Chavez's Venezuela

Hugo Chavez, a former military officer who was once jailed for engineering a failed coup attempt, was elected president of Venezuela in 1998. Chavez, a self-styled democratic socialist, won the presidential election by campaigning against corruption, economic mismanagement, and the "harsh realities" of global capitalism. When he took office in February 1999, Chavez claimed that he had inherited the worst economic situation in the country's recent history. He wasn't far off the mark. A collapse in the price of oil, which accounted for 70 percent of the country's exports, left Venezuela with a large budget deficit and forced the economy into a deep recession.

Soon after taking office, Chavez proceeded to try to consolidate his hold over the apparatus of government. A constituent assembly, dominated by Chavez followers, drafted a new constitution that strengthened the powers of the presidency and allowed Chavez (if reelected) to stay in office until 2012. Subsequently, the national congress, which was controlled by Chavez supporters, approved a measure allowing the government to remove and appoint Supreme Court justices, effectively increasing Chavez's hold over the judiciary. Chavez also extended government control over the media. By 2006, Freedom House, which annually assesses political and civil liberties worldwide, concluded that Venezuela was only "partly free" and that freedoms were being progressively curtailed.

On the economic front, things remained rough. The economy shrank by 9 percent in 2002 and another 8 percent in 2003. Unemployment remained persistently high at 15 to 17 percent and the poverty rate rose to more than 50 percent of the population. A 2003 study by the World Bank concluded that Venezuela was one of the most regulated economies in the world and that state controls over business activities gave public officials ample opportunities to enrich themselves by demanding bribes in return for permission to expand operations or enter

National Differences in Political Economy

2

LEARNING OBJECTIVES

After you have read this chapter you should:

- LO1 Understand how the political systems of countries differ.
- LO2 Understand how the economic systems of countries differ.
- LO3 Understand how the legal systems of countries differ.
- LO4 Be able to explain what determines the level of economic development of a nation.
- LO5 Discuss the macro-political and economic changes taking place worldwide.
- LO6 Describe how transition economies are moving toward market based systems.
- LO7 Articulate the implications for management practice of national difference in political economy.

new lines of business. Indeed, despite Chavez's anti-corruption rhetoric, Transparency International, which ranks the world's nations according to the extent of public corruption, has noted that corruption has increased under Chavez. In 2006, Transparency International ranked Venezuela 138 out of 163 nations, down from 114 in 2004. Consistent with his socialist rhetoric, Chavez has progressively taken various enterprises into state ownership and has required that other enterprises be restructured as "workers' cooperatives" in return for government loans. In addition, the government has begun to seize large rural farms and ranches that Chavez claims are not sufficiently productive, turning them into state-owned cooperatives.

In 2004, the world oil market bailed Chavez out of mounting economic difficulties. Oil prices surged from the low $20s, reaching $70 a barrel by the spring of 2006, and Venezuela, the world's fifth-largest producer, began to reap a bonanza. On the back of surging oil exports, the economy grew by 18 percent in 2004, 9 percent in 2005 and 10.5 percent in 2006. Chavez's reaction to the oil price increase was to extend government control over foreign oil producers doing business in Venezuela, which he accused of making outsized profits at the expense of a poor nation. In 2005, he increased government royalties on oil sales from 1 percent to 30 percent and the tax rate on sales from 34 to 50 percent. In 2006, he announced plans to reduce foreign companies' stakes in oil projects in the Orinoco regions and to give the state-run oil company, Petroleos de Venezuela SA, a majority position. Riding a wave of popularity at home, in December 2006 Chavez won reelection as president. He celebrated his victory by stepping on the revolutionary accelerator. Parliament gave him the power to legislate by decree for 18 months, and a committee of his supporters started to draft a constitutional reform to turn Venezuela into an avowedly socialist country and to allow the president to stand for reelection indefinitely.[1]

Introduction

International business is much more complicated than domestic business because countries differ in many ways. Countries have different political, economic, and legal systems. Cultural practices can vary dramatically, as can the education and skill level of the population, and countries are at different stages of economic development. All these differences can and do have major implications for the practice of international business. They have a profound impact on the benefits, costs, and risks associated with doing business in different countries; the way in which operations in different countries should be managed; and the strategy international firms should pursue in different countries. A main function of this chapter and the next is to develop an awareness of and appreciation for the significance of country differences in political systems, economic systems, legal systems, and national culture. Another function of the two 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.

The opening case illustrates some of the issues covered in this chapter. Under the leadership of Hugo Chavez, Venezuela has shifted to the left. The state has become more involved in business activity, regulation has expanded, and private enterprise is on the defensive, which has hurt economic growth. Corruption, long a problem in the country, has if anything gotten worse, despite the fact that Chavez originally came to power by running on an anticorruption platform. As we shall see in this chapter, corruption also tends to depress economic growth. Moreover, Chavez has unilaterally rewritten the contracts with foreign oil companies that have invested in Venezuela, raising royalty rates and taxes and demanding that the state-run oil company be given a majority stake in all oil projects. While this may increase the government's take in the short run, if foreign enterprises respond by reducing their investments in Venezuela, as some are now doing, it could further constrain the country's economic growth down the road.

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

Political Systems

The political system of a country shapes its economic and legal systems.[2] As such, 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 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 AND INDIVIDUALISM

Collectivism refers to a political system that stresses the primacy of collective goals over individual goals.[3] 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 BC), who argued in *The Republic* 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, socialists have picked up the collectivist mantle.

Socialism

Modern **socialists** trace their intellectual roots to Karl Marx (1818–83), 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.[4]

In the early 20th 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 20th 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. The largely bloodless revolutions of 1989 swept Communism out of Eastern Europe. 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. Other than China, communism hangs on only in some small fringe states, such as North Korea and Cuba.

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, 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 Marxists roots, many social democratic governments after World War II nationalized private companies in certain industries, transforming them into state-owned enterprises to be run for the "public good rather than private profit." In Great Britain by the end of the 1970s, for

example, 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 have regained power, as in Great Britain in 1997 when the left-leaning Labor Party won control of the government, they too now seem committed to continued private ownership.

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 BC). 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 16th century. The philosophy was refined in the work of a number of British philosophers, including David Hume (1711–76), Adam Smith (1723–90), and John Stuart Mill (1806–73). Individualism exercised a profound influence on those in the American colonies who sought independence from Great Britain. Indeed, the concept underlies the ideas expressed in the Declaration of Independence. In the 20th century, several Nobel Prize–winning economists, including Milton Friedman, Friedrich von Hayek, and James Buchanan, have 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. As John Stuart Mill put it,

> The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of action of any of their number is self-protection. . . . The only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant. . . . The only part of the conduct of any one, for which he is amenable to society, is that which concerns others. In the part which merely concerns himself, his independence is, of right, absolute. Over himself, over his own body and mind, the individual is sovereign.[5]

The second tenet of individualism is that the welfare of society is best served by letting people pursue their own economic self-interest, as opposed to some collective body (such as government) dictating what is in society's best interest. Or as Adam Smith put it in a famous passage from *The Wealth of Nations*, an individual who intends his own gain is

> led by an invisible hand to promote an end which was no part of his intention. Nor is it always worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who effect to trade for the public good.[6]

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.

In practical terms, individualism translates into an advocacy for democratic political systems and free market economics. Since the late 1980s, the waning of collectivism has been matched by the ascendancy of individualism. Democratic ideals and free market economics have swept away socialism and communism in many states. The changes of the past 20 years go beyond the revolutions in Eastern Europe and the former Soviet Union to include a move toward greater individualism in Latin America and many of the social democratic states of the West (e.g., Great Britain and Sweden). This is not to claim that individualism has finally won a long battle with collectivism. It has clearly not (indeed, during 2005 and into 2006 there were signs of a swing back toward left-leaning socialist ideas in several countries, most notably in Latin America like Venezuela and Bolivia—see the Opening Case). But as a guiding political philosophy, individualism has been on the ascendancy. This is good news for international business because the pro-business and pro–free trade values of individualism create a favorable environment within which international business can thrive.

East and West Germans tear down the Berlin Wall on November 9, 1989. Berlin had been politically divided since the end of World War II, with the eastern portion of the city serving as the capital of the German Democratic Republic. The two parts of the city were physically divided in 1961 with the construction of the Berlin Wall.

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 collectivism–individualism 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 has moved toward greater individual freedom in the economic sphere, but the country is still ruled by a totalitarian dictatorship that constrains political freedom.

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, direct democracy is impractical. Most modern democratic states practice **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.

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.[7]

Totalitarianism

In a totalitarian country, citizens are denied 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. 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 are 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 all these states exhibit clear signs that the Communist Party's monopoly on political power is retreating. In many respects, the governments of China, Vietnam, and Laos are communist in name only since those nations now adhere to 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 Hugo Chavez is starting to display some totalitarian tendencies (see the Opening Case).

A second form of totalitarianism might be labeled **theocratic totalitarianism.** Theocratic totalitarianism is found in states where a party, group, or individual that governs according to religious principles monopolizes political power. 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. Tribal totalitarianism occurs when a political party that represents the interests of a particular tribe (and not always the majority tribe) monopolizes power. Such one-party states still exist in Africa.

A fourth major form of totalitarianism might be described as **right-wing totalitarianism.** Right-wing totalitarianism generally permits some individual economic freedom but restricts individual political freedom, 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. They were also found in several Asian countries, particularly South Korea, Taiwan, Singapore, Indonesia, and the Philippines. Since the early 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 (see the closing case).

Economic Systems

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 free market 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

In a pure **market economy,** all productive activities are privately owned, as opposed to being owned by the state. The goods and services that a country produces 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. Since a monopolist has no competitors, it has no incentive to search for ways to lower production costs. Rather, it can simply pass on cost increases to consumers in the form of higher prices. The net result is that the monopolist is likely to become increasingly inefficient, producing high-priced, low-quality goods, and society suffers as a consequence.

Given the dangers inherent in monopoly, the role of government in a market economy is to encourage vigorous free and fair competition between private producers. Governments do this by outlawing monopolies and restrictive business practices designed to monopolize a market (antitrust laws serve this function in the United States). Private ownership also encourages vigorous competition and economic efficiency. Private ownership ensures that entrepreneurs have a right to the profits generated by their own efforts. This gives entrepreneurs an incentive to search for better ways of serving consumer needs. They may introduce new products, develop more efficient production processes, pursue better marketing and after-sale service, or simply manage their businesses more efficiently than their competitors. In turn, the constant improvement in product and process that results from such an incentive, it has been argued, has a major positive impact on economic growth and development.[8]

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.

