government of Vladimir Putin has become increasingly totalitarian over time (see the Country Focus).

A second form of totalitarianism might be labeled **theocratic totalitarianism**. Theocratic totalitarianism is found in states where political power is monopolized by a party, group, or individual that governs according to religious principles. The most common form of theocratic totalitarianism is based on Islam and is exemplified by states such as Iran and Saudi Arabia. These states limit freedom of political and religious expression with laws based on Islamic principles.

A third form of totalitarianism might be referred to as **tribal totalitarianism**. Tribal totalitarianism has arisen from time to time in African countries such as Zimbabwe, Tanzania, Uganda, and Kenya. The borders of most African states reflect the administrative boundaries drawn by the old European colonial powers rather than tribal realities. Consequently, the typical African country contains a number of tribes (e.g., in Kenya there are more than 40 tribes). Tribal totalitarianism occurs when a political party that represents the interests of a particular tribe (and not always the majority tribe) monopolizes power. In Kenya, for example, politicians from the Kikuyu tribe have long dominated the political system.

A fourth major form of totalitarianism might be described as **right-wing totalitarianism**. Right-wing totalitarianism generally permits some individual economic freedom but restricts individual political freedom, frequently on the grounds that it would lead to the rise of communism. A common feature of many right-wing dictatorships is an overt hostility to socialist or communist ideas. Many right-wing totalitarian governments are backed by the military, and in some cases, the government may be made up of military officers. The fascist regimes that ruled Germany and Italy in the 1930s and 1940s were right-wing totalitarian states. Until the early 1980s, right-wing dictatorships, many of which were military dictatorships, were common throughout Latin America (e.g., Brazil was ruled by a military dictatorship between 1964 and 1985). They were also found in several Asian countries, particularly South Korea, Taiwan, Singapore, Indonesia, and the Philippines. Since the early

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

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

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

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

Is Representative Democracy the Best Way?

Chile is a country in South America that borders the South Pacific Sea. Neighboring countries include Argentina, Bolivia, and Peru—also representative democracies. Chile has a strategic location relative to sealanes between the Atlantic and Pacific Oceans, including the Strait of Magellan, the Beagle Channel, and the Drake Passage. Chile has a market-oriented economy in which the prices of goods and services are determined in a free price system. The government system is a republic (and it returned to a democracy in 1990). The chief of state and head of government is the president. Presidential and congressional elections are held periodically, with each election since the post-Pinochet era (which ended in 1988) being viewed as free and fair. How often do you believe elections should be held for the head of state?

Source: http://globalEDGE.msu.edu/countries/chile/government.

1980s, however, this form of government has been in retreat. Most Latin American countries are now genuine multiparty democracies. Similarly, South Korea, Taiwan, and the Philippines have all become functioning democracies, as has Indonesia.

Pseudo-Democracies Many of the world's nations are neither pure democracies nor iron-clad totalitarian states. Rather they lie between pure democracies and complete totalitarian systems of government. They might be described as imperfect or pseudo-democracies, where authoritarian elements have captured some or much of the machinery of state and use this in an attempt to deny basic political and civil liberties. In the Russia of Vladimir Putin, for example, elections are still held, people compete through the ballot box for political office, and the independent press does not always toe the official line. However, Putin has used his position to systematically limit the political and civil liberties of opposition groups. His control is not yet perfect, though. Voices opposing Putin are still heard in Russia, and in theory, elections are still contested. But in practice, it is becoming increasingly difficult to challenge a man and régime that have systematically extended their political, legal, and economic power over the past two decades (see the Country Focus).

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Economic Systems

LO 2-2
Understand how the economic systems of countries differ.

It should be clear from the previous section that political ideology and economic systems are connected. In countries where individual goals are given primacy over collective goals, we are more likely to find market-based economic systems. In contrast, in countries where collective goals are given preeminence, the state may have taken control over many enterprises; markets in such countries are likely to be restricted rather than free. We can identify three broad types of economic systems: a market economy, a command economy, and a mixed economy.

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

MARKET ECONOMY

In the archetypal pure **market economy**, all productive activities are privately owned, as opposed to being owned by the state. The goods and services that a country produces are not planned by anyone. Production is determined by the interaction of supply and demand and signaled to producers through the price system. If demand for a product exceeds supply, prices will rise, signaling producers to produce more. If supply exceeds demand, prices will fall, signaling producers to produce less. In this system, consumers are sovereign. The purchasing patterns of consumers, as signaled to producers through the mechanism of the price system, determine what is produced and in what quantity.

For a market to work in this manner, supply must not be restricted. A supply restriction occurs when a single firm monopolizes a market. In such circumstances, rather than increase output in response to increased demand, a monopolist might restrict output and let prices rise. This allows the monopolist to take a greater profit margin on each unit it sells. Although this is good for the monopolist, it is bad for the consumer, who has to pay higher prices. It also is probably bad for the welfare of society. Because a monopolist has no competitors, it has no incentive to search for ways to lower production costs. Rather, it can simply pass on cost increases to consumers in the form of higher prices. The net result is that the monopolist is likely to become increasingly inefficient, producing high-priced, low-quality goods, and society suffers as a consequence.

