

Brazil's Struggling Economy

opening case

Between 2000 and 2012, Brazil had one of the fastest growing economies in the world, expanding by over 5 percent per year. In 2012, the Brazilian economy temporarily surpassed that of the United Kingdom, making it the world's sixth largest economy. However, since then Brazil has been beset by a deep economic malaise. Economic growth decelerated in 2013. The economy entered into a serious recession in 2014. Economic activity contracted by over 3.5 percent in both 2015 and 2016 before growing by a sluggish 0.7 percent in 2017.

Brazil's economic problems were partly due to a fall in global commodity prices—Brazil is a major exporter of coffee, soybeans, and iron ore—but the country has other deep structural problems. Under the leadership of President Dilma Rousseff and her left of center Workers' Party, between 2011 and 2014 the government spent extravagantly and unwisely on higher pensions and unproductive tax breaks for favored industries. When the recession hit, unemployment surged to over 12 percent and tax revenues slumped. As a result of higher outlays and lower tax revenues, the fiscal deficit swelled from 2 percent of GDP in 2010 to 10 percent in 2015. This pushed up total government debt to 70 percent of GDP and required higher interest rates to sell government bonds, which were seen as increasingly risky. The government also raised interest rates to keep inflation in check, which historically has been a problem in Brazil. Because of high interest rates, the cost of servicing government debt expanded to 7 percent of GDP—and of course, higher interest rates, by raising borrowing costs for consumers and businesses, further depressed economic activity.

Given high interest rates, the only way for the government to get the fiscal deficit under control is to cut spending and raise taxes. This has not been easy to do. A central problem in Brazil is the country's pension obligations. The pension system entitles Brazilians to retire, on average, at just 54. Pension obligations already account for 13 percent of GDP. Without reform, that figure could balloon to 25 percent by mid-century as the population ages.

In addition, tariff barriers protecting inefficient local enterprises from foreign competition, labor laws, and burdensome tax laws have long been seen as a drag on the Brazilian economy. A typical manufacturing firm spends 2,600 hours a year complying with the country's complex tax code; the Latin American average is 356 hours. Labor laws make it expensive to fire even incompetent workers. And protection from international competition has resulted in manufacturing productivity that is low by international standards. To compound matters, the country has been beset by a massive corruption scandal that has reached into the highest levels of government. This resulted in the impeachment of Rousseff in 2016 and further damaged confidence in the economy (see the Country Focus "Corruption in Brazil" in Chapter 2).

In 2016, Michel Temer replaced Rousseff as President. He made a promising start to reforming the economy. Public spending has been frozen in real terms for the next twenty years. He also overhauled

continued

the country's labor laws, making it much easier to fire unproductive workers. Inflation has moderated significantly and global economic recovery, together with a rise in commodity prices, has helped increase exports. This has allowed the central bank to reduce interest rates to 6.75 percent (they were as high as 12 percent), further boosting economic growth. There has also been a rash of privatizations—including that of the leading electric utility, Eletrobras—as the government seeks to raise capital by selling state assets and tries to increase the efficiency of the economy. As a consequence of such actions, in 2018 the International Monetary Fund (IMF) forecasts that the Brazilian economy will grow by close to 2 percent.

What remains is to fix the country's pension problems. At a minimum, this will require raising the retirement age significantly. Temer is running up against strong resistance. His initial proposals failed to garner enough votes in the Brazilian congress to change the law on pensions. Unless these can be changed, government debt will continue to grow as the population ages, and Brazil could fall back into a crisis. ●

Sources: Denise Crispim Marin, "Brazil's Half Glass Economy," *Global Finance*, October 3, 2017; "Michel Temer Is Trying to Fix Brazil's Pension Systems," *The Economist*, February 15, 2018; "Will Brazil's Future Arrive?" *The Economist*, August 17, 2017; and "Brazil's Fall," *The Economist*, January 2, 2016.

Introduction

In Chapter 2, we described how countries differ with regard to their political systems, economic systems, and legal systems. In this chapter, we build on this material to explain how these differences influence the level of economic development of a nation and, thus, how attractive it is as a place for doing business. We also look at how economic, political, and legal systems are changing around the world and what the implications of this are for the future rate of economic development of nations and regions. The past three decades have seen a general move toward more democratic forms of government, market-based economic reforms, and adoption of legal systems that better enforce property rights. Taken together, these trends have helped foster greater economic development around the world and have created a more favorable environment for international business. In the final section of this chapter, we pull all this material together to explore how differences in political, economic, and legal institutions affect the benefits, costs, and risks of doing business in different nations.

The opening case, which looks at the state of the Brazilian economy, highlights some of the issues that we will discuss in this chapter. Brazil is one of the world's largest emerging economies (together with China and India). This nation of 210 million people enjoyed strong economic growth from 2000 to 2012 due to market-based reforms and strong export growth, making it an attractive location for international business. Since then, however, the economy has stalled. The reasons include poor economic management by the government of Dilma Rousseff, corruption scandals that sapped confidence in the economy, trade barriers that protected inefficient local enterprises from foreign competition, labor laws that made it difficult to remove unproductive employees, and pension obligations that, if left unreformed, could result in higher tax rates and slower economic growth down the road. Fixing the economy and unleashing Brazil's considerable potential requires economic reforms, and while progress has been made in key areas, significant structural problems still remain, particularly with regard to pension obligations and trade barriers. Unless these structural problems are fixed by the government, they will negatively impact economic growth in Brazil, and reduce the attractiveness of the country going forward as a location for investment by international businesses.

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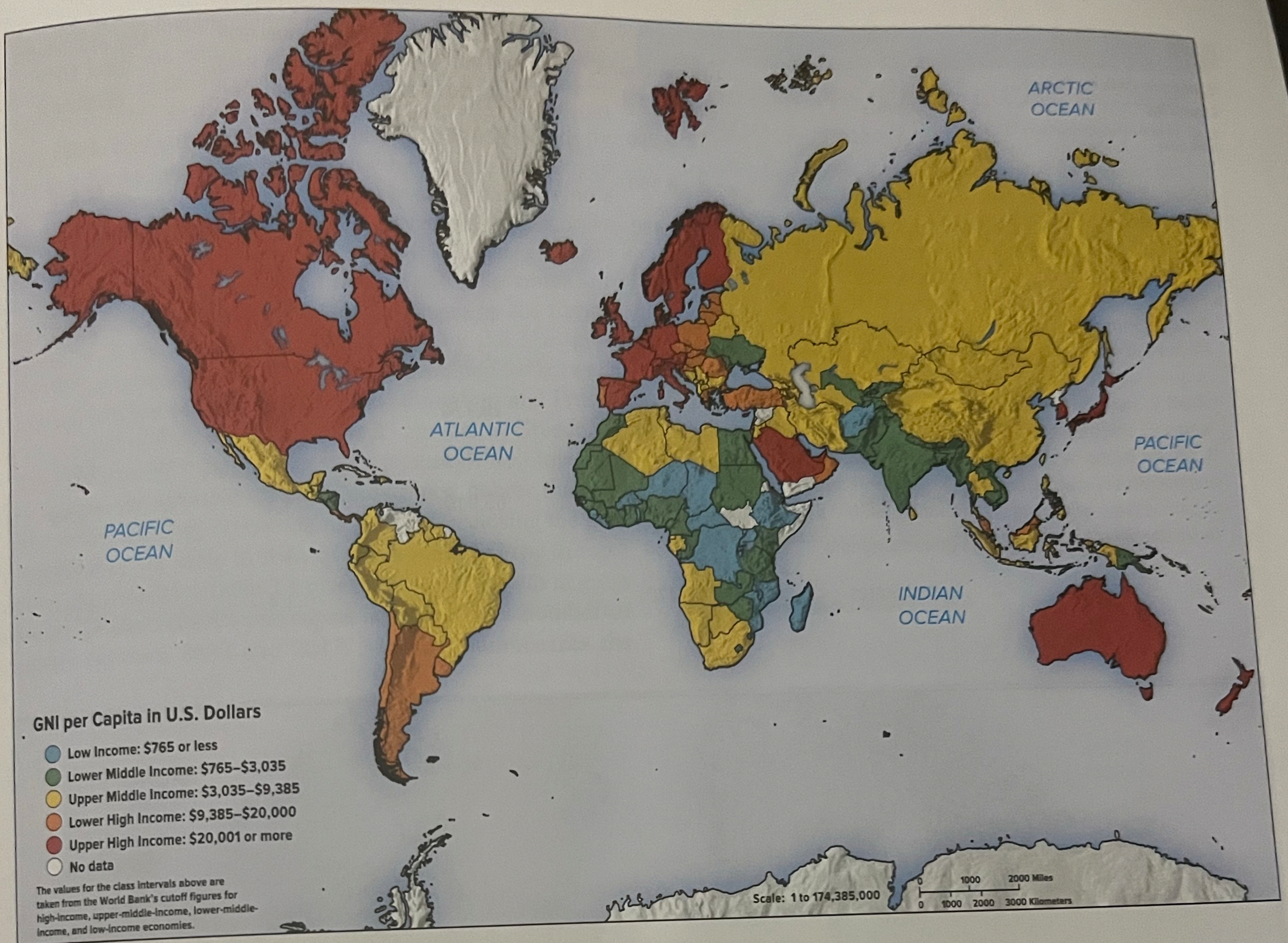
Explain what determines the level of economic development of a nation.

gross national income (GNI)

Measures the total annual income received by residents of a nation.

Differences in Economic Development

Different countries have dramatically different levels of economic development. One common measure of economic development is a country's **gross national income (GNI)** per head of population. GNI is regarded as a yardstick for the economic activity of a country; it measures the total annual income received by residents of a nation. Map 3.1 summarizes the GNI per capita of the world's nations in 2017. As can be seen, countries such as Japan, Sweden, Switzerland, the United States, and Australia are among the richest on this measure, whereas the large developing countries of China and India are significantly poorer. Japan, for example, had a 2017 GNI per capita of \$38,550, but China achieved only \$8,690 and India just \$1,820.¹



3.1 MAP

GNI per capita, 2017.