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

MIXED ECONOMY

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

In mixed economies, governments also tend to take over troubled firms they consider to be vital to national interests. Consider, for example, the French automobile company Renault. The government took over the company when it ran into serious financial problems. The French government reasoned that the social costs of the unemployment that might result if Renault collapsed were unacceptable, so it nationalized the company to save it from bankruptcy. Renault's competitors weren't thrilled by this move because they had to compete with a company whose costs were subsidized by the state.

Legal Systems

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

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

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, since the judges rely upon 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.

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 20th century. Islamic law is primarily a moral rather than a commercial law and is intended to govern all aspects of life.[9] 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.

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.[10] By 2005, some 300 Islamic financial institutions in the world collectively managed more than $250 billion in assets. In addition to Pakistan, Islamic financial institutions are found in many of the Gulf states, Egypt, and Malaysia.[11]

Islamic law governs all aspects of the Muslims' lives, even commercial activities.

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.

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 for 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, have ratified the **United Nations Convention on Contracts for the International Sale of Goods (CIGS).** The CIGS establishes a uniform set of rules governing certain aspects of making and performing everyday commercial contracts between sellers and buyers who have their places of business in different nations. By adopting the CIGS, a nation signals to other adopters that it will treat the convention's rules as part of its law. The CIGS applies automatically to all contracts for the sale of goods between different firms based in countries that have ratified the convention, unless the parties to the contract explicitly opt out. One problem with the CIGS, however, is that fewer than 70 nations have ratified the convention (the CIGS went into effect in 1988).[12] Many of the world's larger trading nations, including Japan and the United Kingdom, have not ratified the CIGS.

When firms do not wish to accept the CIGS, 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. In 2005, this court handled some 521 requests for arbitration involving 1,422 parties from 117 countries.[13]

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.[14] 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).[15] However, in many countries the authorities do not enforce these laws and property rights are violated (see the opening case). Property rights can be violated in two ways—through private action and through public action.

Private Action

In this context, **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 for a much higher level of criminal action in some than in others. For example, in Russia in the chaotic period following the collapse of communism, an outdated legal system, coupled with a weak police force and judicial system, offered both domestic and foreign businesses scant protection from blackmail by the "Russian Mafia." Successful business owners in Russia often had to pay "protection money" to the Mafia or face violent retribution, including bombings and assassinations (about 500 contract killings of businessmen occurred in 1995 and again in 1996).[16]

Russia is not alone in having Mafia problems (and the situation in Russia has improved significantly since the mid-1990s). The Mafia has a long history in the United States (Chicago in the 1930s was similar to Moscow in the 1990s). In Japan, the local version of the Mafia, known as the *yakuza*, runs protection rackets, particularly in the food and entertainment industries.[17] 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. This difference arose because the legal enforcement apparatus, such as the police and court system, was so 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 that Russia experienced.

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.[18]

Corruption has been well documented in every society, from the banks of the Congo River to the palace of the Dutch royal family, from Japanese politicians to Brazilian bankers, and from Indonesian government officials to the New York City Police Department. 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.[19] 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.

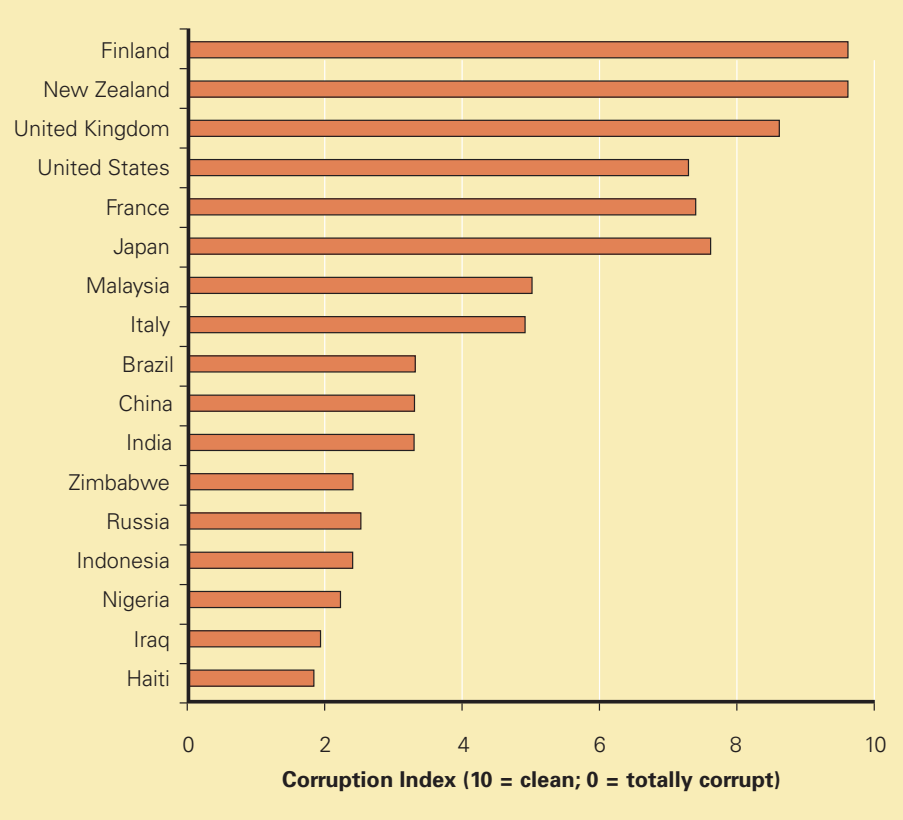
According to Transparency International, an independent nonprofit organization dedicated to exposing and fighting corruption, businesses and individuals spend some $400 billion a year worldwide on bribes related to government procurement contracts alone.[20] Transparency International has also measured the level of corruption among public officials in different countries.[21] As Figure 2.1 shows, the organization rated countries such as Finland and New Zealand as clean; it rated others, such as Russia, India, Indonesia, and Zimbabwe, as corrupt. Haiti ranked last out of all 163 countries in the survey, and Finland ranked first.

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.[22] By siphoning off profits, corrupt politicians and bureaucrats reduce the returns

FIGURE 2.1

Rankings of Corruption by Country, 2006

Source: Transparency International, "Global Corruption Report," 2006.



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 such as Indonesia, Nigeria, and Russia to have a much lower rate of economic growth than might otherwise have been the case. A detailed example of the negative effect that corruption can have on economic progress is given in the accompanying Country Focus, which looks at the impact of corruption on economic growth in Nigeria.

Foreign Corrupt Practices Act

In the 1970s, the United States passed the **Foreign Corrupt Practices Act** 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. Along the same lines, in 1997 trade and finance ministers from the member states of the Organization for Economic Cooperation and Development (OECD), an association of the world's 30 most powerful economies, adopted the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.[24] The convention obliges member states to make the bribery of foreign public officials a criminal offense.

However, both the U.S. law and OECD convention include language that allows for 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.[25] For example, they allow for small payments to speed up

COUNTRY FOCUS

Corruption in Nigeria

When Nigeria gained independence from Great Britain in 1960, there were hopes that the country might emerge as an economic heavyweight in Africa. Not only was Nigeria Africa's most populous country, but it also was blessed with abundant natural resources, particularly oil, from which the country earned over $400 billion between 1970 and 2005. Despite this, Nigeria remains one of the poorest countries in the world. According to the United Nations' 2006 Human Development Index, Nigeria ranked 159 out of 177 countries covered. Gross domestic product per capita was just $560, 51 percent of the adult population was illiterate, and life expectancy at birth was only 43 years.

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

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

Some of the excesses were simply astounding. In the 1980s an aluminum smelter was built on the orders of the government, which wanted to industrialize Nigeria. The cost of the smelter was $2.4 billion, some 60 to 100 percent higher than the cost of comparable plants elsewhere in the developed world. This high cost was widely interpreted to reflect the bribes that the international contractors who built the plant had to pay to local politicians. The smelter has never operated at more than a fraction of its intended capacity.

Has the situation in Nigeria improved since the country returned to civilian rule in 1999? In 2003, Olusegun Obasanjo was elected president on a platform that included a promise to fight corruption. By some accounts, progress has been seen. His anticorruption chief, Nuhu Ribadu, has claimed that whereas 70 percent of the country's oil revenues were being stolen or wasted in 2002, by 2004 the figure was "only" 40 percent. But in its most recent survey, Transparency International still ranked Nigeria among the most corrupt countries in the world in 2006 (see Figure 2.1), suggesting that the country still has a long way to go. In an effort to move things along, in early 2007 the country's top anticorruption body, the Economic and Financial Crimes Commission, sent letters to political parties listing 130 candidates for upcoming elections who it stated would soon be charged with corruption. Several parties responded by removing candidates identified as corrupt from their lists. Others argued that the list was itself influenced by political motives and in particular a desire to strengthen the position of President Obasanjo by blacklisting opponents.[23]

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.

A security guard stands near a pile of pirated CDs and DVDs before they were destroyed at a ceremony in Beijing Saturday, Feb. 26, 2005. Thousands of pirated items were destroyed in the event, one of a number of activities, including an antipiracy pop concert later Saturday, which were staged by China's government to publicize its antipiracy efforts.

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 that invention. **Copyrights** are the exclusive legal rights of authors, composers, playwrights, artists, and publishers to publish and disperse their work as they see fit. **Trademarks** are designs and names, often officially registered, by which merchants or manufacturers designate and differentiate their products (e.g., Christian Dior clothes). In the high-technology "knowledge" economy of the 21st century, intellectual property has become an increasingly important source of economic value for businesses. Protecting intellectual property has also become increasingly problematic, particularly if it can be rendered in a digital form and then copied and distributed at very low cost via pirated CDs or over the Internet (e.g., computer software, music and video recordings).[26]

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 $800 million 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.[27]

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 183 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 some 169 nations as of 2006. Weak enforcement encourages the piracy (theft) of intellectual property. China and Thailand have recently been among the worst offenders in Asia. Pirated computer software is widely available in China. Similarly, the streets of Bangkok, Thailand's capital, are lined with stands selling pirated copies of Rolex watches, Levi Strauss jeans, videotapes, and computer software.