Given the dangers inherent in monopoly, one role of government in a market economy is to encourage vigorous free and fair competition between private producers. Governments do this by banning restrictive business practices designed to monopolize a market (antitrust laws serve this function in the United States and European Union). Private ownership also encourages vigorous competition and economic efficiency. Private ownership ensures that entrepreneurs have a right to the profits generated by their own efforts. This gives entrepreneurs an incentive to search for better ways of serving consumer needs. That may be through introducing new products, by developing more efficient production processes, by pursuing better marketing and after-sale service, or simply through managing their businesses more efficiently than their competitors. In turn, the constant improvement in product and process that results from such an incentive has been argued to have a major positive impact on economic growth and development.[6]

COMMAND ECONOMY In a pure **command economy**, the government plans the goods and services that a country produces, the quantity in which they are produced, and the prices at which they are sold. Consistent with the collectivist ideology, the objective of a command economy is for government to allocate resources for "the good of society." In addition, in a pure command economy, all businesses are state owned, the rationale being that the government can then direct them to make investments that are in the best interests of the nation as a whole rather than in the interests of private individuals. Historically, command economies were found in communist countries where collectivist goals were given priority over individual goals. Since the demise of communism in the late 1980s, the number of command economies has fallen dramatically. Some elements of a command economy were also evident in a number of democratic nations led by socialist-inclined governments. France and India both experimented with extensive government planning and state ownership, although government planning has fallen into disfavor in both countries.

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

While the objective of a command economy is to mobilize economic resources for the public good, the opposite often seems to have occurred. In a command economy, state-owned enterprises have little incentive to control costs and be efficient because they cannot go out of business. Also, the abolition of private ownership means there is no incentive for individuals to look for better ways to serve consumer needs; hence, dynamism and innovation are absent from command economies. Instead of growing and becoming more prosperous, such economies tend to stagnate.

MIXED ECONOMY Mixed economies can be found between market and command economies. In a mixed economy, certain sectors of the economy are left to private ownership and free market mechanisms, while other sectors have significant state ownership and government planning. Mixed economies were once common throughout much of the developed world, although they are becoming less so. Until the 1980s, Great Britain, France, and Sweden were mixed economies, but extensive privatization has reduced state ownership of businesses in all three nations. A similar trend occurred in many other countries where there was once a large state-owned sector, such as Brazil, Italy, and India (although there are still state-owned enterprises in all of these nations). As a counterpoint, the involvement of the state in economic activity has been on the rise again in countries such as Russia and Venezuela, where authoritarian

North Korean leader Kim Jong-un visiting a factory.
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regimes have seized control of the political structure, typically by first winning power through democratic means and then subverting those same structures to maintain their grip on power.

In mixed economies, governments also tend to take into state ownership troubled firms whose continued operation is thought to be vital to national interests. For example, in 2008 the U.S. government took an 80 percent stake in AIG to stop that financial institution from collapsing, the theory being that if AIG did collapse, it would have very serious consequences for the entire financial system. The U.S. government usually prefers market-oriented solutions to economic problems, and in the AIG case, the intention was to sell the institution back to private investors as soon as possible. The United States also took similar action with respect to a number of other troubled private enterprises, including Citigroup and General Motors. In all these cases, the government stake was seen as nothing more than a short-term action designed to stave off economic collapse by injecting capital into troubled enterprises in highly unusually circumstances. As soon as it was able to, the government sold these stakes. In early 2010, for example, the U.S. government sold its stake in Citigroup. The government stake in AIG was sold off in 2012, and by 2014, it had also disposed of its stake in GM.

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Legal Systems

LO 2-3
Understand how the legal systems of countries differ.

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

The **legal system** of a country refers to the rules, or laws, that regulate behavior along with the processes by which the laws are enforced and through which redress for grievances is obtained. The legal system of a country is of immense importance to international business. A country's laws regulate business practice, define the manner in which business transactions are to be executed, and set down the rights and obligations of those involved in business transactions. The legal environments of countries differ in significant ways. As we shall see, differences in legal systems can affect the attractiveness of a country as an investment site or market.

Like the economic system of a country, the legal system is influenced by the prevailing political system (although it is also strongly influenced by historical tradition). The government of a country defines the legal framework within which firms do business, and often the laws that regulate business reflect the rulers' dominant political ideology. For example, collectivist-inclined totalitarian states tend to enact laws that severely restrict private enterprise, whereas the laws enacted by governments in democratic states where individualism is the dominant political philosophy tend to be pro-private enterprise and pro-consumer.

Here, we focus on several issues that illustrate how legal systems can vary—and how such variations can affect international business. First, we look at some basic differences in legal systems. Next we look at contract law. Third, we look at the laws governing property rights with particular reference to patents, copyrights, and trademarks. Then we discuss protection of intellectual property. Finally, we look at laws covering product safety and product liability.

DIFFERENT LEGAL SYSTEMS

There are three main types of legal systems—or legal traditions—in use around the world: common law, civil law, and theocratic law.

common law
A system of law based on tradition, precedent, and custom; when law courts interpret common law, they do so with regard to these characteristics.

Common Law

The common law system evolved in England over hundreds of years. It is now found in most of Great Britain's former colonies, including the United States. **Common law** is based on tradition, precedent, and custom. *Tradition* refers to a country's legal history, *precedent* to cases that have come before the courts in the past, and *custom* to the ways in which laws are applied in specific situations. When law courts interpret common law, they do so with regard to these characteristics. This gives a common law system a degree of flexibility that other systems lack. Judges in a common law system have the power to interpret the law so that it applies to the unique circumstances of an individual case. In turn, each new interpretation sets a precedent that may be followed in future cases. As new precedents arise, laws may be altered, clarified, or amended to deal with new situations.

civil law system
A system of law based on a very detailed set of written laws and codes.

Civil Law

A **civil law system** is based on a detailed set of laws organized into codes. When law courts interpret civil law, they do so with regard to these codes. More than 80 countries—including Germany, France, Japan, and Russia—operate with a civil law system. A civil law system tends to be less adversarial than a common law system because the judges rely on detailed legal codes rather than interpreting tradition, precedent, and custom. Judges under a civil law system have less flexibility than those under a common law system. Judges in a common law system have the power to interpret the law, whereas judges in a civil law system have the power only to apply the law.