GNI per person figures can be misleading because they don't consider differences in the cost of living. For example, although the 2017 GNI per capita of Switzerland at \$80,560 exceeded that of the United States by a wide margin, the higher cost of living in Switzerland meant that U.S. citizens could actually afford almost as many goods and services as the average Swiss citizen. To account for differences in the cost of living, one can adjust GNI per capita by purchasing power. Referred to as a **purchasing power parity (PPP)** adjustment, it allows a more direct comparison of living standards in different countries. The base for the adjustment is the cost of living in the United States. The PPP for different countries is then adjusted (up or down) depending on whether the cost of living is lower or higher than in the United States. For example, in 2017 the GNI per capita for China was \$8,690, but the PPP per capita was \$15,500, suggesting that the cost of living was lower in China and that \$8,260 in China would buy as much as \$16,760 in the United States. Table 3.1 gives the GNI per capita measured at PPP in 2017 for a selection of countries, along with their GNI per capita and their growth rate in gross domestic product (GDP) from 2008 to 2017. Map 3.2 summarizes the GNI PPP per capita in 2017 for the nations of the world.

As can be seen, there are striking differences in the standards of living among countries. Table 3.1 suggests the average Indian citizen can afford to consume only about 12 percent of the goods and services consumed by the average U.S. citizen on a PPP basis. Given this, we might conclude that despite having a population of 1.2 billion, India is unlikely to be a very lucrative market for the consumer products produced by many Western international businesses. However, this would be incorrect because India has a fairly wealthy middle class of close to 250 million people, despite its large number of poor citizens. In absolute terms, the Indian economy now rivals that of Russia.

purchasing power parity (PPP)

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

Did You Know?

Did you know that the United States has an economy that is 70 percent larger than that of China and has four times the standard of living?

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3.1 TABLE

Economic Data for Select Countries

Source: World Development Indicators Online, 2018.

Country	GNI per Capita, 2017 (\$)	GNI PPP per Capita, 2017 (\$)	Annual GDP Growth Rate, 2008–2017 (%)	Size of Economy GDP, 2017 (\$ billions)
Brazil	\$ 8,580	\$15,160	1.6	\$ 2,055
China	8,690	16,760	8.3	12,238
Germany	43,490	51,760	1.2	3,677
India	1,820	7,060	7.0	2,597
Japan	38,550	45,470	0.5	4,872
Nigeria	2,080	5,680	4.4	376
Poland	12,710	28,170	3.3	525
Russia	9,232	24,893	1.2	1,577
Switzerland	80,560	65,910	1.4	679
United Kingdom	40,530	43,160	1.1	2,622
United States	58,270	60,200	1.4	19,391



3.2 MAP

GNI PPP per capita, 2017.

Size of Economy GDP, 2017 (\$ billions)
\$ 2,055
12,238
3,677
2,597
4,872
376
525
1,577
679
2,622
19,391

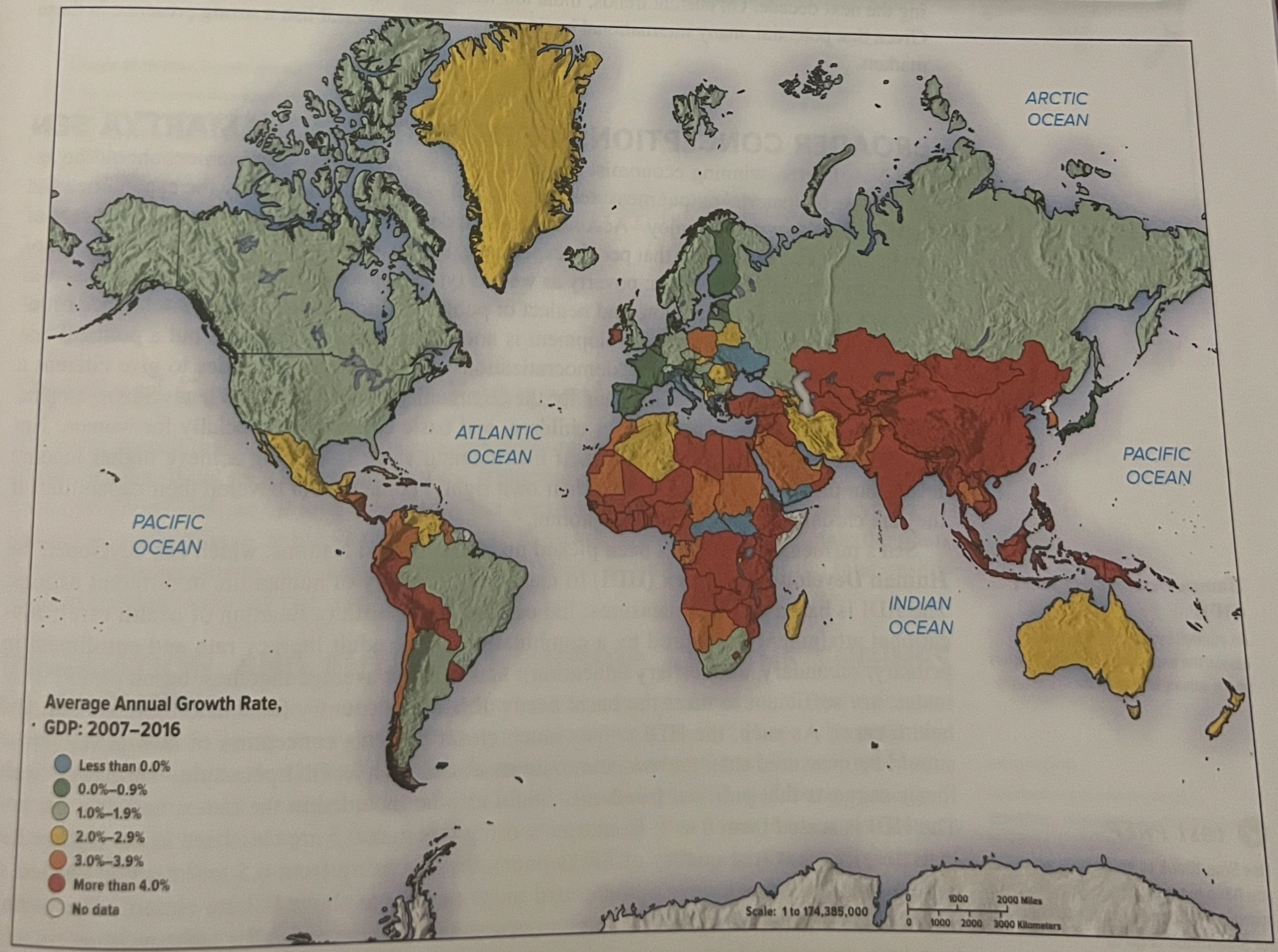
To complicate matters, in many countries the “official” figures do not tell the entire story. Large amounts of economic activity may be in the form of unrecorded cash transactions or barter agreements. People engage in such transactions to avoid paying taxes, and although the share of total economic activity accounted for by such transactions may be small in developed economies such as the United States, in some countries (India being an example), they are reportedly very significant. Known as the *black economy* or *shadow economy*, estimates suggest that in India it may be around 50 percent of GDP, which implies that the Indian economy is half as big again as the figures reported in Table 3.1. Estimates produced by the European Union suggest that the shadow economy accounted for between 10 and 12 percent of GDP in the United Kingdom and France but 21 percent in Italy and as much as 23 percent in Greece.²

The GNI and PPP data give a static picture of development. They tell us, for example, that China is much poorer than the United States, but they do not tell us if China is closing the gap. To assess this, we have to look at the economic growth rates achieved by countries. Table 3.1 gives the rate of growth in gross domestic product (GDP) per capita achieved by a number of countries between 2008 and 2017. Map 3.3 summarizes the

What If We Were a Community of 100 People?

The “Miniature Earth” project was developed by Allysson Luca in 2001 as a way to better illustrate and create understanding of differences in the world. He thought that reducing the world’s population to a community of only 100 people would be a useful and easy-to-understand illustration of various dynamics in the global marketplace. And this Miniature Earth captures a variety of issues related to the political economy and economic development that are discussed in this chapter. At the basic level, if the earth were a community of 100 people, 61 people would be Asian, 13 African, 12 European, 8 North American, 5 South American, and 1 would be from Oceania. Twenty people would own 75 percent of the financial wealth. If you could decide, how would you redistribute wealth among the 100 people? Make some richer, make the wealth among people more even, or let market forces distribute wealth as we have it now?

Source: www.miniature-earth.com.



3.3 MAP

Average annual growth rate in GDP (%), 2008–2017.

The “Country Comparator” tool on globalEDGE™ (globaledge.msu.edu/comparator) includes data from as early as 1960 to the most recent year. Using this tool, it is easy to compare countries across a variety of macro variables to better understand the economic changes occurring in countries. As related to Chapter 3, the globalEDGE™ Country Comparator tool is an effective way to statistically get an overview of the political economy and economic development by country worldwide.

Comparisons of up to 20 countries at a time can be made in table format. Sometimes we talk about the BRIC countries when referring to Brazil, Russia, India, and China—in essence, we broadly classify them as “superstar” emerging markets, but are they really that similar? Using the Country Comparator tool on globalEDGE, we find that the GDP adjusted for purchasing power parity is by far the greatest in Russia. Where do you think Brazil, India, and China fall on the GDP PPP scale?

annual average percentage growth rate in GDP from 2008 to 2017. Although countries such as China and India are currently relatively poor, their economies are already large in absolute terms and growing far more rapidly than those of many advanced nations. They are already huge markets for the products of international businesses. In 2010, China overtook Japan to become the second-largest economy in the world after the United States. Indeed, if both China and the United States maintain their current economic growth rates, China will become the world’s largest economy sometime during the next decade. On current trends, India too will be among the largest economies in the world. Given that potential, many international businesses are trying to establish a strong presence in these markets.