Piracy in music recordings is rampant. The International Federation of the Phonographic Industry claims that about one-third of all recorded music products sold worldwide in 2005 were pirated (illegal) copies, suggesting that piracy costs the industry more than $4.5 billion annually.[28] The computer software industry also suffers from lax enforcement of intellectual property rights. Estimates suggest that violations of intellectual property rights cost personal computer software firms revenues equal to $40 billion in 2006.[29] According to the Business Software Alliance, a software industry association, in 2006 some 35 percent of all software applications used in the world were pirated. The worst region was Central and Eastern Europe where the piracy rate was 68 percent (see Figure 2.2). One of the worst countries was China, where the piracy rate in 2006 ran at 82 percent and cost the industry more than $5.42 billion in lost sales, up from $444 million in 1995.

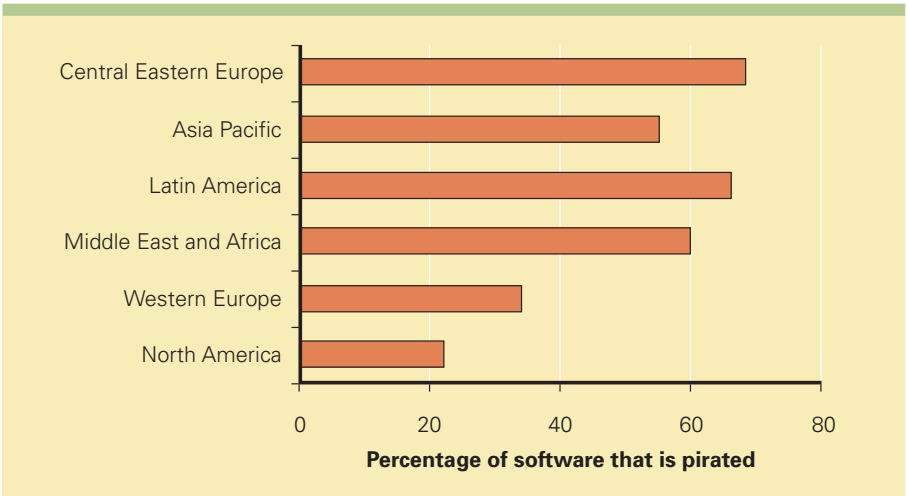


FIGURE 2.2

Regional Piracy Rates for Software, 2006

Source: Business Software Alliance, "Fourth Annual BSA and IDC Global Software Piracy Study," May 2007, www.bsa.org, accessed June 14, 2007.

The piracy rate in the United States was much lower at 21 percent; however, the value of sales lost was more significant because of the size of the U.S. market, reaching an estimated $7.3 billion in 2006.[30]

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 6, 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. The new agreement, known as the Trade Related Aspects of Intellectual Property Rights (or TRIPS), established a council of the World Trade Organization to oversee enforcement of much stricter intellectual property regulations, beginning in 1995. These regulations oblige WTO members to grant and enforce patents lasting at least 20 years and copyrights lasting 50 years. Rich countries had to comply with the rules within a year. Poor countries, in which such protection generally was much weaker, had five years of grace, and the very poorest have 10 years.[31] (For further details of the TRIPS agreement, see Chapter 6.)

In addition to lobbying governments, firms can file lawsuits on their own behalf. For example, Starbucks recently won a landmark trademark copyright case in China against a copycat (see the Management Focus feature 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 least extensive

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 2006 it had more than 220 outlets. But in China, copycats of well-established Western brands are commonplace, and 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 Starbuck's ubiquitous logo. Moreover, the name 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 that it was just an accident that the logo and name were so similar to that of Starbucks. Moreover, 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 commonplace, the courts seem to be signaling that a shift toward greater protection of intellectual property rights may be in progress. This is perhaps not surprising, since foreign governments and the World Trade Organization have been pushing China hard recently to start respecting intellectual property rights.[32]

in less developed nations. A boom in product liability suits and awards in the United States resulted in a dramatic increase in the cost of liability insurance. Many business executives argue that the high costs of liability insurance make American businesses less competitive in the global marketplace.

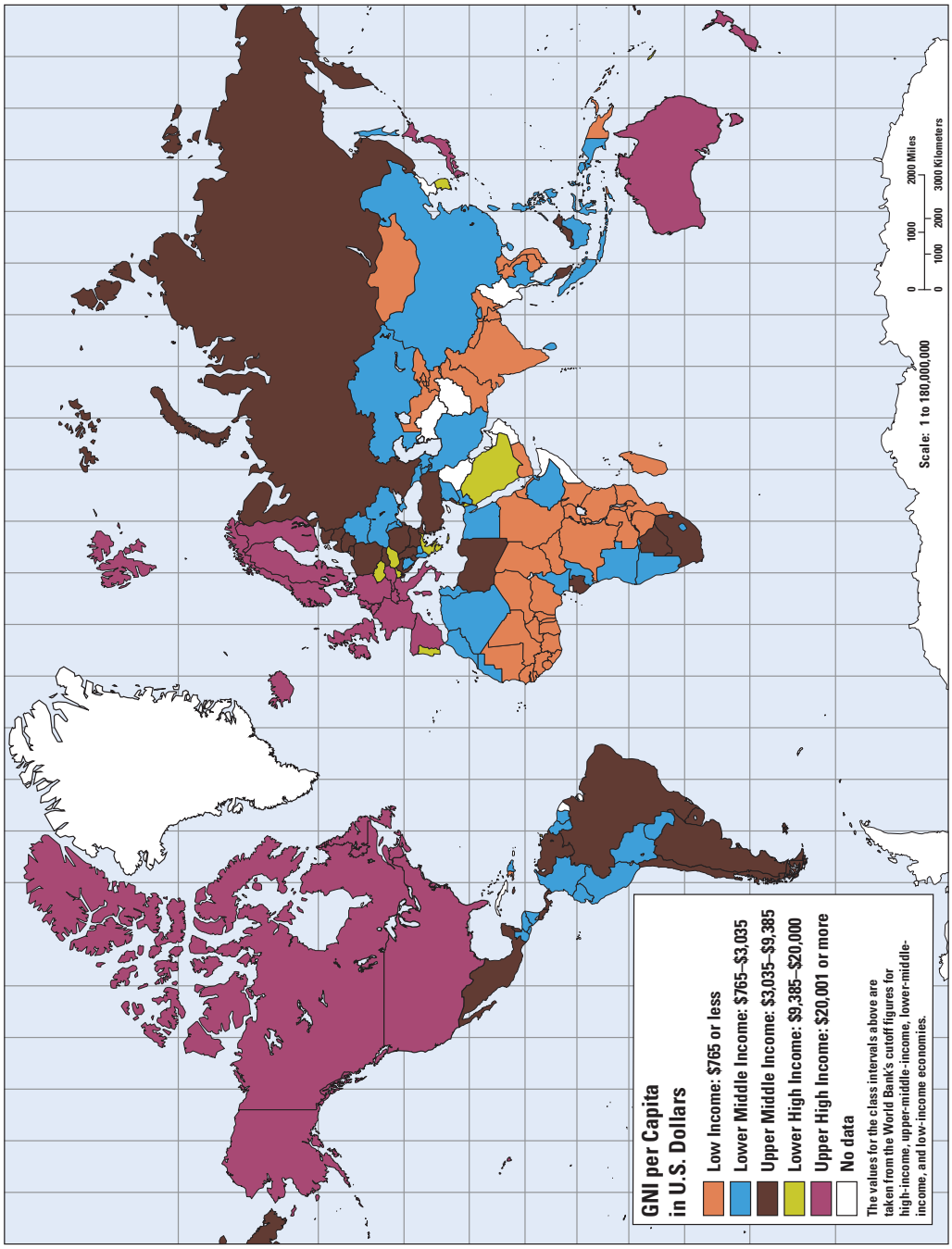
In addition to the competitiveness issue, country differences in product safety and liability laws raise an important ethical issue for firms doing business abroad. When product safety laws are tougher in a firm's home country than in a foreign country or when liability laws are more lax, should a firm 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.

The Determinants of Economic Development

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

DIFFERENCES IN ECONOMIC DEVELOPMENT

Different countries have dramatically different levels of economic development. One common measure of economic development is a country's **gross national 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 2.1



MAP 2.1
GNI per Capita, 2005

Country	GNI per Capita, 2005 ($)	GNI PPP per Capita, 2005 ($)	GDP Growth Rate, 1996–2005 (%)	Size of Economy GDP, 2005 ($ billions)
Brazil	3,460	8,230	2.2	794
China	1,740	6,600	9.1	2,229
Germany	34,580	29,210	1.4	2,782
India	720	3,460	6.3	785
Japan	38,950	31,410	1.3	4,560
Nigeria	560	1,040	4.3	99
Poland	7,110	13,490	4.2	299
Russia	4,460	10,640	4.0	764
Switzerland	54,930	37,080	1.5	366
United Kingdom	37,600	32,690	2.7	2,193
United States	43,740	41,950	3.4	12,455