Do You Agree with the Unique System of Islamic Banking?

How can a banking system operate without interest (*riba* in Arabic)? The basic economic idea is that commercial risk should be shared. In the Western approach, interest guarantees the banker a return, so on a collateralized loan, the banker avoids much of the commercial risk that's inherent in business. No matter what happens to the business, the banker gets a return. In contrast, Islam requires that the banker share this commercial risk. If the business venture is successful, the banker shares the profit. If the venture doesn't do well, neither does the banker. The value of community in Islam is stronger than the value of individual profit. As a result, Islamic Banking was born in the mid-1970s and has grown ever since, now to the point of having millions of clients, a resilient code of ethics, and engagement from many conventional banks around the world. What do you think? Should the banker be paid regardless of entrepreneurial success, or is the Islamic Banking system a better way to share commercial risk?

Theocratic Law A **theocratic law system** is one in which the law is based on religious teachings. Islamic law is the most widely practiced theocratic legal system in the modern world, although usage of both Hindu and Jewish law persisted into the twentieth century. Islamic law is primarily a moral rather than a commercial law and is intended to govern all aspects of life.[7] The foundation for Islamic law is the holy book of Islam, the Koran, along with the Sunnah, or decisions and sayings of the Prophet Muhammad, and the writings of Islamic scholars who have derived rules by analogy from the principles established in the Koran and the Sunnah. Because the Koran and Sunnah are holy documents, the basic foundations of Islamic law cannot be changed. However, in practice, Islamic jurists and scholars are constantly debating the application of Islamic law to the modern world. In reality, many Muslim countries have legal systems that are a blend of Islamic law and a common or civil law system.

theocratic law system
A system of law based on religious teachings.

Although Islamic law is primarily concerned with moral behavior, it has been extended to cover certain commercial activities. An example is the payment or receipt of interest, which is considered usury and outlawed by the Koran. To the devout Muslim, acceptance of interest payments is seen as a grave sin; the giver and the taker are equally damned. This is not just a matter of theology; in several Islamic states, it has also become a matter of law. In the 1990s, for example, Pakistan's Federal Shariat Court, the highest Islamic lawmaking body in the country, pronounced interest to be un-Islamic and therefore illegal and demanded that the government amend all financial laws accordingly. In 1999, Pakistan's Supreme Court ruled that Islamic banking methods should be used in the country after July 1, 2001.[8] By the late 2000s, there were some 500 Islamic financial institutions in the world, and as of 2014, they collectively managed more than $1 trillion in assets. In addition to Pakistan, Islamic financial institutions are found in many of the Gulf states, Egypt, Malaysia, and Iran.[9]

DIFFERENCES IN CONTRACT LAW The difference between common law and civil law systems can be illustrated by the approach of each to contract law (remember, most theocratic legal systems also have elements of common or civil law). A **contract** is a document that specifies the conditions under which an exchange is to occur and details the rights and obligations of the parties involved. Some form of contract regulates many business transactions. **Contract law** is the body of law that governs contract enforcement. The parties to an agreement normally resort to contract law when one party feels the other has violated either the letter or the spirit of an agreement.

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

contract law
The body of law that governs contract enforcement.

Because common law tends to be relatively ill specified, contracts drafted under a common law framework tend to be very detailed with all contingencies spelled out. In civil law systems, however, contracts tend to be much shorter and less specific because many of the issues are already covered in a civil code. Thus, it is more expensive to draw up contracts in a common law jurisdiction, and resolving contract disputes can be very adversarial in common law systems. But common law systems have the advantage of greater flexibility and allow judges to interpret a contract dispute in light of the prevailing situation. International businesses need to be sensitive to these differences; approaching a contract dispute in a state with a civil law system as if it had a common law system may backfire, and vice versa.

When contract disputes arise in international trade, there is always the question of which country's laws to apply. To resolve this issue, a number of countries, including the United States,

United Nations Convention on Contracts for the International Sale of Goods (CISG)
A set of rules governing certain aspects of the making and performance of commercial contracts between sellers and buyers who have their places of businesses in different nations.

have ratified the **United Nations Convention on Contracts for the International Sale of Goods (CISG)**. The CISG establishes a uniform set of rules governing certain aspects of the making and performance of everyday commercial contracts between sellers and buyers who have their places of business in different nations. By adopting the CISG, a nation signals to other adopters that it will treat the convention's rules as part of its law. The CISG applies automatically to all contracts for the sale of goods between different firms based in countries that have ratified the convention, unless the parties to the contract explicitly opt out. One problem with the CISG, however, is that as of 2016, only 83 nations had ratified the convention (the CISG went into effect in 1988).[10] Some of the world's important trading nations, including India and the United Kingdom, have not ratified the CISG.

When firms do not wish to accept the CISG, they often opt for arbitration by a recognized arbitration court to settle contract disputes. The most well known of these courts is the International Court of Arbitration of the International Chamber of Commerce in Paris, which handles more than 500 requests per year from more than 100 countries.[11]

PROPERTY RIGHTS AND CORRUPTION

In a legal sense, the term *property* refers to a resource over which an individual or business holds a legal title, that is, a resource that it owns. Resources include land, buildings, equipment, capital, mineral rights, businesses, and intellectual property (ideas, which are protected by patents, copyrights, and trademarks). **Property rights** refer to the legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.[12] Countries differ in the extent to which their legal systems define and protect property rights. Almost all countries now have laws on their books that protect property rights. Even China, still nominally a communist state despite its booming market economy, finally enacted a law to protect the rights of private property holders in 2007 (the law gives individuals the same legal protection for their property as the state has).[13] However, in many countries these laws are not enforced by the authorities, and property rights are violated. Property rights can be violated in two ways: through private action and through public action.

property rights
Bundle of legal rights over the use to which a resource is put and over the use made of any income that may be derived from that resource.