BROADER CONCEPTIONS OF DEVELOPMENT: AMARTYA SEN

The Nobel Prize–winning economist Amartya Sen has argued that development should be assessed less by material output measures such as GNI per capita and more by the capabilities and opportunities that people enjoy.³ According to Sen, development should be seen as a process of expanding the real freedoms that people experience. Hence, development requires the removal of major impediments to freedom: poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, and neglect of public facilities as well as the intolerance of repressive states. In Sen’s view, development is not just an economic process but a political one too, and to succeed requires the “democratization” of political communities to give citizens a voice in the important decisions made for the community. This perspective leads Sen to emphasize basic health care, especially for children, and basic education, especially for women. Not only are these factors desirable for their instrumental value in helping achieve higher income levels, but they are also beneficial in their own right. People cannot develop their capabilities if they are chronically ill or woefully ignorant.

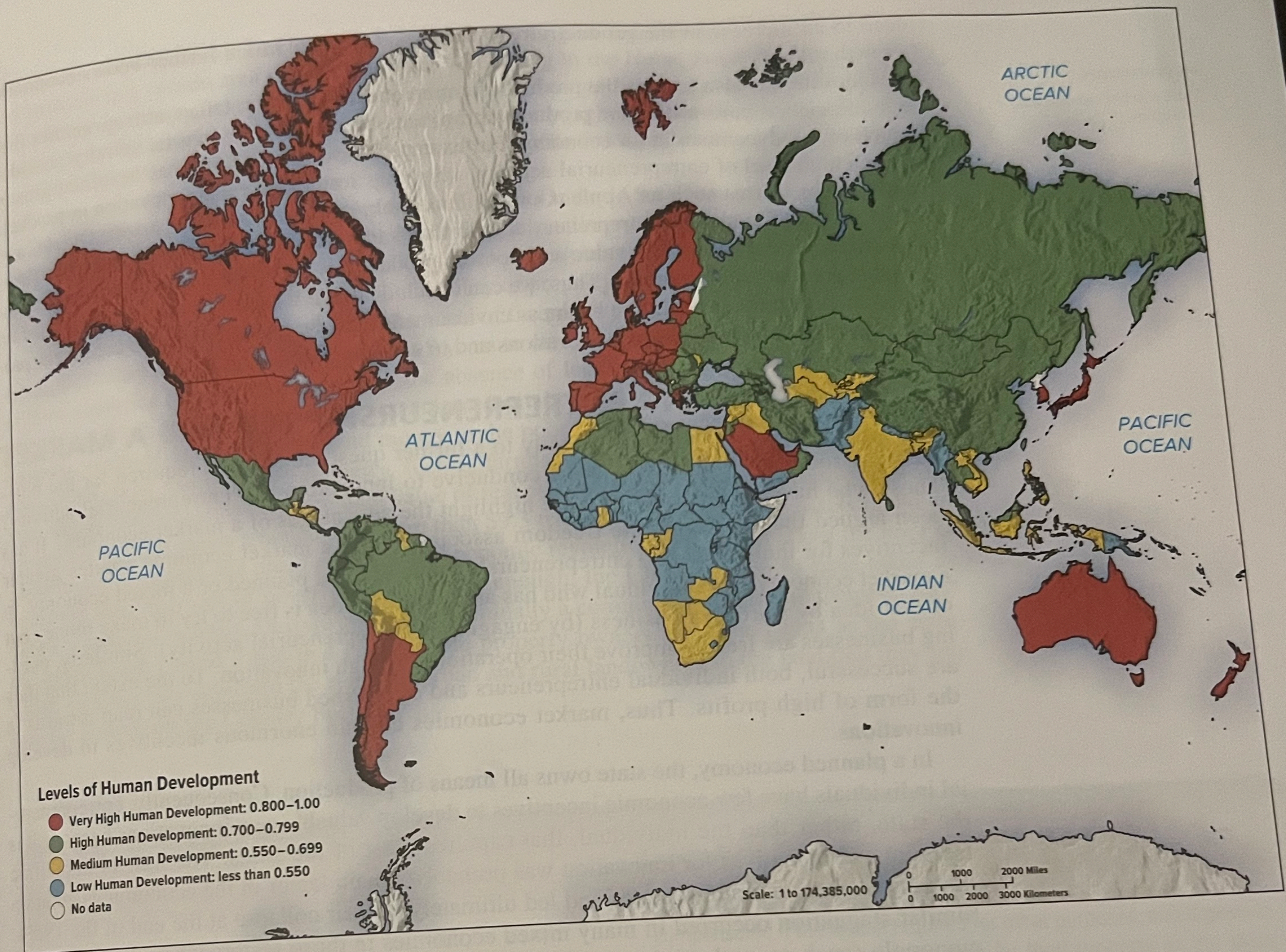
Sen’s influential thesis has been picked up by the United Nations, which has developed the **Human Development Index (HDI)** to measure the quality of human life in different nations. The HDI is based on three measures: life expectancy at birth (a function of health care); educational attainment (measured by a combination of the adult literacy rate and enrollment in primary, secondary, and tertiary education); and whether average incomes, based on PPP estimates, are sufficient to meet the basic needs of life in a country (adequate food, shelter, and health care). As such, the HDI comes much closer to Sen’s conception of how development should be measured than narrow economic measures such as GNI per capita—although Sen’s thesis suggests that political freedoms should also be included in the index, and they are not. The HDI is scaled from 0 to 1. Countries scoring less than 0.5 are classified as having low human development (the quality of life is poor), those scoring from 0.5 to 0.8 are classified as having medium human development, and those that score above 0.8 are classified as having high human development. Map 3.4 summarizes the HDI scores for 2015, the most recent year for which data is available.

Human Development Index (HDI)

An attempt by the United Nations to assess the impact of a number of factors on the quality of human life in a country.

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3.4 MAP

Human Development Index, 2015.

Political Economy and Economic Progress

It is often argued that a country's economic development is a function of its economic and political systems. What then is the nature of the relationship between political economy and economic progress? Despite the long debate over this question among academics and policymakers, it is not possible to give an unambiguous answer. However, it is possible to untangle the main threads of the arguments and make a few generalizations as to the nature of the relationship between political economy and economic progress.

INNOVATION AND ENTREPRENEURSHIP ARE THE ENGINES OF GROWTH

There is substantial agreement among economists that innovation and entrepreneurial activity are the engines of long-run economic growth.⁴ Those who make this argument define **innovation** broadly to include not just new products, but also new processes, new organizations, new management practices, and new strategies. Thus, Uber's strategy of letting riders hail a cab using a smartphone application can be seen as an innovation because it was the first company to pursue this strategy in its industry. Similarly, the development of mass-market online retailing by Amazon.com can be seen as an innovation. Innovation and entrepreneurial activity help increase economic activity by creating new products and markets that did not previously exist. Moreover, innovations in production and business processes

innovation

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

entrepreneurs

Those who first commercialize innovations.

lead to an increase in the productivity of labor and capital, which further boosts economic growth rates.⁵

Innovation is also seen as the product of entrepreneurial activity. Often, **entrepreneurs** first commercialize innovative new products and processes, and entrepreneurial activity provides much of the dynamism in an economy. For example, the U.S. economy has benefited greatly from a high level of entrepreneurial activity, which has resulted in rapid innovation in products and process. Firms such as Apple, Google, Facebook, Amazon, Dell, Microsoft, Oracle, and Uber were all founded by entrepreneurial individuals to exploit new technology. All these firms created significant economic value and boosted productivity by helping commercialize innovations in products and processes. Thus, we can conclude that if a country's economy is to sustain long-run economic growth, the business environment must be conducive to the consistent production of product and process innovations and to entrepreneurial activity.

INNOVATION AND ENTREPRENEURSHIP REQUIRE A MARKET ECONOMY

This leads logically to a further question: What is required for the business environment of a country to be conducive to innovation and entrepreneurial activity? Those who have considered this issue highlight the advantages of a market economy.⁶ It has been argued that the economic freedom associated with a market economy creates greater incentives for innovation and entrepreneurship than either a planned or a mixed economy. In a market economy, any individual who has an innovative idea is free to try to make money out of that idea by starting a business (by engaging in entrepreneurial activity). Similarly, existing businesses are free to improve their operations through innovation. To the extent that they are successful, both individual entrepreneurs and established businesses can reap rewards in the form of high profits. Thus, market economies contain enormous incentives to develop innovations.

In a planned economy, the state owns all means of production. Consequently, entrepreneurial individuals have few economic incentives to develop valuable new innovations because it is the state, rather than the individual, that captures most of the gains. The lack of economic freedom and incentives for innovation was probably a main factor in the economic stagnation of many former communist states and led ultimately to their collapse at the end of the 1980s. Similar stagnation occurred in many mixed economies in those sectors where the state had a monopoly (such as coal mining and telecommunications in Great Britain). This stagnation provided the impetus for the widespread privatization of state-owned enterprises that we witnessed in many mixed economies during the mid-1980s and that is still going on today (*privatization* refers to the process of selling state-owned enterprises to private investors; see Chapter 2 for details).

A study of 102 countries over a 20-year period provided evidence of a strong relationship between economic freedom (as provided by a market economy) and economic growth.⁷ The study found that the more economic freedom a country had between 1975 and 1995, the more economic growth it achieved and the richer its citizens became. The six countries that had persistently high ratings of economic freedom from 1975 to 1995 (Hong Kong, Switzerland, Singapore, the United States, Canada, and Germany) were also all in the top 10 in terms of economic growth rates. In contrast, no country with persistently low economic freedom achieved a respectable growth rate. In the 16 countries for which the index of economic freedom declined the most during 1975 to 1995, gross domestic product fell at an annual rate of 0.6 percent. Other studies have reached broadly similar conclusions.