TABLE 2.1

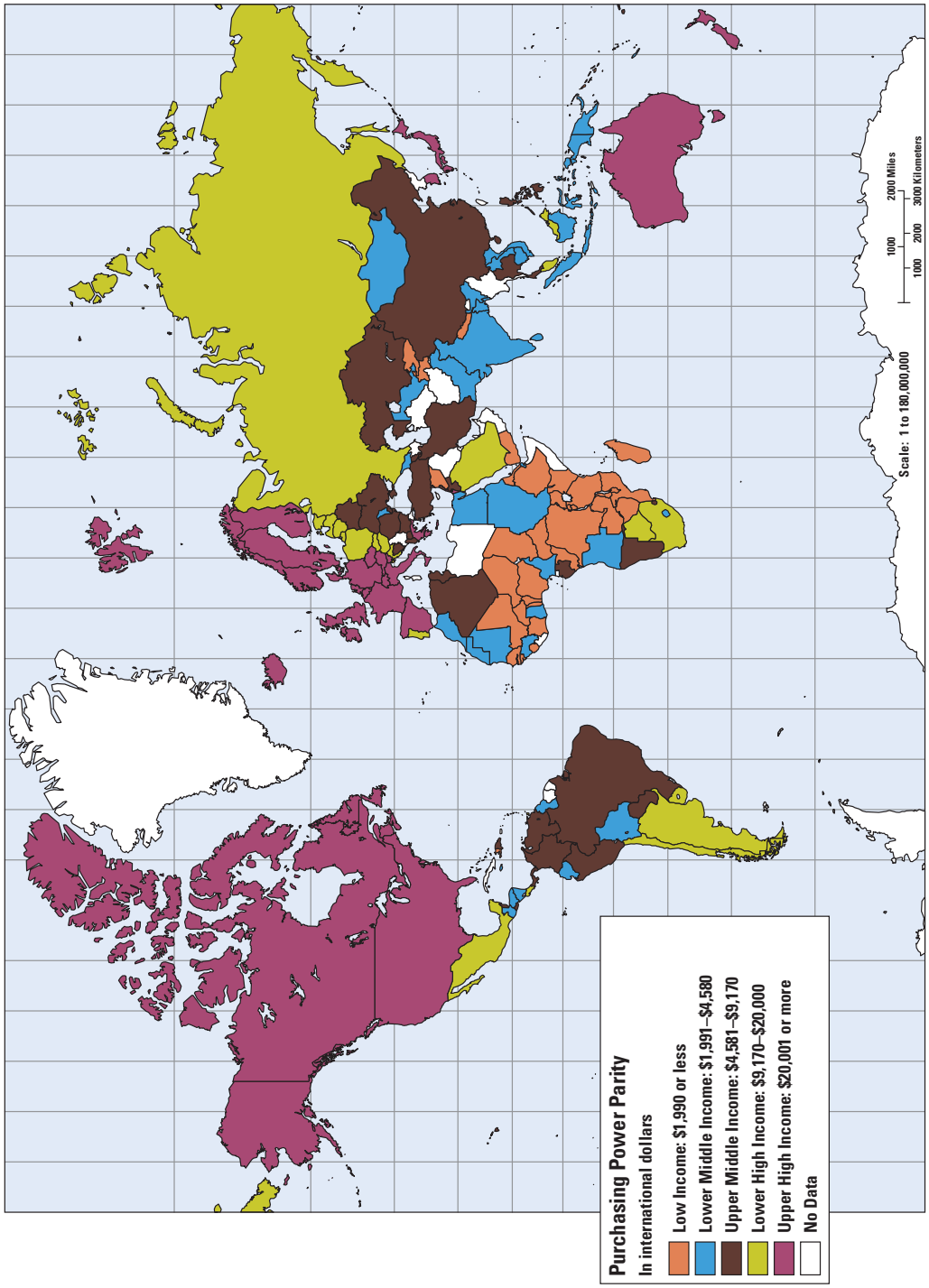
Economic Data for Select Countries

Source: World Development Indicators Online, 2007.

summarizes the GNI per capita of the world's nations in 2005. As can be seen, countries such as Japan, Sweden, Switzerland, and the United States are among the richest on this measure, whereas the large countries of China and India are among the poorest. Japan, for example, had a 2005 GNI per capita of $38,980, but China achieved only $1,740 and India just $720.[33]

GNI per person figures can be misleading because they don't consider differences in the cost of living. For example, although the 2005 GNI per capita of Switzerland, at $54,930, exceeded that of the United States, which was $43,740, the higher cost of living in Switzerland meant that U.S. citizens could actually afford more goods and services than Swiss citizens. 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 for a more direct comparison of living standards in different countries. The base for the adjustment is the cost of living in the United States. The PPP for different countries is then adjusted (up or down) depending upon whether the cost of living is lower or higher than in the United States. For example, in 2005 the GNI per capita for China was $1,740, but the PPP per capita was $6,660, suggesting that the cost of living was lower in China and that $1,500 in China would buy as much as $6,600 in the United States. Table 2.1 gives the GNI per capita measured at PPP in 2005 for a selection of countries, along with their GNI per capita and their growth rate in gross domestic product (GDP) from 1996 to 2005. Map 2.2 summarizes the GNI PPP per capita in 2005 for the nations of the world.

As can be seen, there are striking differences in the standards of living between countries. Table 2.1 suggests that the average Indian citizen can afford to consume only 8 percent of the goods and services consumed by the average U.S. citizen on a PPP basis. Given this, one might conclude that, despite having a population of 1 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 200 million people, despite its large number of very



MAP 2.2
GNI Purchasing Power Parity per Capita, 2005

poor. Moreover, in absolute terms the Indian economy is now larger than that of Brazil, Poland, and Russia (see Table 2.1).

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 countries achieve. Table 2.1 gives the rate of growth in gross domestic product (GDP) a number of countries achieved between 1996 and 2005. Map 2.3 summarizes the growth rate in GDP from 1996 to 2006. Although countries such as China and India are currently poor, their economies are already large in absolute terms and growing more rapidly than those of many advanced nations. They are already huge markets for the products of international businesses. If it maintains its growth rates, China's economy in particular will be larger than all but that of the United States within a decade, and India too will be among the largest economies in the world. Given that potential, many international businesses are trying to gain a foothold in these markets now. Even though their current contributions to an international firm's revenues might be relatively small, their future contributions could be much larger.

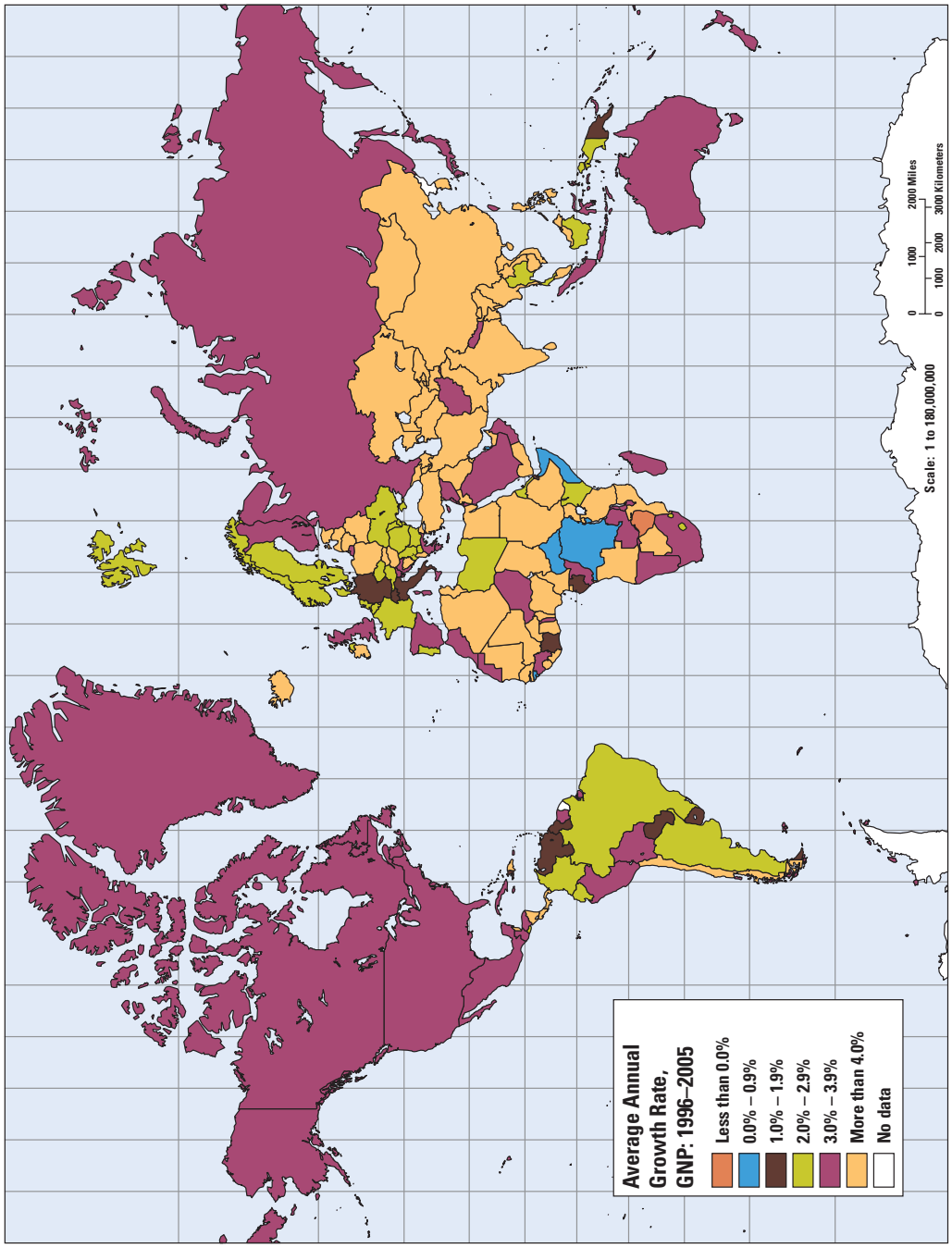
BROADER CONCEPTIONS OF DEVELOPMENT: AMARTYA SEN

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.[34] According to Sen, development should be seen as a process of expanding the real freedoms that people experience. Hence, development requires the removal of major impediments to freedom: poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as the intolerance of repressive states. In Sen's view, development is not just an economic process, but a political one too, and it requires the "democratization" of political communities to give citizens a voice in the important decisions made for the community. This perspective leads Sen to emphasize basic health care, especially for children, and basic education, especially for women. Not only are these factors desirable for their instrumental value in helping to achieve higher income levels, but they are also beneficial in their own right. People cannot develop their capabilities if they are chronically ill or woefully ignorant.