Private Action

In terms of violating property rights, **private action** refers to theft, piracy, blackmail, and the like by private individuals or groups. Although theft occurs in all countries, a weak legal system allows a much higher level of criminal action. For example, in the chaotic period following the collapse of communism in Russia, an outdated legal system, coupled with a weak police force and judicial system, offered both domestic and foreign businesses scant protection from blackmail by the "Russian Mafia." Successful business owners in Russia often had to pay "protection money" to the Mafia or face violent retribution, including bombings and assassinations (about 500 contract killings of businessmen occurred per year in the 1990s).[14]

private action
Violation of property rights through theft, piracy, blackmail, and the like by private individuals or groups.

Russia is not alone in having organized crime problems (and the situation in Russia has improved since the 1990s). The Mafia has a long history in the United States (Chicago in the 1930s was similar to Moscow in the 1990s). In Japan, the local version of the Mafia, known as the *yakuza*, runs protection rackets, particularly in the food and entertainment industries.[15] However, there was a big difference between the magnitude of such activity in Russia in the 1990s and its limited impact in Japan and the United States. The difference arose because the legal enforcement apparatus, such as the police and court system, was weak in Russia following the collapse of communism. Many other countries from time to time have had problems similar to or even greater than those experienced by Russia.

Public Action and Corruption

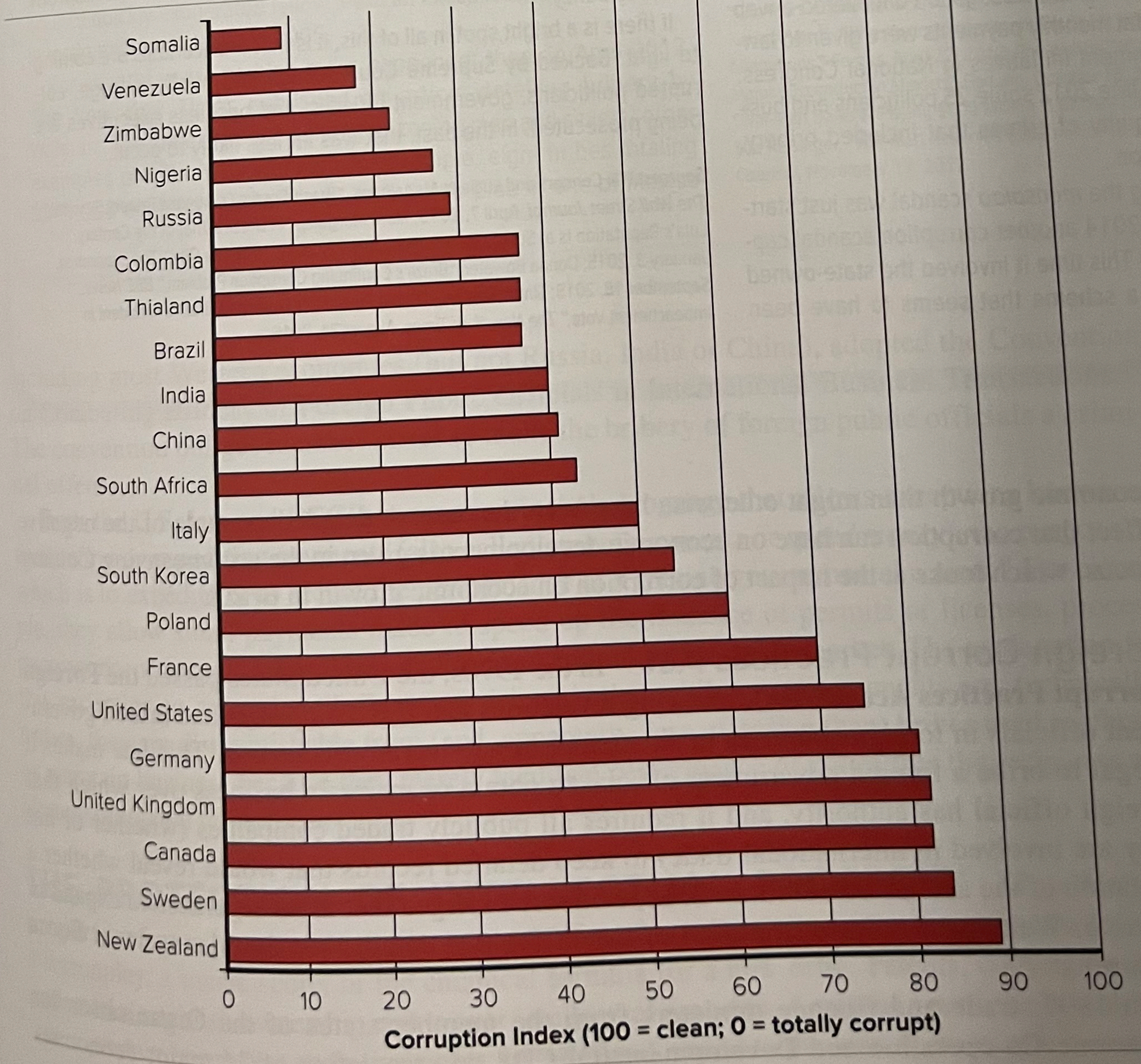
Public action to violate property rights occurs when public officials, such as politicians and government bureaucrats, extort income, resources, or the property itself from property holders. This can be done through legal mechanisms such as levying excessive taxation, requiring expensive licenses or permits from property holders, taking assets into state ownership without compensating the owners, or redistributing assets without compensating the prior owners. It can also be done through illegal means, or corruption, by demanding bribes from businesses in return for the rights to operate in a country, industry, or location.[16]