INNOVATION AND ENTREPRENEURSHIP REQUIRE STRONG PROPERTY RIGHTS

Strong legal protection of property rights is another requirement for a business environment to be conducive to innovation, entrepreneurial activity, and hence economic growth.⁸ Both individuals and businesses must be given the opportunity to profit from innovative ideas. Without strong property rights protection, businesses and individuals run the risk that the profits from their innovative efforts will be expropriated, either by criminal elements or by the state. The state can expropriate the profits from innovation through legal means, such as excessive taxation, or through illegal means, such as demands

from state bureaucrats for kickbacks in return for granting an individual or firm a license to do business in a certain area (i.e., corruption). According to the Nobel Prize-winning economist Douglass North, throughout history many governments have displayed a tendency to engage in such behavior.⁹ Inadequately enforced property rights reduce the incentives for innovation and entrepreneurial activity—because the profits from such activity are “stolen”—and hence reduce the rate of economic growth.

The influential Peruvian development economist Hernando de Soto has argued that much of the developing world will fail to reap the benefits of capitalism until property rights are better defined and protected.¹⁰ De Soto’s arguments are interesting because he says the key problem is not the risk of expropriation but the chronic inability of property owners to establish legal title to the property they own. As an example of the scale of the problem, he cites the situation in Haiti, where individuals must take 176 steps over 19 years to own land legally. Because most property in poor countries is informally “owned,” the absence of legal proof of ownership means that property holders cannot convert their assets into capital, which could then be used to finance business ventures. Banks will not lend money to the poor to start businesses because the poor possess no proof that they own property, such as farmland, that can be used as collateral for a loan. By de Soto’s calculations, the total value of real estate held by the poor in third-world and former communist states amounted to more than \$9.3 trillion in 2000. If those assets could be converted into capital, the result could be an economic revolution that would allow the poor to bootstrap their way out of poverty. Interestingly enough, the Chinese seem to have taken de Soto’s arguments to heart. Despite still being nominally a communist country, in October 2007 the government passed a law that gave private property owners the same rights as the state, which significantly improved the rights of urban and rural landowners to the land that they use (see the accompanying Country Focus).

country FOCUS

Property Rights in China

On October 1, 2007, a new property law took effect in China, granting rural and urban landholders far more secure property rights. The law was a much-needed response to how China’s economy has changed over the past 30 years as it transitions from a centrally planned system to a more dynamic market-based economy where two-thirds of economic activity is in the hands of private enterprises.

Although all land in China still technically belongs to the state—an ideological necessity in a country where the government still claims to be guided by Marxism—urban landholders had been granted 40- to 70-year leases to use the land, while rural farmers had 30-year leases. However, the lack of legal title meant that landholders were at the whim of the state. Large-scale appropriation of rural land for housing and factory construction had rendered millions of farmers landless. Many were given little or no compensation, and they drifted to the cities where they added to a growing underclass. In both urban and rural areas, property and land disputes had become a leading cause of social unrest. According to government sources, in 2006 there were about 23,000 “mass incidents” of social unrest in China, many related to disputes over property rights.

The 2007 law, which was 14 years in gestation due to a rearguard action fought by left-wing Communist Party activists who objected to it on ideological grounds, gives urban and rural land users the right to automatic renewal of their leases after the expiration of the 30- to 70-year terms. In addition, the law requires that land users be fairly

compensated if the land is required for other purposes, and it gives individuals the same legal protection for their property as the state. Taken together with a 2004 change in China’s constitution, which stated that private property “was not to be encroached upon,” the new law significantly strengthens property rights in China.

Nevertheless, the law has its limitations; most notably, it still falls short of giving peasants marketable ownership rights to the land they farm. If they could sell their land, tens of millions of underemployed farmers might find more productive work elsewhere. Those who stayed could acquire bigger landholdings that could be used more efficiently. Also, farmers might be able to use their landholdings as security against which they could borrow funds for investments to boost productivity.

Recognizing such limitations, in 2016 the ruling Communist Party released a set of guidelines for further shoring up property rights protection, including better legal enforcement of property rights. There is no doubt that additional protection is needed. Chinese firms and residents have continued to suffer under poor property protections, facing eviction to make way for new developments and facing fierce competition as patents and copyrights are repeatedly violated. Whether these new guidelines will improve matters, however, remains to be seen.

Sources: “China’s Next Revolution—Property Rights in China,” *The Economist*, March 10, 2007, p. 11; “Caught between the Right and Left,” *The Economist*, March 10, 2007, pp. 25–27; Z. Keliang and L. Ping, “Rural Land Rights under the PRC Property Law,” *China Law and Practice*, November 2007, pp. 10–15; and Sara Hsu, “China Is Finally Improving Property Rights Protection,” *Forbes*, November 30, 2016.

THE REQUIRED POLITICAL SYSTEM Much debate surrounds which kind of political system best achieves a functioning market economy with strong protection for property rights.¹¹ People in the West tend to associate a representative democracy with a market economic system, strong property rights protection, and economic progress. Building on this, we tend to argue that democracy is good for growth. However, some totalitarian regimes have fostered a market economy and strong property rights protection and have experienced rapid economic growth. Five of the fastest-growing economies of the past 40 years—China, South Korea, Taiwan, Singapore, and Hong Kong—had one thing in common at the start of their economic growth: undemocratic governments. At the same time, countries with stable democratic governments, such as India, experienced sluggish economic growth for long periods. In 1992, Lee Kuan Yew, Singapore's leader for many years, told an audience, "I do not believe that democracy necessarily leads to development. I believe that a country needs to develop discipline more than democracy. The exuberance of democracy leads to undisciplined and disorderly conduct which is inimical to development."¹²

However, those who argue for the value of a totalitarian regime miss an important point: If dictators made countries rich, then much of Africa, Asia, and Latin America should have been growing rapidly during 1960 to 1990, and this was not the case. Only a totalitarian regime that is committed to a market system and strong protection of property rights is capable of promoting economic growth. Also, there is no guarantee that a dictatorship will continue to pursue such progressive policies. Dictators are rarely benevolent. Many are tempted to use the apparatus of the state to further their own private ends, violating property rights and stalling economic growth. Given this, it seems likely that democratic regimes are far more conducive to long-term economic growth than are dictatorships, even benevolent ones. Only in a well-functioning, mature democracy are property rights truly secure.¹³ Nor should we forget Amartya Sen's arguments reviewed earlier. Totalitarian states, by limiting human freedom, also suppress human development and therefore are detrimental to progress.

ECONOMIC PROGRESS BEGETS DEMOCRACY While it is possible to argue that democracy is not a necessary precondition for a market economy in which property rights are protected, subsequent economic growth often leads to establishment of a democratic regime. Several of the fastest-growing Asian economies adopted more democratic governments during the past three decades, including South Korea and Taiwan. Thus, although democracy may not always be the cause of initial economic progress, it seems to be one consequence of that progress.

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

GEOGRAPHY, EDUCATION, AND ECONOMIC DEVELOPMENT While a country's political and economic systems are probably the big engine driving its rate of economic development, other factors are also important. One that has received attention is geography.¹⁴ But the belief that geography can influence economic policy, and hence economic growth rates, goes back to Adam Smith. The influential economist Jeffrey Sachs argues that



Democracy in the Arab World: New Realities in an Ancient Land?

Democracy is finally making an appearance in the ancient lands of the Middle East, as witnessed by the recent uprisings known as the "The Arab Spring." Wissam Yafi, an expert in technology and international development, believes geo-economic, geosocial, technological, and geo-political forces will lead to inevitable changes in the Arab world. Economic forces will make these governments cut many of the social services offered, putting people out of work, which will lead toward democratic alternatives. Technology is another major binding force connecting populations across the Middle East, which will mean less censorship—something that has been widespread in many parts of the Arab world. People will continue to challenge the status quo as rapid urbanization, population growth, and movements toward self-determination grow. Wissam Yafi has a lot of guesses on what will happen. Do you agree with his forecasts?

Source: carnegieendowment.org.

throughout history, coastal states, with their long engagements in international trade, have been more supportive of market institutions than landlocked states, which have tended to organize themselves as hierarchical (and often militarised) societies. Mountainous states, as a result of physical isolation, have often neglected market-based trade. Temperate climates have generally supported higher densities of population and thus a more extensive division of labour than tropical regions.¹⁵

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

Education emerges as another important determinant of economic development (a point that Amartya Sen emphasizes). The general assertion is that nations that invest more in education will have higher growth rates because an educated population is a more productive population. Anecdotal comparisons suggest this is true. In 1960, Pakistanis and South Koreans were on equal footing economically. However, just 30 percent of Pakistani children were enrolled in primary schools, while 94 percent of South Koreans were. By the mid-1980s, South Korea's GNP per person was three times that of Pakistan.¹⁶ A survey of 14 statistical studies that looked at the relationship between a country's investment in education and its subsequent growth rates concluded investment in education did have a positive and statistically significant impact on a country's rate of economic growth.¹⁷ Similarly, the work by Sachs discussed earlier suggests that investments in education help explain why some countries in Southeast Asia, such as Indonesia, Malaysia, and Singapore, have been able to overcome the disadvantages associated with their tropical geography and grow far more rapidly than tropical nations in Africa and Latin America.

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States in Transition

The political economy of many of the world's nation-states has changed radically since the late 1980s. Three trends have been evident. First, during the late 1980s and early 1990s, a wave of democratic revolutions swept the world. Totalitarian governments fell and were replaced by democratically elected governments that were typically more committed to free market capitalism than their predecessors had been. Second, over the same period, there has been a move away from centrally planned and mixed economies and toward a more free market economic model. Third, and somewhat counter to the two prior trends, since 2012 there has been a shift back toward greater authoritarianism in some nations, and there are some signs that certain nations may be retreating from the free market model, particularly in the area of international trade where protectionism is on the rise again.

LO 3-2

Identify the macropolitical and macroeconomic changes occurring worldwide.