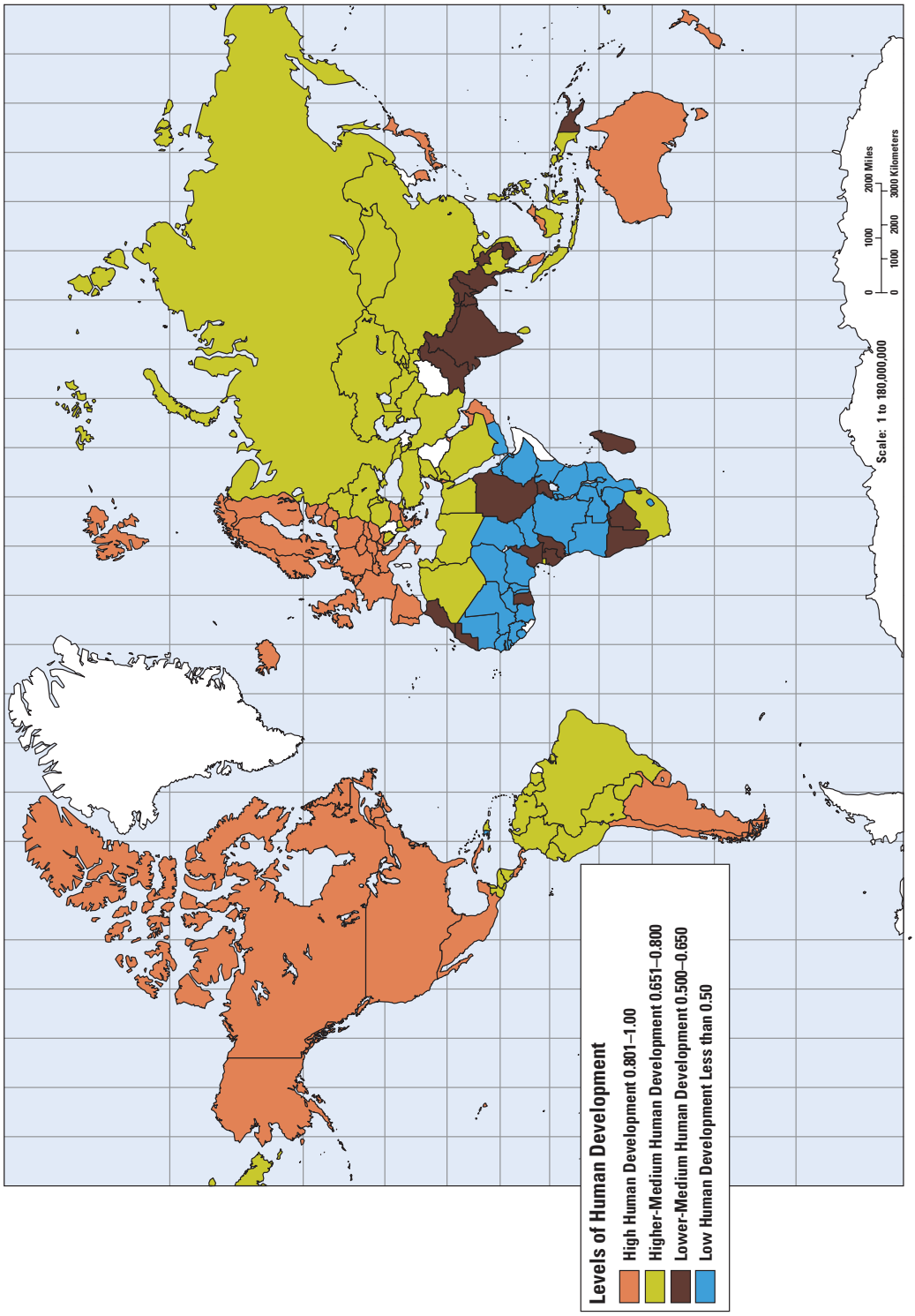
The United Nations has endorsed Sen's influential thesis by developing the **Human Development Index (HDI)** to measure the quality of human life in different nations. The HDI is based on three measures: life expectancy at birth (a function of health care), educational attainment (measured by a combination 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 2.4 summarizes the HDI scores for 2004, the most recent year for which data are available.

POLITICAL ECONOMY AND ECONOMIC PROGRESS

It is often argued that a country's economic development is a function of its economic and political systems. What then is the nature of the relationship between political economy and economic progress? This question has been the subject of vigorous debate



MAP 2.3
Growth Rate in GDP per Capita, 1996–2005



MAP 2.4
Human Development Indicators, 2004

among academics and policymakers for some time. Despite the long debate, this remains a question for which it is not possible to give an unambiguous answer. However, it is possible to untangle the main threads of the 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 wide agreement that innovation and entrepreneurial activity are the engines of long-run economic growth.[35] Those who make this argument define **innovation** broadly to include not just new products but also new processes, new organizations, new management practices, and new strategies. Thus, the Toys "R" Us strategy of establishing large warehouse-style toy stores and then engaging in heavy advertising and price discounting to sell the merchandise can be classified as an innovation because it was the first company to pursue this strategy. Innovation and entrepreneurial activity help to increase economic activity by creating new products and markets that did not previously exist. Moreover, innovations in production and business processes lead to an increase in the productivity of labor and capital, which further boosts economic growth rates.[36]

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 Cisco Systems, Dell, Microsoft, and Oracle were all founded by entrepreneurial individuals to exploit new technology, and all these firms created significant economic value and boosted productivity by helpings to commercialize innovations in products and processes. Thus, one can conclude that if a country's economy is to sustain long-run economic growth, the business environment must be conducive to the consistent production of product and process innovations and to entrepreneurial activity.

Innovation and Entrepreneurship Require a Market Economy

The first conclusion 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.[37] 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 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 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 health care and telecommunications in Great Britain). This stagnation provided the impetus for the widespread privatization of state-owned enterprises that we witnessed in many mixed economies during the mid-1980s and that is still going on today (*privatization* refers to the process of selling state-owned enterprises to private investors).

A study of 102 countries over a 20-year period provided evidence of a strong relationship between economic freedom (as provided by a market economy) and economic growth.[38] 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.

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.[39] 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. 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.[40] De Soto's arguments are interesting because he claims that 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.

Democratic Regimes Are More Conducive to Long-Term Economic Growth

Much debate surrounds which kind of political system best achieves a functioning market economy with strong protection for property rights.[41] 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 idea, 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 30 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."[42]

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 free 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 so benevolent. Many are tempted to use the apparatus of the state to further their own private ends, violating property rights and stalling economic growth. Therefore, 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.[43] Nor should we forget Amartya Sen's arguments that we reviewed earlier. Totalitarian states, by limiting human freedom, also suppress human development and therefore are detrimental to progress.

Economic Progress Begets Democracy

While it is possible to argue that democracy is not a necessary precondition for a free market economy in which property rights are protected, subsequent economic growth often leads to establishment of a democratic regime. Several of the fastest growing Asian economies adopted more democratic governments during the past two decades, including South Korea and Taiwan. Thus, 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 foreign criticism 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 recently is geography.[44] But the belief that geography can influence economic policy, and hence economic growth rates, goes back to Adam Smith. The influential Harvard University economist Jeffrey Sachs argues

> that throughout history, coastal states, with their long engagements in international trade, have been more supportive of market institutions than landlocked states, which have tended to organize themselves as hierarchical (and often military) societies. Mountainous states, as a result of physical isolation, have often neglected market-based trade. Temperate climes have generally supported higher densities of population and thus a more extensive division of labor than tropical regions.[45]

Sachs's point is that by virtue of favorable geography, certain societies were more likely to engage in trade than others and were thus more likely to be open to and develop market-based economic systems, which in turn would promote faster economic growth. He also argues that, irrespective of the economic and political institutions a country adopts, adverse geographical conditions, such as the high rate of disease, poor soils, and hostile climate that afflict many tropical countries, can have a negative impact on development. Together with colleagues at Harvard's Institute for International Development, Sachs tested for the impact of geography on a country's economic growth rate between 1965 and 1990. He found that the economies of 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.[46] A survey of 14 statistical studies that looked at the relationship between a country's investment in education and its subsequent growth rates concluded that investment in education did have a positive and statistically significant impact on a country's rate of economic growth.[47] Similarly, the work by Sachs discussed above suggests that investments in education help explain why some countries in Southeast Asia, such as Indonesia, Malaysia, and Singapore, have been able to overcome the disadvantages associated with their tropical geography and grow far more rapidly than tropical nations in Africa and Latin America.

States in Transition

The political economy of many of the world's nation-states has changed radically since the late 1980s. Two trends have been evident. First, during the late 1980s and early 1990s, a wave of democratic revolutions swept the world. Totalitarian governments collapsed and were replaced by democratically elected governments that were typically more committed to free market capitalism than their predecessors had been. Second, there has been a strong move away from centrally planned and mixed economies and toward a more free market economic model. We shall look first at the spread of democracy and then turn our attention to the spread of free market economics.