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

Corruption has been well documented in every society, from the banks of the Congo River to the palace of the Dutch royal family, from Japanese politicians to Brazilian bankers, and from government officials in Zimbabwe to the New York City Police Department. The government of the late Ferdinand Marcos in the Philippines was famous for demanding bribes from foreign businesses wishing to set up operations in that country. The same was true of government officials in Indonesia under the rule of former President Suharto. No society is immune to corruption. However, there are systematic differences in the extent of corruption. In some countries, the rule of law minimizes corruption. Corruption is seen and treated as illegal, and when discovered, violators are punished by the full force of the law. In other countries, the rule of law is weak and corruption by bureaucrats and politicians is rife. Corruption is so endemic in some countries that politicians and bureaucrats regard it as a perk of office and openly flout laws against corruption. This seems to have been the case in Brazil until recently; the situation there may be evolving in a more positive direction.

According to Transparency International, an independent nonprofit organization dedicated to exposing and fighting corruption, businesses and individuals spend some $400 billion a year worldwide on bribes related to government procurement contracts alone.[17] Transparency International has also measured the level of corruption among public officials in different countries.[18] As can be seen in Figure 2.1, the organization rated countries such as New Zealand and Sweden as clean; it rated others, such as Russia, India, Zimbabwe and Venezuela, as corrupt. Somalia ranked last out of all 180 countries in the survey (the country is often described as a "failed state").

Economic evidence suggests that high levels of corruption significantly reduce the foreign direct investment, level of international trade, and economic growth rate in a country.[19] By siphoning off profits, corrupt politicians and bureaucrats reduce the returns to business investment and, hence, reduce the incentive of both domestic and foreign businesses to invest in that country. The lower level of investment that results hurts economic growth. Thus, we would expect countries with high levels of corruption such as Indonesia, Nigeria, and Russia to have a lower rate of



2.1 FIGURE

Rankings of corruption by country, 2017.

Source: Constructed by the author from raw data from Transparency International, Corruption Perceptions Index 2017.

country FOCUS

Corruption in Brazil

Brazil is the seventh-largest economy in the world with a gross domestic product of $2 trillion. The country has a democratic government and an economy characterized by moderately free markets, although the country's largest oil producer (Petrobras) and one of its top banks (Banco do Brazil) are both state owned. Many economists, however, have long felt that the country has never quite lived up to its considerable economic potential. A major reason for this has been an endemically high level of corruption that favors those with political connections and discourages investment by more ethical businesses.

Transparency International, a nongovernmental organization that evaluates countries based on perceptions of how corrupt they are, ranked Brazil 96th out of the 180 countries it looked at in its 2017 report. The problems it identifies in Brazil include public officials who demand bribes in return for awarding government contracts and "influence peddling," in which elected officials use their position in government to obtain favors or preferential treatment. Consistent with this, according to a study by the World Economic Forum, Brazil ranks 135th out of 144 countries in the proper use of public funds.

Over the last decade, several corruption scandals have come to light that serve to emphasize Brazil's corruption problem. In 2005, a scandal known as the *mensalao* (the monthly payoff scandal) broke. The scandal started when a midlevel postal official was caught on film pocketing a modest bribe in exchange for promises to favor certain businesses in landing government contracts. Further investigation uncovered a web of influence peddling in which fat monthly payments were given to lawmakers willing to back government initiatives in National Congress. After a lengthy investigation, in late 2012 some 25 politicians and business executives were found guilty of crimes that included bribery, money laundering, and corruption.

The public uproar surrounding the *mensalao* scandal was just starting to die down when in March 2014 another corruption scandal captured the attention of Brazilians. This time it involved the state-owned oil company, Petrobras. Under a scheme that seems to have been operating since 1997, construction firms wanting to do business with Petrobras agreed to pay bribes to the company's executives. Many of these executives were themselves political appointees. The executives would inflate the value of contracts they awarded, adding a 3 percent "fee," which was effectively a kickback. The 3 percent fee was shared among Petrobras executives, construction industry executives, and politicians. The construction companies established shell companies to make payments and launder the money. According to prosecutors investigating the case, the total value of bribes may have exceeded $3.7 billion.

Four former Petrobras officials and at least 23 construction company executives have been charged with crimes that include corruption and money laundering. In addition, Brazil's Supreme Court has given prosecutors the go-ahead to investigate 48 current or former members of Congress, including the former Brazilian President Fernando Collor de Mello. The Brazilian president, Dilma Rousseff, was also tainted by the scandal. In June 2016, she was suspended from the presidency pending an impeachment trial. She was chair of Petrobras during the time this was occurring. She is also a member of the governing Workers' Party, several members of which seem to have been among the major beneficiaries of the kickback scandal. Although there is no evidence that Rousseff knew of the bribes or profited from them, her ability to govern effectively has been severely damaged by association. The scandal has so rocked Brazil that it has pushed the country close to a recession. In August 2016, Rousseff was impeached and removed from the presidency.

If there is a bright spot in all of this, it is that the scandals are coming to light. Backed by Supreme Court rulings and public outrage, corrupted politicians, government officials, and business executives are being prosecuted. In the past, that was far less likely to occur.

Sources: Will Conners and Luciana Magalhaes, "Brazil Cracks Open Vast Bribery Scandal," *The Wall Street Journal*, April 7, 2015; Marc Margolis, "In Brazil's Trial of the Century, Lula's Reputation Is at Stake," *Newsweek*, July 27, 2012; "The Big Oily," *The Economist*, January 3, 2015; Donna Bowater, "Brazil's Continuing Corruption Problem," *BBC News*, September 18, 2015; Simon Romero, "Dilma Rousseff Is Ousted as Brazil's President in Impeachment Vote," *The New York Times*, August 31, 2016.

economic growth than might otherwise have been the case. A detailed example of the negative effect that corruption can have on economic development is given in the accompanying Country Focus, which looks at the impact of corruption on economic growth in Brazil.