THE SPREAD OF DEMOCRACY One notable development of the last 30 years has been the spread of democracy (and, by extension, the decline of totalitarianism). Map 3.5 reports on the extent of totalitarianism in the world as determined by Freedom House.¹⁸ This map charts political freedom in 2018, grouping countries into three broad groupings: free, partly free, and not free. In “free” countries, citizens enjoy a high degree of political and civil freedoms. “Partly free” countries are characterized by some restrictions on political rights and civil liberties, often in the context of corruption, weak rule of law, ethnic strife, or civil war. In “not free” countries, the political process is tightly controlled and basic freedoms are denied.

Freedom House classified some 88 countries as free in 2018, accounting for about 45 percent of the world's nations. These countries respect a broad range of political rights. Another 58 countries accounting for 30 percent of the world's nations were classified as partly free, while



3.5 MAP

Freedom in the world, 2018.

Source: The Freedom House Survey Team, "Freedom in the World 2018," www.freedomhouse.org.

49 countries representing approximately 25 percent of the world's nations were classified as not free. The number of democracies in the world has increased from 69 nations in 1987 to 125 in 2018. But not all democracies are free, according to Freedom House, because some democracies still restrict certain political and civil liberties. For example, although Russia is nominally a democracy, it has consistently been rated "not free" since the early 2000s. According to Freedom House,

Russia's step backwards into the Not Free category is the culmination of a growing trend . . . to concentrate political authority, harass and intimidate the media, and politicize the country's law-enforcement system.¹⁹

Similarly, Freedom House argues that democracy was restricted in Venezuela under the leadership of the late Hugo Chávez, a trend that continued under his successor Nicolas Maduro. Many of the newer democracies are to be found in eastern Europe and Latin America, although there also have been notable gains in Africa during this time, including South Africa and Nigeria. Entrants into the ranks of the world's democracies during the last 25 years include Mexico, which held its first fully free and fair presidential election in 2000 after free and fair parliamentary and state elections in 1997 and 1998; Senegal, where free and fair presidential elections led to a peaceful transfer of power; Myanmar, where in 2015, after decades of rule by a military dictatorship, the opposition party won a landslide victory in

elections that were mostly free and fair; and Nigeria, where in 2015 for the first time the opposition won an election and there was a peaceful transfer of power.

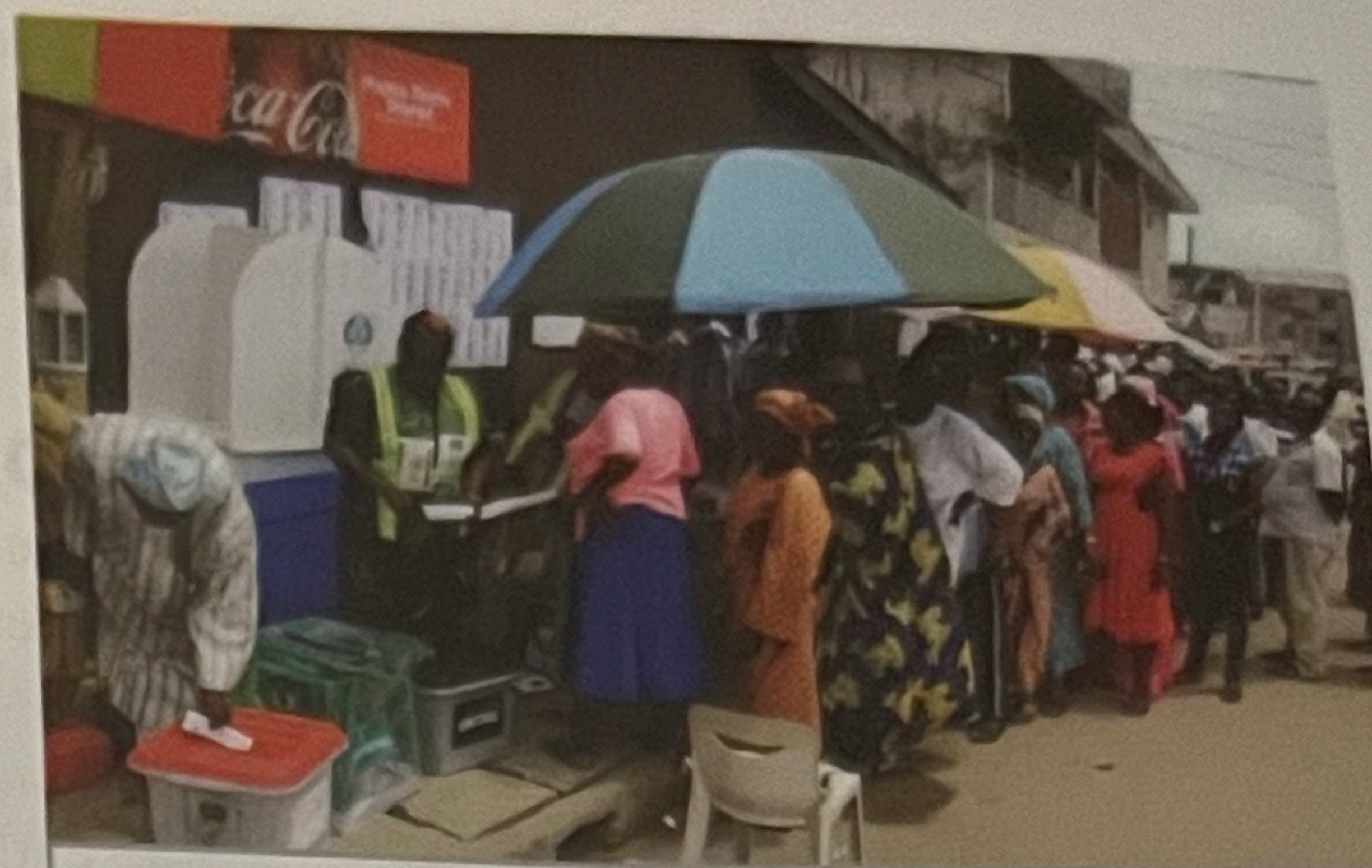
Three main reasons account for the spread of democracy.²⁰ First, many totalitarian regimes failed to deliver economic progress to the vast bulk of their populations. The collapse of communism in eastern Europe, for example, was precipitated by the growing gulf between the vibrant and wealthy economies of the West and the stagnant economies of the communist East. In looking for alternatives to the socialist model, the populations of these countries could not have failed to notice that most of the world's strongest economies were governed by representative democracies. Today, the economic success of many of the newer democracies—such as Poland and the Czech Republic in the former communist bloc, the Philippines and Taiwan in Asia, and Chile in Latin America—has strengthened the case for democracy as a key component of successful economic advancement.

Second, new information and communication technologies—including satellite television, desktop publishing, and, most important, the Internet and associated social media—have reduced a state's ability to control access to uncensored information. These technologies have created new conduits for the spread of democratic ideals and information from free societies. Today, the Internet is allowing democratic ideals to penetrate closed societies as never before.²¹ Young people who utilized Facebook and Twitter to reach large numbers of people very quickly and coordinate their actions organized the demonstrations in 2011 that led to the overthrow of the Egyptian government.

Third, in many countries, economic advances have led to the emergence of increasingly prosperous middle and working classes that have pushed for democratic reforms. This was certainly a factor in the democratic transformation of South Korea. Entrepreneurs and other business leaders, eager to protect their property rights and ensure the dispassionate enforcement of contracts, are another force pressing for more accountable and open government.

Despite this, it would be naive to conclude that the global spread of democracy will continue unchallenged. Democracy is still rare in large parts of the world. In sub-Saharan Africa in 2018, only 9 countries were considered free, 21 were partly free, and 19 were not free. Among the post-communist countries in eastern and central Europe and the former Soviet Union, only 13 are classified as free (primarily in eastern Europe). And there are only 2 free states among the 18 nations of the Middle East and North Africa. Although the wave of unrest that spread across the Middle East during 2011–2013 created hope for change, with the exception of Tunisia, this has not been realized.

Moreover, authoritarianism has been gaining ground in several countries where political and civil liberties have been progressively limited in recent years, including Russia, Ukraine, Indonesia, Ecuador, and Venezuela. An increasingly autocratic Russia annexed the Crimea region from the Ukraine in 2014 and has actively supported pro-Russian rebels in eastern Ukraine. Libya, where there was hope that a democracy might be established, appears to have slipped into anarchy. In Egypt, after a brief flirtation with democracy, the military stepped in, removing the government of Mohamed Morsi, after Morsi and his political movement, the Muslim Brotherhood, had exhibited its own authoritarian tendencies. The military-backed government, however, has also acted in an authoritarian manner, effectively reversing much of the progress that had occurred after the revolution of 2011. Indeed, Freedom House observes that since the mid-2000s, there has been a notable decline in civil and political freedoms in many parts of the world, suggesting that the shift toward greater democracy that occurred during the 1985–2005 period has peaked for the time being and that there have been some notable reversals in



Voters wait in a queue in front of the election center in the city of Lagos, Nigeria.

©Anadolu Agency/Getty Images



Is World Peace Through Commerce Possible?

Interested in world peace? Business students worldwide can participate in Peace Through Commerce's "Matrix of Peace," an integrated program that shows how business schools can promote peace. The program is sponsored by the Association to Advance Collegiate Schools of Business (AACSB International), the global accrediting organization of business schools. Peace Through Commerce is built on the premise that peace is achieved and maintained by an interdependent system of commerce, consciousness, and laws and structure. As the AACSB puts it: "If we educate students that it is their responsibility to advance society, over a generation we may be able to have more impact than governments have had." What do you think? Can business people advance global societies more than governments if educated according to the framework of the "Matrix of Peace"?

Source: www.peacethroughcommerce.com.

states such as Russia and Venezuela. Freedom House also expressed concerns that under the leadership of Donald Trump, America has withdrawn from its traditional role of promoting democracy and human rights around the world, a development that it views with some alarm since pressure from the United States has historically helped to spread democratic ideals.