THE SPREAD OF DEMOCRACY

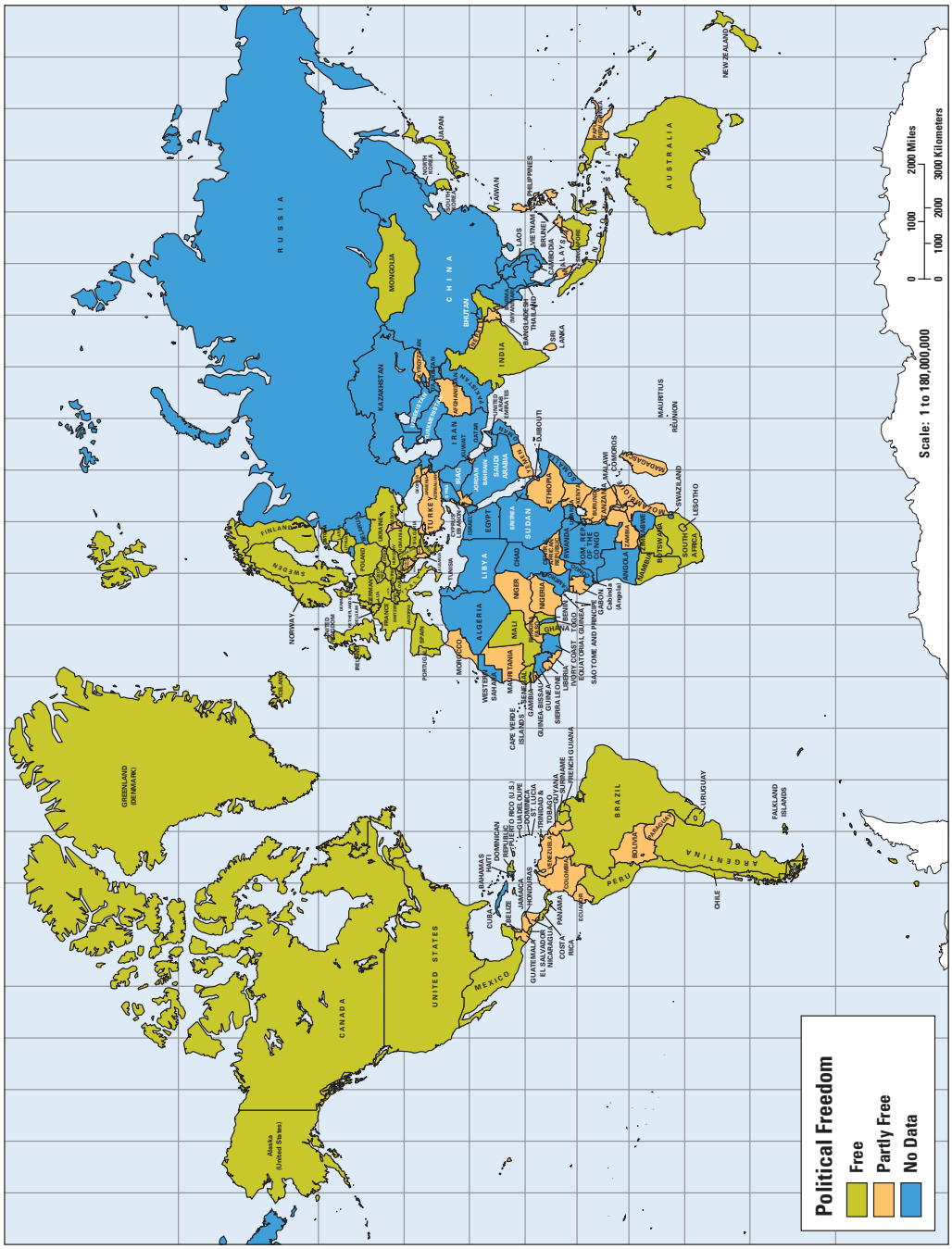
One notable development of the past 15 years has been the spread of democracy (and, by extension, the decline of totalitarianism). Map 2.5 reports on the extent of totalitarianism in the world as determined by Freedom House.[48] This map charts political freedom in 2006, grouping countries into three 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 90 countries as free in 2006, accounting for some 47 percent of the world's population. These countries respect a broad range of political rights. Another 58 countries accounting for 30 percent of the world's population were classified as partly free, while 45 countries representing some 23 percent of the world's population were classified as not free. The number of democracies in the world has increased from 69 nations in 1987 to 123 in 2006, the highest number in history. But not all democracies are free, according to Freedom House, because some democracies still restrict certain political and civil liberties. For example, Russia was rated "not free." According to Freedom House,

> Russia's step backwards into the Not Free category is the culmination of a growing trend under President Vladimir Putin to concentrate political authority, harass and intimidate the media, and politicize the country's law-enforcement system.[49]

Similarly, Freedom House argues that democracy is being restricted in Venezuela under the leadership of Hugo Chavez (see the Opening Case).

Many of the newer democracies are in Eastern Europe and Latin America, although there also have been notable gains in Africa during this time, such as in South Africa.



MAP 2.5

Distribution of Economic Freedom in 2007

Source: Heritage Foundation, http://www.heritage.org/index/

Entrants into the ranks of the world's democracies 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; Yugoslavia, where a democratic election took place despite attempted fraud by the incumbent; and Ukraine, where popular unrest following widespread ballot fraud in the 2004 presidential election resulted in a second election, the victory of a reform candidate, and a marked improvement in civil liberties.

Three main reasons account for the spread of democracy.[50] 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 shortwave radio, satellite television, fax machines, desktop publishing, and, most important, the Internet, have reduced the 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.[51]

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

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 2006, only 11 countries were considered free, 22 were partly free, and 15 were not free. Among the 27 post-Communist countries in Eastern and Central Europe, 7 are still not electoral democracies and Freedom House classifies only 13 of these states as free (primarily in Eastern Europe). And there are no free states among the 16 Arab nations of the Middle East and North Africa.

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, have given rise to intense speculation about the future shape of global geopolitics. Author Francis Fukuyama has 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."[52] Fukuyama goes on to say that the war of ideas may be at an end and that liberal democracy has triumphed.

Others question Fukuyama's vision of a more harmonious world dominated by a universal civilization characterized by democratic regimes and free market capitalism. In a controversial book, the influential political scientist Samuel Huntington argues that there is no "universal" civilization based on widespread acceptance of Western liberal democratic ideals.[53] Huntington maintains that while many societies may be modernizing—they are adopting the material paraphernalia of the modern world, from automobiles to Coca-Cola and

MTV—they are not becoming more Western. On the contrary, Huntington theorizes that modernization in non-Western societies can result in a retreat toward the traditional, such as the resurgence of Islam in many traditionally Muslim societies. He writes,

> 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.[54]

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

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

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

In Huntington's thesis, global terrorism is a product of the tension between civilizations and the clash of value systems and ideology. Others point to terrorism's roots in long-standing conflicts that seem to defy political resolution, the Palestinian, Kashmir, and Northern Ireland conflicts being obvious examples. It should also be noted that a substantial amount of terrorist activity in some parts of the world, such as Colombia, has been interwoven with the illegal drug trade. The attacks of September 11, 2001, created the impression that global terror is on the rise, although accurate statistics are hard to come by. What we do know is that according to data from the U.S. Department of State, in 2006 there were some 14,388 terrorist attacks worldwide, a 25 percent increase over 2005. These attacks resulted in 20,498 deaths in 2006, a 40 percent increase over 2005. Iraq alone, however, accounted for 45 percent of the attacks and 65 percent of the fatalities.[55] Other global hot spots for terrorist incidents in 2006 included the Sudan, Nigeria, and Afghanistan. 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 21st century.[56]

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.[57] 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 2.6, 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, such as the extent to which the government intervenes in the economy, trade policy, the degree to which property rights are protected, foreign investment regulations, and taxation rules. A country can score between 1 (most free) and 5 (least free) on each of these indicators. The lower a country's average score across all 10 indicators, the more closely its economy represents the pure market model. According to the 2007 index, which is summarized in Map 2.6, the world's freest economies are (in rank order) Hong Kong, Singapore, Australia, United States, New Zealand, United Kingdom, Ireland, Luxembourg, Switzerland, and Canada. Japan came in at 18, France at 45; Mexico, 49; Brazil, 70; India, 104; China, 119; and Russia, 120. The economies of Cuba, Laos, Iran, Venezuela, and North Korea are to be found near the bottom of the rankings.[58]

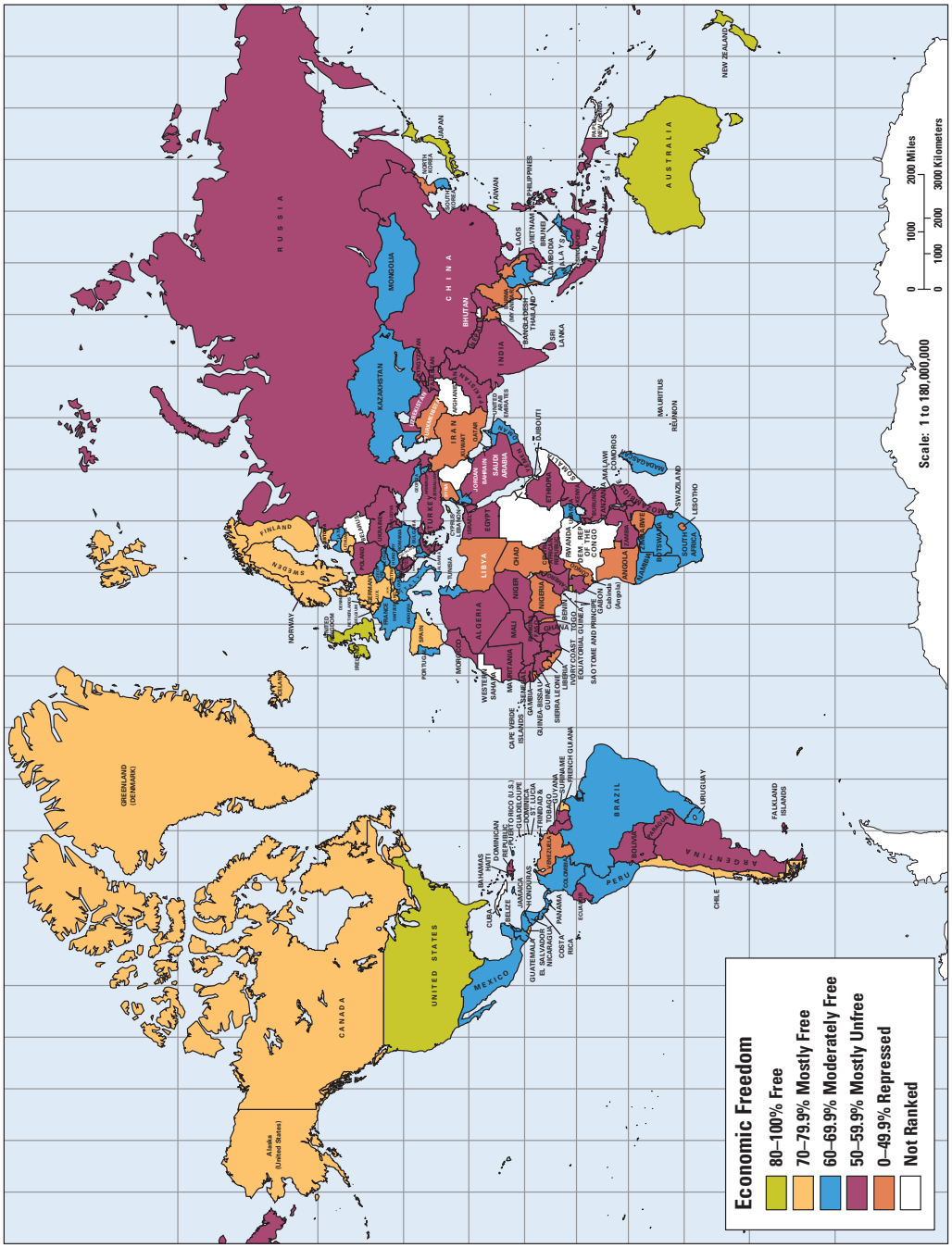
Economic freedom does not necessarily equate with political freedom, as detailed in Map 2.6. For example, the two top states in the Heritage Foundation index, Hong Kong and Singapore, cannot be classified as politically free. Hong Kong was reabsorbed into Communist China in 1997, and the first thing 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.