Foreign Corrupt Practices Act (FCPA)
U.S. law regulating behavior regarding the conduct of international business in the taking of bribes and other unethical actions.

Foreign Corrupt Practices Act In the 1970s, the United States passed the **Foreign Corrupt Practices Act (FCPA)** following revelations that U.S. companies had bribed government officials in foreign countries in an attempt to win lucrative contracts. This law makes it illegal to bribe a foreign government official to obtain or maintain business over which that foreign official has authority, and it requires all publicly traded companies (whether or not they are involved in international trade) to keep detailed records that would reveal whether a violation of the act has occurred. In 2012, evidence emerged that in its eagerness to expand in Mexico, Walmart may have run afoul of the FCPA (for details, see the Management Focus feature).

In 1997, trade and finance ministers from the member states of the Organisation for Economic Co-operation and Development (OECD), an association of 34 major economies

management FOCUS

Did Walmart Violate the Foreign Corrupt Practices Act?

In the early 2000s, Walmart wanted to build a new store in San Juan Teotihuacan, Mexico, barely a mile from ancient pyramids that drew tourists from around the world. The owner of the land was happy to sell to Walmart, but one thing stood in the way of a deal: the city's new zoning laws. These prohibited commercial development in the historic area. Not to be denied, executives at the headquarters of Walmart de Mexico found a way around the problem: They paid a $52,000 bribe to a local official to redraw the zoning area so that the property Walmart wanted to purchase was placed *outside* the commercial-free zone. Walmart then went ahead and built the store, despite vigorous local opposition, opening it in late 2004.

A former lawyer for Walmart de Mexico subsequently contacted Walmart executives at the company's corporate headquarters in Bentonville, Arkansas. He told them that Walmart de Mexico routinely resorted to bribery, citing the altered zoning map as just one example. Alarmed, executives at Walmart started their own investigation. Faced with growing evidence of corruption in Mexico, top Walmart executives decided to engage in damage control, rather than coming clean. Walmart's top lawyer shipped the case files back to Mexico and handed over responsibility for the investigation to the general council of Walmart de Mexico. This was an interesting choice as the very same general council was alleged to have authorized bribes. The general council quickly exonerated fellow Mexican executives, and the internal investigation was closed in 2006.

For several years nothing more happened; then, in April 2012, *The New York Times* published an article detailing bribery by Walmart. The *Times* cited the changed zoning map and several other examples of bribery by Walmart: for example, eight bribes totaling $341,000 enabled Walmart to build a Sam's Club in one of Mexico City's most densely populated neighborhoods without a construction license, an environmental permit, an urban impact assessment, or even a traffic permit. Similarly, thanks to nine bribe payments totaling $765,000, Walmart built a vast refrigerated distribution center in an environmentally fragile flood basin north of Mexico City, in an area where electricity was so scarce that many smaller developers were turned away.

Walmart responded to *The New York Times* article by ramping up a second internal investigation into bribery that it had initiated in 2011. By mid-2015, there were reportedly more than 300 outside lawyers working on the investigation, and it had cost more than $612 million in fees. In addition, the U.S. Department of Justice and the Securities and Exchange Commission both announced that they had started investigations into Walmart's practices. In November 2012, Walmart reported that its own investigation into violations had extended beyond Mexico to include China and India. Among other things, it was looking into the allegations by the *Times* that top executives at Walmart, including former CEO Lee Scott Jr., had deliberately squashed earlier investigations. In late 2016 people familiar with the matter stated that the federal investigation had not uncovered evidence of widespread bribery. In November 2017 it was reported that Walmart had settled with the Justice Department and paid a $283 million fine, significantly less than had been expected.

Sources: David Barstow, "Vast Mexican Bribery Case Hushed Up by Wal-Mart after Top Level Struggle," *The New York Times*, April 21, 2012; Stephanie Clifford and David Barstow, "Wal-Mart Inquiry Reflects Alarm on Corruption," *The New York Times*, November 15, 2012; Nathan Vardi, "Why Justice Department Could Hit Wal-Mart Hard over Mexican Bribery Allegations," *Forbes*, April 22, 2012; Phil Wahba,"Walmart Bribery Probe by Feds Finds No Major Misconduct in Mexico," *Fortune*, October 18, 2015; T. Schoenberg and M. Robinson, "Wal-Mart Balks at Paying $600 Million in Bribery Case," *Bloomberg*, October 6, 2016; and Sue Reisinger, "Wal-Mart Reserves $283 million to Settle Mexico FCPA Case," *Corporate Counsel*, November 17, 2017.

including most Western economies (but not Russia, India or China), adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.[20] The convention obliges member states to make the bribery of foreign public officials a criminal offense.

Both the U.S. law and OECD convention include language that allows exceptions known as facilitating or expediting payments (also called *grease payments* or *speed money*), the purpose of which is to expedite or to secure the performance of a routine governmental action.[21] For example, they allow small payments made to speed up the issuance of permits or licenses, process paperwork, or just get vegetables off the dock and on their way to market. The explanation for this exception to general antibribery provisions is that while grease payments are, technically, bribes, they are distinguishable from (and, apparently, less offensive than) bribes used to obtain or maintain business because they merely facilitate performance of duties that the recipients are already obligated to perform.

Did You Know?
Did you know that it's illegal for Americans to bribe public officials to gain business in a foreign country, even if bribery is commonplace in that nation?