THE NEW WORLD ORDER AND GLOBAL TERRORISM The end of the Cold War and the “new world order” that followed the collapse of communism in eastern Europe and the former Soviet Union, taken together with the demise of many authoritarian regimes in Latin America, gave rise to intense speculation about the future shape of global geopolitics. In an influential book, 25 years ago author Francis Fukuyama argued, “We may be witnessing . . . the end of history as such: that is, the end point of mankind’s ideological evolution and the universalization of Western liberal democracy as the final form of human government.”²² Fukuyama went on to argue that the war of ideas may be at an end and that liberal democracy has triumphed.

Many questioned Fukuyama’s vision of a more harmonious world dominated by a universal civilization characterized by democratic regimes and free market capitalism. In a controversial book, the late influential political scientist Samuel Huntington argued there is no “universal” civilization based on widespread acceptance of Western liberal democratic ideals.²³ Huntington maintained that while many societies may be modernizing—they are adopting the material paraphernalia of the modern world, from automobiles and Facebook to Coca-Cola and smartphones—they are not becoming more Western. On the contrary, Huntington theorized that modernization in non-Western societies can result in a retreat toward the traditional, such as the resurgence of Islam in many traditionally Muslim societies. He wrote,

The Islamic resurgence is both a product of and an effort to come to grips with modernization. Its underlying causes are those generally responsible for indigenization trends in non-Western societies: urbanization, social mobilization, higher levels of literacy and education, intensified communication and media consumption, and expanded interaction with Western and other cultures. These developments undermine traditional village and clan ties and create alienation and an identity crisis. Islamist symbols, commitments, and beliefs meet these psychological needs, and Islamist welfare organizations, the social, cultural, and economic needs of Muslims caught in the process of modernization. Muslims feel a need to return to Islamic ideas, practices, and institutions to provide the compass and the motor of modernization.²⁴

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

In contrast to Fukuyama, Huntington envisioned a world split into different civilizations, each of which has its own value systems and ideology. Huntington predicted conflict between the West and Islam and between the West and China. While some commentators originally dismissed Huntington’s thesis, in the aftermath of the terrorist attacks on the United States on September 11, 2001, Huntington’s views received new attention. The dramatic rise of the Islamic State (ISIS) in war-torn Syria and neighboring Iraq during 2014–2015 drew further attention to Huntington’s thesis, as has the growing penchant for ISIS to engage in terrorist acts outside the Middle East, as in Paris in 2015.

If Huntington’s views are even partly correct, they have important implications for international business. They suggest many countries may be difficult places in which to do business, either because they are shot through with violent conflicts or because they are part of a civilization that is in conflict with an enterprise’s home country. Huntington’s views are speculative and controversial. More likely than his predictions coming to pass is the evolution of a global political system that is positioned somewhere between Fukuyama’s universal global civilization based on liberal democratic ideals and Huntington’s vision of a fractured world. That would still be a world, however, in which geopolitical forces limit the ability of business enterprises to operate in certain foreign countries.

As for terrorism, in Huntington’s thesis, global terrorism is a product of the tension between civilizations and the clash of value systems and ideology. The terror attacks undertaken by al-Qaeda and ISIS are consistent with this view. Others point to terrorism’s roots in long-standing

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Chinese construction workers build the new African Union Buildings in Addis Ababa, Ethiopia.

©Per-Anders Pettersson/Getty Images

conflicts that seem to defy political resolution—the Palestinian, Kashmir, and Northern Ireland conflicts being obvious examples. It is also true that much of the terrorism perpetrated by al-Qaeda affiliates in Iraq during the 2000s and more recently by ISIS in Iraq and Syria can be understood in part as a struggle between radicalized Sunni and Shia factions within Islam. Moreover, a substantial amount of terrorist activity in some parts of the world, such as Colombia, has been interwoven with the illegal drug trade. As former U.S. Secretary of State Colin Powell has maintained, terrorism represents one of the major threats to world peace and economic progress in the twenty-first century.²⁵

THE SPREAD OF MARKET-BASED SYSTEMS Paralleling the spread of democracy since the 1980s has been the transformation from centrally planned command economies to market-based economies. More than 30 countries that were in the former Soviet Union or the eastern European communist bloc have changed their economic systems. A complete list of countries where change is now occurring also would include Asian states such as China and Vietnam, as well as African countries such as Angola, Ethiopia, and Mozambique.²⁶ There has been a similar shift away from a mixed economy. Many states in Asia, Latin America, and Western Europe have sold state-owned businesses to private investors (privatization) and deregulated their economies to promote greater competition.

The rationale for economic transformation has been the same the world over. In general, command and mixed economies failed to deliver the kind of sustained economic performance that was achieved by countries adopting market-based systems, such as the United States, Switzerland, Hong Kong, and Taiwan. As a consequence, even more states have gravitated toward the market-based model.

Map 3.6, based on data from the Heritage Foundation, a politically conservative U.S. research foundation, gives some idea of the degree to which the world has shifted toward market-based economic systems. The Heritage Foundation's index of economic freedom is based on 10 indicators, including the extent to which the government intervenes in the economy, trade policy, the degree to which property rights are protected, foreign investment regulations, taxation rules, freedom from corruption, and labor freedom. A country can score between 100 (freest) and 0 (least free) on each of these indicators. The higher a country's average score across all 10 indicators, the more closely its economy represents the pure market model.



3.6 MAP

Index of economic freedom, 2018.

Source: The Heritage Foundation, "2018 Index of Economic Freedom," www.heritage.org/index/heatmap.

According to the 2018 index, which is summarized in Map 3.6, the world's freest economies are (in rank order) Hong Kong, Singapore, New Zealand, Switzerland, Australia, Ireland, Estonia, United Kingdom, Canada, and the United Arab Emirates. The United States was ranked 17, Germany came in at 25, Japan at 30, Mexico at 63, France at 71, Russia at 107, China at 110, India at 130, and Brazil at 153. The economies of Zimbabwe, Venezuela, Cuba, and North Korea are to be found at the bottom of the rankings.²⁷

Economic freedom does not necessarily equate with political freedom, as detailed in Map 3.6. For example, the two top states in the Heritage Foundation index, Hong Kong and Singapore, cannot be classified as politically free. Hong Kong was reabsorbed into communist China in 1997, and the first thing Beijing did was shut down Hong Kong's freely elected legislature. Singapore is ranked as only partly free on Freedom House's index of political freedom due to practices such as widespread press censorship.

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LO 3-3

Describe how transition economies are moving toward market-based systems.

The Nature of Economic Transformation

The shift toward a market-based economic system often entails a number of steps: deregulation, privatization, and creation of a legal system to safeguard property rights.²⁸

deregulation

Removal of government restrictions concerning the conduct of a business.

DEREGULATION Deregulation involves removing legal restrictions to the free play of markets, the establishment of private enterprises, and the manner in which private enterprises operate. Before the collapse of communism, the governments in most command economies exercised tight control over prices and output, setting both through detailed state planning. They also prohibited private enterprises from operating in most sectors of the economy, severely

restricted direct investment by foreign enterprises, and limited international trade. Deregulation in these cases involved removing price controls, thereby allowing prices to be set by the interplay between demand and supply; abolishing laws regulating the establishment and operation of private enterprises; and relaxing or removing restrictions on direct investment by foreign enterprises and international trade.

In mixed economies, the role of the state was more limited; but here, too, in certain sectors the state set prices, owned businesses, limited private enterprise, restricted investment by foreigners, and restricted international trade. For these countries, deregulation has involved the same kind of initiatives that we have seen in former command economies, although the transformation has been easier because these countries often had a vibrant private sector. India is an example of a country that has substantially deregulated its economy over the past two decades (see the Country Focus on India).

country FOCUS

India's Economic Transformation

After gaining independence from Britain in 1947, India adopted a democratic system of government. The economic system that developed in India after 1947 was a mixed economy characterized by a large number of state-owned enterprises, centralized planning, and subsidies. This system constrained the growth of the private sector. Private companies could expand only with government permission. It could take years to get permission to diversify into a new product. Much of heavy industry, such as auto, chemical, and steel production, was reserved for state-owned enterprises. Production quotas and high tariffs on imports also stunted the development of a healthy private sector, as did labor laws that made it difficult to fire employees.

By the early 1990s, it was clear this system was incapable of delivering the kind of economic progress that many Southeast Asian nations had started to enjoy. In 1994, India's economy was still smaller than Belgium's, despite having a population of 950 million. Its GDP per capita was a paltry \$310, less than half the population could read, only 6 million had access to telephones, and only 14 percent had access to clean sanitation; the World Bank estimated that some 40 percent of the world's desperately poor lived in India, and only 2.3 percent of the population had an annual household income in excess of \$2,484.

The lack of progress led the government to embark on an ambitious economic reform program. Starting in 1991, much of the industrial licensing system was dismantled. Several areas once closed to the private sector were opened, including electricity generation, parts of the oil industry, steelmaking, air transport, and some areas of the telecommunications industry. Investment by foreign enterprises, formerly allowed only grudgingly and subject to arbitrary ceilings, was suddenly welcomed. Approval was made automatic for foreign equity stakes of up to 51 percent in an Indian enterprise, and 100 percent foreign ownership was allowed under certain circumstances. Raw materials and many industrial goods could be freely imported, and the maximum tariff that could be levied on imports was reduced from 400 percent to 65 percent. The top income tax rate was also reduced, and corporate tax fell from 57.5 percent to 46 percent in 1994, and then to 35 percent in 1997. The government also announced plans to start privatizing India's state-owned businesses, some 40 percent of which were losing money in the early 1990s.

Judged by some measures, the response to these economic reforms has been impressive. The Indian economy expanded at an annual rate of about 7 percent from 1997 to 2017. Foreign investment, a key indicator of how attractive foreign companies thought the Indian economy was, jumped from \$150 million in 1991 to over \$40 billion in 2017. In the information technology sector, India has emerged as a vibrant global center for software development with sales of \$150 billion and exports of \$117 billion in 2017, up from sales of just \$150 million in 1990. In pharmaceuticals, too, Indian companies are emerging as credible players in the global marketplace, primarily by selling low-cost, generic versions of drugs that have come off patent in the developed world.