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.[59]

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.



MAP 2.6
Economic Freedom in 2006

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 an example, see the Country Focus on India). 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.

PRIVATIZATION

Hand in hand with deregulation has come a sharp increase in privatization. Privatization, as we discussed earlier in this chapter, transfers the ownership of state property into the hands of private individuals, frequently by the sale of state assets through an auction.[60] 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.[61]

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.[62] In total, these sales were valued at more than $1 trillion (in 1985 dollars). In the United Kingdom alone, some 139 state-owned enterprises were sold for a total of $130 billion. 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 to push the share of gross domestic product accounted for by the private sector up from 11 percent in 1989 to 60 percent in 1995.[63]

As privatization has proceeded around the world, it has become clear that simply selling state-owned assets to private investors is not enough to guarantee economic growth. Studies of privatization in central Europe 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.[64] 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, Telebras 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.

The ownership structure of newly privatized firms also is important.[65] Many former command economies, for example, lack the legal regulations regarding corporate governance that are found in advanced Western economies. In advanced market economies, boards of directors are appointed by shareholders to make sure managers consider the interests of shareholders when making decisions and try to manage the firm in a manner that is consistent with maximizing the wealth of shareholders. However, some former Communist states still lack laws requiring corporations to establish effective boards. In such cases, managers with a small ownership stake can often gain control over the newly privatized entity and run it for their own benefit, while ignoring the interests of other

COUNTRY FOCUS

Building a Market Economy in India

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

In 1991, the lack of progress led the government to embark on an ambitious economic reform program. Much of the industrial licensing system was dismantled, and several areas once closed to the private sector were opened, including electricity generation, parts of the oil industry, steelmaking, air transport, and some areas of the telecommunications industry. Investment by foreign enterprises, formerly allowed only grudgingly and subject to arbitrary ceilings, was suddenly welcomed. Across a wide range of sectors, 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 economy expanded at an annual rate of about 6.5 percent from 1994 to 2006. Foreign investment, a key indicator of how attractive foreign companies thought the Indian economy was, jumped from $150 million in 1991 to $9.5 billion in 2006. Some economic sectors have done particularly well, such as the information technology sector, where India has emerged as a vibrant global center for software development with export sales of $23.4 billion in 2006, up from just $150 million in 1990. In pharmaceuticals too, Indian companies are emerging as credible players on 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. 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. 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, and foreign retailers are banned from selling directly to Indian consumers (although they have found a side door, starting wholesaling and sourcing companies that supply a local retail partner).[68]

shareholders. Sometimes these managers are the same Communist bureaucrats who ran the enterprise before privatization. Because they have been schooled in the old ways of doing things, they often hesitate to take drastic action to increase the efficiency of the enterprise. Instead, they continue to run the firm as a private fiefdom, seeking to extract whatever economic value they can for their own betterment (in the form of perks that are not reported) while doing little to increase the economic efficiency of the enterprise so that shareholders benefit. Such developments seem less likely to occur, however, if a foreign investor takes a stake in the newly privatized entity. The foreign investor, who usually is a major provider of capital, is often able to use control over a critical resource (money) to push through needed change.

LEGAL SYSTEMS

As noted earlier in this chapter, 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 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. When communism collapsed, many of these countries lacked the legal structure required to protect property rights, all property having been held by the state. Although many nations have made big strides toward instituting the required system, it will be many more years before the legal system is functioning as smoothly as it does in the West. For example, in most Eastern European nations, the title to urban and agricultural property is often uncertain because of incomplete and inaccurate records, multiple pledges on the same property, and unsettled claims resulting from demands for restitution from owners in the pre-Communist era. Also, 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.[66] 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 private property holders many of the same protections as those enjoyed by the state.[67]

IMPLICATIONS OF CHANGING POLITICAL ECONOMY

The global changes in political and economic systems discussed above 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 has never been more widespread than it is now. 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 democracy.

The implications for business are enormous. For nearly 50 years, half of the world was off-limits to Western businesses. Now all that is changing. Many of the national markets of Eastern Europe, Latin America, Africa, and Asia may still be undeveloped and impoverished, but they are potentially enormous. With a population of more than 1.2 billion, the Chinese market alone is potentially bigger than that of the United States, the European Union, and Japan combined. Similarly India, with its nearly 1 billion people, is a potentially huge market. Latin America has another 400 million potential consumers. It is unlikely that China, Russia, Vietnam, or any of the other states now moving toward a free 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 Japan continue to grow at the

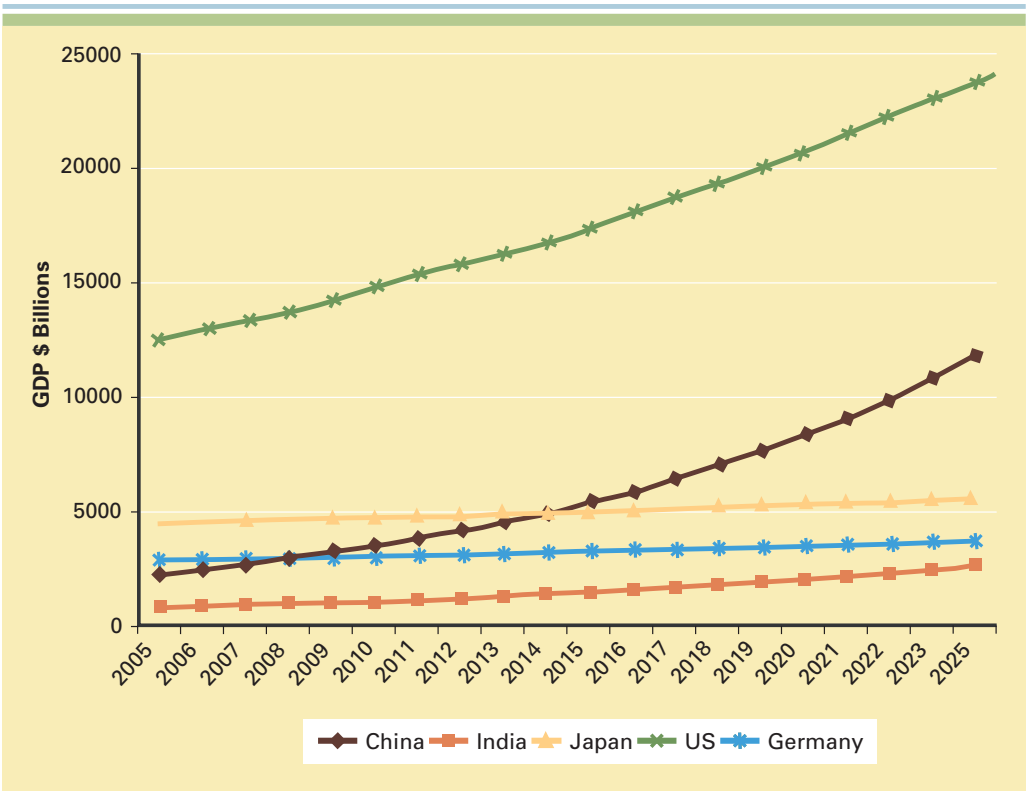


FIGURE 2.3

The World's Largest National Economies, 2005–2025 (GDP $ billions)

Notes: Projections based on nominal GDP, and extrapolate past growth rates into the future.

rate they did during 1996 to 2005, China will surpass Japan and become the world's second largest national economy behind the United States in 2015. Figure 2.3 projects the future size of five major national economies, based on projecting growth rates during the last 10 years forward for another 10. The United States, Japan, and Germany are currently the three largest national economies in the world. As can be seen, China in particular surges, surpassing Germany in 2008 and Japan in 2015, while by 2025 India will be closing in on Germany.[69]

However, 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 risks. 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 and render invalid the projections given in Figure 2.3.

IMPLICATIONS FOR MANAGERS

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 4, 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. Below we consider the determinants of benefits, costs, and risks.

BENEFITS

In the most general sense, the long-run monetary benefits of doing business in a country are a function of the size of the market, the present wealth (purchasing power) of consumers in that market, and the likely future wealth of consumers. While some markets are very large when measured by number of consumers (e.g., China and India), low living standards may imply limited purchasing power and therefore a relatively small market when measured in economic terms. 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 2005 it was the world's eleventh-largest economy, measured in terms of GDP. International firms that recognized South Korea's potential in 1960 and began to do business in that country may have reaped greater benefits than those that wrote off South Korea.

By identifying and investing early in a potential future economic star, international firms may build brand loyalty and gain experience in that country's business practices. These will pay back substantial dividends if that country achieves sustained high economic growth rates. In contrast, late entrants may find that they lack the brand loyalty and experience necessary to achieve a significant presence in the market. In the language of business strategy, early entrants into potential future economic stars may be able to reap substantial first-mover advantages, while late entrants may fall victim to late-mover disadvantages.[70] (**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 second-largest economy by 2015 if it continues growing at current rates (China is already the world's sixth-largest economy). For more than a decade, China has been the largest recipient of foreign direct investment in the developing world as international businesses ranging from General Motors and Volkswagen to Coca-Cola and Unilever try to establish a sustainable advantage in this nation.

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. One must be careful about generalizing too much from this, however, since 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 have 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 4, 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 (since adhering to such regulations is costly). It can also be more costly to do business in a country like the United States, where the absence of a cap on damage awards has meant 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.

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.[71] 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 Chavez won power in 1998, was reelected as president in 2000, and was reelected in 2006. Chavez has declared himself to be a "Fidelista," a follower of Cuba's Fidel Castro. He has pledged to improve the lot of the poor in Venezuela through government intervention in private business and has 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 foreign oil companies operating in Venezuela have to pay the government from 1 to 30 percent of sales (see the opening case).

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.