Visit your instructor's Connect® course and click on your eBook or SmartBook® to view a short video explanation from the authors.

THE PROTECTION OF INTELLECTUAL PROPERTY **Intellectual property** refers to property that is the product of intellectual activity, such as computer software, a screenplay, a music score, or the chemical formula for a new drug. Patents, copyrights, and trademarks establish ownership rights over intellectual property. A **patent** grants the inventor of a new product or process exclusive rights for a defined period to the manufacture, use, or sale of

intellectual property
Products of the mind, ideas (e.g., books, music, computer software, designs, technological know-how); intellectual property can be protected by patents, copyrights, and trademarks.

patent
Grants the inventor of a new product or process exclusive rights to the manufacture, use, or sale of that invention.

copyrights
The exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit.

trademarks
The designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products.

that invention. **Copyrights** are the exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit. **Trademarks** are designs and names, officially registered, by which merchants or manufacturers designate and differentiate their products (e.g., Christian Dior clothes). In the high-technology "knowledge" economy of the twenty-first century, intellectual property has become an increasingly important source of economic value for businesses. Protecting intellectual property has also become increasingly problematic, particularly if it can be rendered in a digital form and then copied and distributed at very low cost via pirated DVDs or over the Internet (e.g., computer software, music, and video recordings).[22]

The philosophy behind intellectual property laws is to reward the originator of a new invention, book, musical record, clothes design, restaurant chain, and the like for his or her idea and effort. Such laws stimulate innovation and creative work. They provide an incentive for people to search for novel ways of doing things, and they reward creativity. For example, consider innovation in the pharmaceutical industry. A patent will grant the inventor of a new drug a 20-year monopoly in production of that drug. This gives pharmaceutical firms an incentive to undertake the expensive, difficult, and time-consuming basic research required to generate new drugs (it can cost $1 billion in R&D and take 12 years to get a new drug on the market). Without the guarantees provided by patents, companies would be unlikely to commit themselves to extensive basic research.[23]

World Intellectual Property Organization
An international organization whose members sign treaties to agree to protect intellectual property.

Paris Convention for the Protection of Industrial Property
International agreement to protect intellectual property.

The protection of intellectual property rights differs greatly from country to country. Although many countries have stringent intellectual property regulations on their books, the enforcement of these regulations has often been lax. This has been the case even among many of the 185 countries that are now members of the **World Intellectual Property Organization**, all of which have signed international treaties designed to protect intellectual property, including the oldest such treaty, the **Paris Convention for the Protection of Industrial Property**, which dates to 1883 and has been signed by more than 170 nations. Weak enforcement encourages the piracy (theft) of intellectual property. China and Thailand have often been among the worst offenders in Asia. Pirated computer software is widely available in China. Similarly, the streets of Bangkok, Thailand's capital, are lined with stands selling pirated copies of Rolex watches, Levi's jeans, DVDs, and computer software.

The computer software industry is an example of an industry that suffers from lax enforcement of intellectual property rights. A study published in 2012 suggested that violations of intellectual property rights cost personal computer software firms revenues equal to $63 billion a year.[24] According to the study's sponsor, the Business Software Alliance, a software industry association, some 42 percent of all software applications used in the world were pirated. One of the worst large countries was China, where the piracy rate ran at 77 percent and cost the industry more than $9.8 billion in lost sales, up from $444 million in 1995. The piracy rate in the United States was much lower at 19 percent; however, the value of sales lost was significant because of the size of the U.S. market.[25]

How Important Are Intellectual Property Rights?

Burundi is a landlocked country in the Great Lake region of eastern Africa. Neighboring countries include Rwanda, Tanzania, and the Democratic Republic of the Congo. Burundi is hilly and mountainous, with access to Lake Tanganyika. The government system is a republic, with the chief of state and head of government being the president. Burundi has a traditional economic system in which the allocation of available resources is made on the basis of primitive methods, and many citizens engage in subsistence agriculture. At the same time, Burundi was last of the 131 countries ranked in the 2013 International Property Rights Index (IPRI). The IPRI is conducted by a partnership of 74 international organizations. The IPRI takes into account legal and political environment, physical property rights, and intellectual property rights. How much should companies focus on intellectual property rights in deciding where to (1) produce their products and (2) sell their products? Does it differ if you produce or sell in the country?

Source: www.internationalpropertyrightsindex.org.

International businesses have a number of possible responses to violations of their intellectual property. They can lobby their respective governments to push for international agreements to ensure that intellectual property rights are protected and that the law is enforced. Partly as a result of such actions, international laws are being strengthened. As we shall see in Chapter 7, the most recent world trade agreement, signed in 1994, for the first time extends the scope of the General Agreement on Tariffs and Trade to cover intellectual property. Under the new agreement, known as the Trade-Related Aspects of Intellectual Property Rights (TRIPS), as of 1995 a council of the World Trade Organization is overseeing enforcement of much stricter intellectual property regulations. These regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years after the death

management FOCUS

Starbucks Wins Key Trademark Case in China

Starbucks has big plans for China. It believes the fast-growing nation will become the company's second-largest market after the United States. Starbucks entered the country in 1999, and by the end of 2016 it had opened more than 1,300 stores. But in China, copycats of well-established Western brands are common. Starbucks faced competition from a look-alike, Shanghai Xing Ba Ke Coffee Shop, whose stores closely matched the Starbucks format, right down to a green-and-white Xing Ba Ke circular logo that mimics Starbucks' ubiquitous logo. The name also mimics the standard Chinese translation for Starbucks. *Xing* means "star," and *Ba Ke* sounds like "bucks."