However, the country still has a long way to go. Attempts to further reduce import tariffs have been stalled by political opposition from employers, employees, and politicians who fear that if barriers come down, a flood of inexpensive Chinese products will enter India. The privatization program continues to hit speed bumps—the latest in September 2003 when the Indian Supreme Court ruled that the government could not privatize two state-owned oil companies without explicit approval from the parliament. State-owned firms still account for 38 percent of national output in the nonfarm sector, yet India's private firms are 30 to 40 percent more productive than state-owned enterprises. There has also been strong resistance to reforming many of India's laws that make it difficult for private business to operate efficiently. For example, labor laws make it almost impossible for firms with more than 100 employees to fire workers, creating a disincentive for entrepreneurs to increase their enterprises beyond 100 employees. Other laws mandate that certain products can be manufactured only by small companies, effectively making it impossible for companies in these industries to attain the scale required to compete internationally.

Sources: "India's Breakthrough Budget?" *The Economist*, March 3, 2001; "America's Pain, India's Gain," *The Economist*, January 11, 2003, p. 57; Joanna Slater, "In Once Socialist India, Privatizations Are Becoming More Like Routine Matters," *The Wall Street Journal*, July 5, 2002, p. A8; "India's Economy: Ready to Roll Again?" *The Economist*, September 20, 2003, pp. 39–40; Joanna Slater, "Indian Pirates Turned Partners," *The Wall Street Journal*, November 13, 2003, p. A14; "The Next Wave: India," *The Economist*, December 17, 2005, p. 67; M. Dell, "The Digital Sector Can Make Poor Nations Prosper," *Financial Times*, May 4, 2006, p. 17; "What's Holding India Back," *The Economist*, March 8, 2008, p. 11; "Battling the Babu Raj," *The Economist*, March 8, 2008, pp. 29–31; Rishi Lyengar, "India Tops Foreign Investment Rankings Ahead of U.S. and China," *Time*, October 11, 2015; and "FDI in India," *Indian Brand Equity Foundation*, March 2018.

PRIVATIZATION Hand in hand with deregulation has come a sharp increase in privatization. Privatization, as discussed in Chapter 2, transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction.²⁹ Privatization is seen as a way to stimulate gains in economic efficiency by giving new private owners a powerful incentive—the reward of greater profits—to search for increases in productivity, to enter new markets, and to exit losing ones.³⁰

The privatization movement started in Great Britain in the early 1980s when then-Prime Minister Margaret Thatcher started to sell state-owned assets such as the British telephone company, British Telecom (BT). In a pattern that has been repeated around the world, this sale was linked with the deregulation of the British telecommunications industry. By allowing other firms to compete head to head with BT, deregulation ensured that privatization did not simply replace a state-owned monopoly with a private monopoly. Since the 1980s, privatization has become a worldwide phenomenon. More than 8,000 acts of privatization were completed around the world between 1995 and 1999.³¹ Some of the most dramatic privatization programs occurred in the economies of the former Soviet Union and its eastern European satellite states. In the Czech Republic, for example, three-quarters of all state-owned enterprises were privatized between 1989 and 1996, helping push the share of gross domestic product accounted for by the private sector up from 11 percent in 1989 to 60 percent in 1995.³²

Privatization is still ongoing today. For example, in 2017 the Brazilian government announced the privatization of a state-owned electric company, airports, highways, ports, and the lottery (see the opening case). In Saudi Arabia, the government has plans to privatize the state-owned oil company, Saudi Aramco. Conversely, in China the privatization of inefficient state-owned enterprises has slowed down somewhat as the state pursues a “mixed ownership” strategy.³³

Despite this three-decade trend, large amounts of economic activity are still in the hands of state-owned enterprises in many nations. In China, for example, state-owned companies still dominate the banking, energy, telecommunications, health care, and technology sectors. Overall, they account for about 40 percent of the country’s GDP. The World Bank cautioned China that unless it reformed these sectors—liberalizing them and privatizing many state-owned enterprises—the country runs the risk of experiencing a serious economic crisis.³⁴

As privatization has proceeded, it has become clear that simply selling state-owned assets to private investors is not enough to guarantee economic growth. Studies of privatization have shown that the process often fails to deliver predicted benefits if the newly privatized firms continue to receive subsidies from the state and if they are protected from foreign competition by barriers to international trade and foreign direct investment.³⁵ In such cases, the newly privatized firms are sheltered from competition and continue acting like state monopolies. When these circumstances prevail, the newly privatized entities often have little incentive to restructure their operations to become more efficient. For privatization to work, it must also be accompanied by a more general deregulation and opening of the economy. Thus, when Brazil decided to privatize the state-owned telephone monopoly, Telebrás Brazil, the government also split the company into four independent units that were to compete with each other and removed barriers to foreign direct investment in telecommunications services. This action ensured that the newly privatized entities would face significant competition and thus would have to improve their operating efficiency to survive.

LEGAL SYSTEMS As noted in Chapter 2, a well-functioning market economy requires laws protecting private property rights and providing mechanisms for contract enforcement. Without a legal system that protects property rights and without the machinery to enforce that system, the




Is Selling in China a Good Strategy?

If China and the United States continue to grow like they did in recent years, some estimates indicate that China will be the world’s largest economy by 2030. Let’s assume this is true. Then China is clearly a country to take a closer look at—not just to outsource from (i.e., build factories in the country, produce products, and then sell those products to other parts of the world), but also to sell into to target their increasing customer base with purchasing power. Between 2000 and 2011, for example, the U.S. increased exports to China by 542 percent, roughly three times that of the increase to Brazil (which was ranked second in increase during the same period). Also, by 2020 China is expected to have some 190 million customers in the middle- and upper-income categories, making this the largest population segment of any country’s middle-/upper-income citizens. If you were a global manager for a company, would you concentrate on selling your products in China without having a production facility in the country?

Source: solutions.mckinsey.com/insightschina.

incentive to engage in economic activity can be reduced substantially by private and public entities, including organized crime, that expropriate the profits generated by the efforts of private-sector entrepreneurs. For example, when communism collapsed in eastern Europe, many countries lacked the legal structure required to protect property rights, all property having been held by the state. Although many nations have made big strides toward instituting the required system, it may be years before the legal system is functioning as smoothly as it does in the West. For example, in most eastern European nations, the title to urban and agricultural property is often uncertain because of incomplete and inaccurate records, multiple pledges on the same property, and unsettled claims resulting from demands for restitution from owners in the pre-communist era. Also, although most countries have improved their commercial codes, institutional weaknesses still undermine contract enforcement. Court capacity is often inadequate, and procedures for resolving contract disputes out of court are often lacking or poorly developed.³⁶ Nevertheless, progress is being made. In 2004, for example, China amended its constitution to state that “private property was not to be encroached upon,” and in 2007 it enacted a new law on property rights that gave property holders many of the same protections as those enjoyed by the state (see the Country Focus “Property Rights in China”).³⁷

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Implications of Changing Political Economy

The global changes in political and economic systems discussed earlier have several implications for international business. The long-standing ideological conflict between collectivism and individualism that defined the twentieth century is less in evidence today. The West won the Cold War, and Western ideology is more widespread. Although command economies remain and totalitarian dictatorships can still be found around the world, the tide has been running in favor of free markets and greater democracy for 30 years. It remains to be seen, however, whether the global financial crisis of 2008–2009 and the recession that followed will lead to a retrenchment. Certainly many commentators have blamed the problems that led to this crisis on a lack of regulation, and some reassessment of Western political ideology seems likely.

Notwithstanding the crisis of 2008–2009, the trends of the past 30 years have enormous implications for business. For nearly 50 years, half of the world was off-limits to Western businesses. Now much of that has changed. Many of the national markets of eastern Europe, Latin America, Africa, and Asia may still be underdeveloped, but they are potentially enormous. With a population of more than 1.3 billion, the Chinese market alone is potentially bigger than that of the United States, the European Union, and Japan combined. Similarly, India, with about 1.2 billion people, is a potentially huge market. Latin America has another 600 million potential consumers. It is unlikely that China, Russia, Vietnam, or any of the other states now moving toward a market system will attain the living standards of the West soon. Nevertheless, the upside potential is so large that companies need to consider making inroads now. For example, if China and the United States continue to grow at the rates they did during 1996–2017, China will surpass the United States to become the world's largest national economy within the next two decades.

Just as the potential gains are large, so are the risks. There is no guarantee that democracy will thrive in many of the world's newer democratic states, particularly if these states have to grapple with severe economic setbacks. Totalitarian dictatorships could return, although they are unlikely to be of the communist variety. Although the bipolar world of the Cold War era has vanished, it may be replaced by a multipolar world dominated by a number of civilizations. In such a world, much of the economic promise inherent in the global shift toward market-based economic systems may stall in the face of conflicts between civilizations. While the long-term potential for economic gain from investment in the world's new market economies is large, the risks associated with any such investment are also substantial. It would be foolish to ignore these. The financial system in China, for example, is not transparent, and many suspect that Chinese banks hold a high proportion of nonperforming loans on their books. If true, these bad debts could trigger a significant financial crisis during the next decade in China, which would dramatically lower growth rates.

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Focus on Managerial Implications

LO 3-4

Explain the implications for management practice of national difference in political economy.

BENEFITS, COSTS, RISKS, AND OVERALL ATTRACTIVENESS OF DOING BUSINESS INTERNATIONALLY

As noted in Chapter 2, the political, economic, and legal environments of a country clearly influence the attractiveness of that country as a market or investment site. In this chapter, we argued that countries with democratic regimes, market-based economic policies, and strong protection of property rights are more likely to attain high and sustained economic growth rates and are thus a more attractive location for international business. It follows that 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. Here, we consider the determinants of benefits, costs, and risks.