In 2003, Starbucks decided to sue Xing Ba Ke in Chinese court for trademark violations. Xing Ba Ke's general manager responded by claiming it was just an accident that the logo and name were so similar to that of Starbucks. He claimed the right to use the logo and name because Xing Ba Ke had registered as a company in Shanghai in 1999, before Starbucks entered the city. "I hadn't heard of Starbucks at the time," claimed the manager, "so how could I imitate its brand and logo?"

However, in January 2006, a Shanghai court ruled that Starbucks had precedence, in part because it had registered its Chinese name in 1998. The court stated that Xing Ba Ke's use of the name and similar logo was "clearly malicious" and constituted improper competition. The court ordered Xing Ba Ke to stop using the name and to pay Starbucks $62,000 in compensation. While the money involved here may be small, the precedent is not. In a country where violation of trademarks has been common, the courts seem to be signaling a shift toward greater protection of intellectual property rights. This is perhaps not surprising because foreign governments and the World Trade Organization have been pushing China hard recently to start respecting intellectual property rights.

Sources: M. Dickie, "Starbucks Wins Case against Chinese Copycat," *Financial Times*, January 3, 2006, p. 1; "Starbucks: Chinese Court Backs Company over Trademark Infringement," *The Wall Street Journal*, January 2, 2006, p. A11; and "Starbucks Calls China Its Top Growth Focus," *The Wall Street Journal*, February 14, 2006, p. 1.

of the author. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years of grace, and the very poorest have 10 years.[26] (For further details of the TRIPS agreement, see Chapter 7.)

In addition to lobbying governments, firms can file lawsuits on their own behalf. For example, Starbucks won a landmark trademark copyright case in China against a copycat that signaled a change in the approach in China (see the accompanying Management Focus for details). Firms may also choose to stay out of countries where intellectual property laws are lax, rather than risk having their ideas stolen by local entrepreneurs. Firms also need to be on the alert to ensure that pirated copies of their products produced in countries with weak intellectual property laws don't turn up in their home market or in third countries. U.S. computer software giant Microsoft, for example, discovered that pirated Microsoft software, produced illegally in Thailand, was being sold worldwide as the real thing.

PRODUCT SAFETY AND PRODUCT LIABILITY **Product safety laws** set certain safety standards to which a product must adhere. **Product liability** involves holding a firm and its officers responsible when a product causes injury, death, or damage. Product liability can be much greater if a product does not conform to required safety standards. Both civil and criminal product liability laws exist. Civil laws call for payment and monetary damages. Criminal liability laws result in fines or imprisonment. Both civil and criminal liability laws are probably more extensive in the United States than in any other country, although many other Western nations also have comprehensive liability laws. Liability laws are typically the least extensive in less developed nations. A boom in product liability suits and awards in the United States resulted in a dramatic increase in the cost of liability insurance. Many business executives argue that the high costs of liability insurance make American businesses less competitive in the global marketplace.

product safety laws
Set certain safety standards to which a product must adhere.

product liability
Involves holding a firm and its officers responsible when a product causes injury, death, or damage.

In addition to the competitiveness issue, country differences in product safety and liability laws raise an important ethical issue for firms doing business abroad. When product safety laws are tougher in a firm's home country than in a foreign country or when liability laws are more lax, should a firm doing business in that foreign country follow the more relaxed local standards or should it adhere to the standards of its home country? While the ethical thing to do is undoubtedly to adhere to home-country standards, firms have been known to take advantage of lax safety and liability laws to do business in a manner that would not be allowed at home.

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Focus on Managerial Implications

LO 2-4
Explain the implications for management practice of national differences in political economy.

THE MACRO ENVIRONMENT INFLUENCES MARKET ATTRACTIVENESS The material discussed in this chapter has two broad implications for international business. First, the political, economic, and legal systems of a country raise important ethical issues that have implications for the practice of international business. For example, what ethical implications are associated with doing business in totalitarian countries where citizens are denied basic human rights, corruption is rampant, and bribes are necessary to gain permission to do business? Is it right to operate in such a setting? A full discussion of the ethical implications of country differences in political economy is reserved for Chapter 5, where we explore ethics in international business in much greater depth.

Second, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. The benefits, costs, and risks associated with doing business in a country are a function of that country's political, economic, and legal systems. The overall attractiveness of a country as a market or investment site depends on balancing the likely long-term benefits of doing business in that country against the likely costs and risks. Because this chapter is the first of two dealing with issues of political economy, we will delay a detailed discussion of how political economy impacts the benefits, costs, and risks of doing business in different nation-states until the end of the next chapter, when we have a full grasp of all the relevant variables that are important for assessing benefits, costs, and risks.

For now, other things being equal, a nation with democratic political institutions, a market-based economic system, and strong legal system that protects property rights and limits corruption is clearly more attractive as a place in which to do business than a nation that lacks democratic institutions, where economic activity is heavily regulated by the state, and where corruption is rampant and the rule of law is not respected. On this basis, for example, a country like Canada is a better place in which to do business than the Russia of Vladimir Putin (see the Country Focus: Putin's Russia). That being said, the reality is often more nuanced and complex. For example, China lacks democratic institutions; corruption is widespread; property rights are not always respected; and even though the country has embraced many market-based economic reforms, there are still large numbers of state-owned enterprises—yet many Western businesses feel that they must invest in China. They do so despite the risks because the market is large, the nation is moving toward a market-based system, economic growth has been strong (although it faltered in 2015–2016), legal protection of property rights has been improving, and China is already the second largest economy in the world and could ultimately replace the United States as the world's largest. Thus, China is becoming increasingly attractive as a place in which to do business, and given the future growth trajectory, significant opportunities may be lost by not investing in the country. We will explore how changes in political economy affect the attractiveness of a nation as a place in which to do business in Chapter 3.

Key Terms

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political system, p. 39
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communists, p. 39
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