Benefits In the most general sense, the long-run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers. While some markets are very large when measured by number of consumers (e.g. India), relatively low living standards may imply limited purchasing power and, therefore, a relatively small market when measured in economic terms. International businesses need to be aware of this distinction, but they also need to keep in mind the likely future prospects of a country. In 1960, South Korea was viewed as just another impoverished third-world nation. By 2017, it had the world's 11th-largest economy. International firms that recognized South Korea's potential in 1960 and began to do business in that country may have reaped greater benefits than those that wrote off South Korea.

By identifying and investing early in a potential future economic star, international firms may build brand loyalty and gain experience in that country's business practices. These will pay back substantial dividends if that country achieves sustained high economic growth rates. In contrast,



Coca-Cola has been in China for about 40 years, and about 140 million servings of the company's products are enjoyed daily in China.

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late entrants may find that they lack the brand loyalty and experience necessary to achieve a significant presence in the market. In the language of business strategy, early entrants into potential future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to late-mover disadvantages.³⁸ (**First-mover advantages** are the advantages that accrue to early entrants into a market. **Late-mover disadvantages** are the handicaps that late entrants might suffer.) This kind of reasoning has been driving significant inward investment into China, which may become the world's largest economy by 2030 if it continues growing at current rates (China is already the world's second-largest national economy). For more than two decades, China has been the largest recipient of foreign direct investment in the developing world as international businesses—including General Motors, Volkswagen, Coca-Cola, and Unilever—try to establish a sustainable advantage in this nation.

first-mover advantages

Advantages accruing to the first to enter a market.

late-mover disadvantages

Handicaps experienced by being a late entrant in a market.

A country's economic system and property rights regime are reasonably good predictors of economic prospects. Countries with free market economies in which property rights are protected tend to achieve greater economic growth rates than command economies or economies where property rights are poorly protected. It follows that a country's economic system, property rights regime, and market size (in terms of population) probably constitute reasonably good indicators of the potential long-run benefits of doing business in a country. In contrast, countries where property rights are not well respected and where corruption is rampant tend to have lower levels of economic growth. We must be careful about generalizing too much from this, however, because both China and India have achieved high growth rates despite relatively weak property rights regimes and high levels of corruption. In both countries, the shift toward a market-based economic system has produced large gains despite weak property rights and endemic corruption.

Costs A number of political, economic, and legal factors determine the costs of doing business in a country. With regard to political factors, a company may be pushed to pay off politically powerful entities in a country before the government allows it to do business there. The need to pay what are essentially bribes is greater in closed totalitarian states than in open democratic societies where politicians are held accountable by the electorate (although this is not a hard-and-fast distinction). Whether a company should actually pay bribes in return for market access should be determined on the basis of the legal and ethical implications of such action. We discuss this consideration in Chapter 5, when we look closely at the issue of business ethics.

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

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

political risk

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

Risks As with costs, the risks of doing business in a country are determined by a number of political, economic, and legal factors. **Political risk** has been defined as the likelihood that political forces will cause drastic changes in a country's business environment that adversely affect the profit and other goals of a business enterprise.³⁹ So defined, political risk tends to be greater in countries experiencing social unrest and disorder or in countries where the underlying nature of a society increases the likelihood of social unrest. Social unrest typically finds expression in strikes, demonstrations, terrorism, and violent conflict. Such unrest is more likely to be found in countries that contain more than one ethnic nationality, in countries where competing ideologies are battling for political control, in countries where economic mismanagement has created high inflation and falling living standards, or in countries that straddle the "fault lines" between civilizations.

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

More generally, a change in political regime can result in the enactment of laws that are less favorable to international business. In Venezuela, for example, the populist socialist politician Hugo Chávez held power from 1998 until his death in 2013. Chávez declared himself to be a "Fidelista," a follower of Cuba's Fidel Castro. He pledged to improve the lot of the poor in Venezuela through government intervention in private business and frequently railed against American imperialism, all of which is of concern to Western enterprises doing business in the country. Among other actions, he increased the royalties that foreign oil companies operating in Venezuela had to pay the government from 1 to 30 percent of sales.

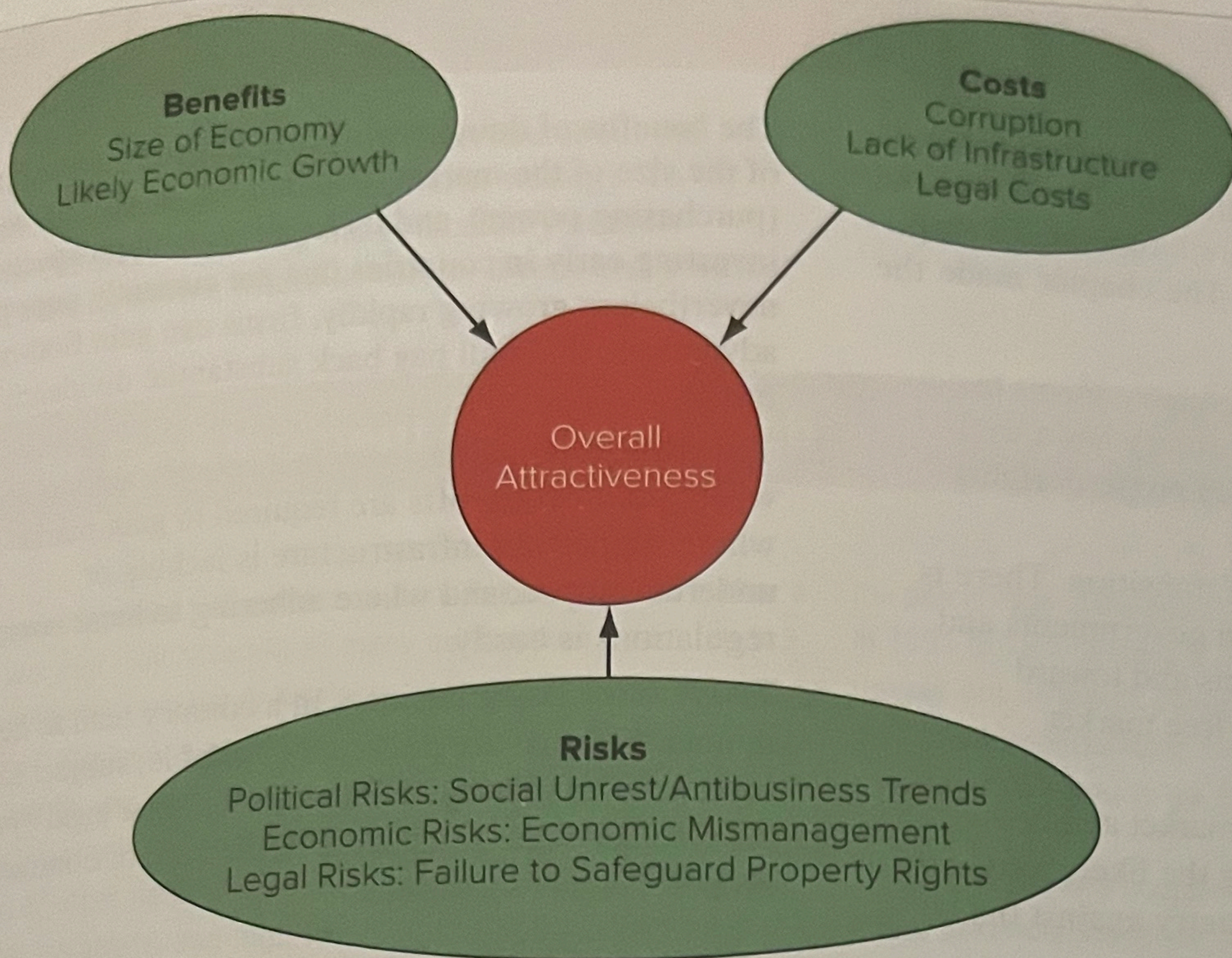
Other risks may arise from a country's mismanagement of its economy. An **economic risk** can be defined as the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a particular business enterprise. Economic risks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

The collapse in oil prices that occurred in 2014–2015 exposed economic mismanagement and increased economic risk in a number of countries that had been overly dependent upon oil revenues to finance profligate government spending. In countries such as Russia, Saudi Arabia, and Venezuela, high oil prices had enabled national governments to spend lavishly on social programs and public sector infrastructure. As oil prices collapsed, these countries saw government revenues tumble. Budget deficits began to climb sharply, their currencies fell on foreign exchange markets, price inflation began to accelerate as the price of imports rose, and their economies started to contract, increasing unemployment and creating the potential for social disruption. None of this was good for those countries, nor did it benefit foreign business that had invested in those economies.

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

legal risk

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



3.1 FIGURE
Country attractiveness.

believed that the Indian legal system did not provide adequate protection of intellectual property rights, creating the very real danger that their Indian partners might expropriate the intellectual property of the American companies—which for IBM and Coca-Cola amounted to the core of their competitive advantage.

Overall Attractiveness The overall attractiveness of a country as a potential market or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country (see Figure 3.1). Generally, the costs and risks associated with doing business in a foreign country are typically lower in economically advanced and politically stable democratic nations and greater in less developed and politically unstable nations. The calculus is complicated, however, because the potential long-run benefits are dependent not only on a nation's current stage of economic development or political stability but also on likely future economic growth rates. Economic growth appears to be a function of a free market system and a country's capacity for growth (which may be greater in less developed nations). This leads us to conclude that, other things being equal, the benefit–cost–risk trade-off is likely to be most favorable in politically stable developed and developing nations that have free market systems and no dramatic upsurge in either inflation rates or private-sector debt. It is likely to be least favorable in politically unstable developing nations that operate with a mixed or command economy or in developing nations where speculative financial bubbles have led to excess borrowing.

Key Terms

gross national income (GNI), p. 60

purchasing power parity (PPP), p. 61

Human Development Index (HDI), p. 64

innovation, p. 65

entrepreneurs, p. 66

deregulation, p. 74

first-mover advantages, p. 79

late-mover disadvantages, p. 79

political risk, p. 80

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legal risk, p. 80