In Asian states such as Indonesia, Thailand, and South Korea, businesses increased their debt rapidly during the 1990s, often at the bequest of the government, which was encouraging them to invest in industries deemed to be of "strategic importance" to the country. The result was overinvestment, with more industrial (factories) and commercial capacity (office space) being built than could be justified by demand conditions. Many of these investments turned out to be uneconomic. The borrowers failed to generate the profits necessary to service their debt payment obligations. In turn, the banks that had lent money to these businesses suddenly found that they had rapid increases in nonperforming loans on their books. Foreign investors, believing that many local companies and banks might go bankrupt, pulled their money out of these countries, selling local stock, bonds, and currency. This action precipitated the 1997–98 financial crisis in Southeast Asia. The crisis included a precipitous decline in the value of Asian stock markets, which in some cases exceeded 70 percent; a similar collapse in the value of many Asian currencies against the U.S. dollar; an implosion of local demand; and a severe economic recession that will affect many Asian countries for years to come. In short, economic risks were rising throughout Southeast Asia during the 1990s. Astute foreign businesses and investors limited their exposure in this part of the world. More naive businesses and investors lost their shirts.

On the legal front, risks arise when a country's legal system fails to provide adequate safeguards in the case of contract violations or to protect property rights. When legal safeguards are weak, firms are more likely to break contracts 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 believed that the Indian legal system did not provide for adequate protection of intellectual property rights, creating the very real danger that their Indian partners might expropriate the intellectual property of the American companies—which for IBM and Coca-Cola amounted to the core of their competitive advantage.

OVERALL ATTRACTIVENESS

The overall attractiveness of a country as a potential market or investment site for an international business depends on balancing the benefits, costs, and risks associated with doing business in that country (see Figure 2.4). 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 upon 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 one 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.

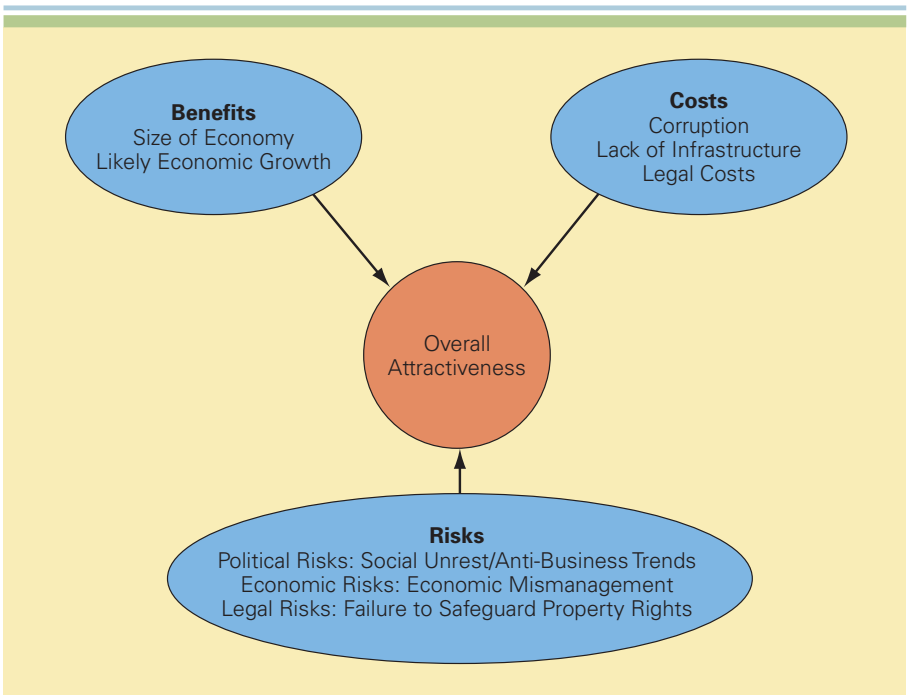


FIGURE 2.4

Country Attractiveness

CHAPTER SUMMARY

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

1. Political systems can be assessed according to two dimensions: the degree to which they emphasize collectivism as opposed to individualism, and the degree to which they are democratic or totalitarian.
2. Collectivism is an ideology that views the needs of society as being more important than the needs of the individual. Collectivism translates into an advocacy for state intervention in economic activity and, in the case of communism, a totalitarian dictatorship.
3. Individualism is an ideology that is built on an emphasis of the primacy of an individual's freedoms in the political, economic, and cultural realms. Individualism translates into an advocacy for democratic ideals and free market economics.
4. Democracy and totalitarianism are at different ends of the political spectrum. In a representative democracy, citizens periodically elect individuals to represent them and political freedoms are guaranteed by a constitution. In a totalitarian state, political power is monopolized by a party, group, or individual, and basic political freedoms are denied to citizens of the state.
5. There are three broad types of economic systems: a market economy, a command economy, and a mixed economy. In a market economy, prices are free of controls and private ownership is predominant. In a command economy, prices are set by central planners, productive assets are owned by the state, and private ownership is forbidden. A mixed economy has elements of both a market economy and a command economy.
6. Differences in the structure of law between countries can have important implications for the practice of international business. The degree to which property rights are protected can vary dramatically from country to country, as can product safety and product liability legislation and the nature of contract law.
7. The rate of economic progress in a country seems to depend on the extent to which that country has a well-functioning market economy in which property rights are protected.
8. Many countries are now in a state of transition. There is a marked shift away from totalitarian governments and command or mixed economic systems and toward democratic political institutions and free market economic systems.
9. The attractiveness of a country as a market and/or investment site depends on balancing the likely long-run benefits of doing business in that country against the likely costs and risks.
10. The benefits of doing business in a country are a function of the size of the market (population), its present wealth (purchasing power), and its future growth prospects. By investing early in countries that are currently poor but are nevertheless growing rapidly, firms can gain first-mover advantages that will pay back substantial dividends in the future.
11. The costs of doing business in a country tend to be greater where political payoffs are required to gain market access, where supporting infrastructure is lacking or underdeveloped, and where adhering to local laws and regulations is costly.
12. The risks of doing business in a country tend to be greater in countries that are politically unstable, are subject to economic mismanagement, and lack a legal system to provide adequate safeguards in the case of contract or property rights violations.

Critical Thinking and Discussion Questions

1. Free market economies stimulate greater economic growth, whereas state-directed economies stifle growth. Discuss.
2. A democratic political system is an essential condition for sustained economic progress. Discuss.
3. What is the relationship between corruption in a country (i.e., bribe taking by government officials) and economic growth? Is corruption always bad?
4. The Nobel Prize–winning economist Amartya Sen argues that the concept of development

should be broadened to include more than just economic development. What other factors does Sen think should be included in an assessment of development? How might adoption of Sen's views influence government policy? Do you think Sen is correct that development is about more than just economic development? Explain.

5. You are the CEO of a company that has to choose between making a $100 million investment in Russia or the Czech Republic. Both investments promise the same long-run return, so your choice is driven by risk considerations. Assess the various risks of doing business in each of these nations. Which investment would you favor and why?
6. Read the Country Focus on India in this chapter and answer the following questions:
   a. What kind of economic system did India operate under during 1947 to 1990? What kind of system is it moving toward today? What are the impediments to completing this transformation?
   b. How might widespread public ownership of businesses and extensive government regulations have impacted (*i*) the efficiency of state and private businesses, and (*ii*) the rate of new business formation in India during the 1947–90 time frame? How do you think these factors affected the rate of economic growth in India during this time frame?
   c. How would privatization, deregulation, and the removal of barriers to foreign direct investment affect the efficiency of business, new business formation, and the rate of economic growth in India during the post-1990 time period?
   d. India now has pockets of strengths in key high-technology industries such as software and pharmaceuticals. Why do you think India is developing strength in these areas? How might success in these industries help to generate growth in the other sectors of the Indian economy?
   e. Given what is now occurring in the Indian economy, do you think the country represents an attractive target for inward investment by foreign multinationals selling consumer products? Why?

Research Task

Use the globalEDGE™ site to complete the following exercises:

1. The definition of words and political ideas can have different meanings in different contexts worldwide. In fact, the *Freedom in the World* survey evaluates the state of political rights and civil liberties around the world. Provide a description of this survey and a ranking (in terms of "freedom") of the leaders and laggards of the world. What factors are taken into consideration in this survey?
2. One way that experts analyze conditions in different emerging markets and cultures in transition is through the use of economic indictors. Market Potential Indicators (MPI) is an indexing study conducted by the Michigan State University Center for International Business Education and Research (MSU-CIBER) to compare emerging markets on a variety of dimensions. Provide a description of the indicators used in the indexing procedure. Which of the indicators would have greater importance for a company that markets laptop computers? Considering the MPI rankings, which developing countries would you advise this company to enter first?

CLOSING CASE

Indonesia—The Troubled Giant

Indonesia is a vast country. Its 220 million people are spread out over some 17,000 islands that span an arc 3,200 miles long from Sumatra in the west to Irian Jaya in the east. It is the world's most populous Muslim nation—some 85 percent of the population count themselves as Muslims—but also one of the most ethnically diverse. More than 500 languages are spoken in the country, and separatists are active in a number of provinces. For 30 years, this sprawling nation was held together by the strong arm of President Suharto. Suharto

was a virtual dictator who was backed by the military establishment. Under his rule, the Indonesian economy grew steadily, but there was a cost. Suharto brutally repressed internal dissent. He was also famous for "crony capitalism," using his command of the political system to favor the business enterprises of his supporters and family.

In the end, Suharto was overtaken by massive debts that Indonesia had accumulated during the 1990s. In 1997, the Indonesian economy went into a tailspin. The International Monetary Fund stepped in with a $43 billion rescue package. When it was revealed that much of this money found its way into the personal coffers of Suharto and his cronies, people took to the streets in protest and he was forced to resign.

After Suharto, Indonesia moved rapidly toward a vigorous democracy, culminating in October 2004 with the inauguration of Susilo Bambang Yudhoyono, the country's first directly elected president. The economic front has also seen progress. Public debt as a percentage of GDP fell from close to 100 percent in 2000 to less than 60 percent by 2004. Inflation declined from 12 percent annually in 2001 to 6 percent in 2004, and the economy grew by around 4 percent per annum during 2001 to 2005.

But Indonesia lags behind its Southeast Asian neighbors. Its economic growth trails that of China, Malaysia, and Thailand. Unemployment is still high at around 10 percent of the working population. Inflation started to reaccelerate in 2005, hitting 14 percent by year end. Growth in labor productivity has been nonexistent for a decade. Worse still, foreign capital is fleeing the country. Sony made headlines by shutting down an audio equipment factory in 2003, and a number of apparel enterprises have left Indonesia for China and Vietnam. In total, the stock of foreign direct investment in Indonesia fell from $24.8 billion in 2001 to $11.4 billion in 2004 as foreign firms left the nation.

Some observers feel that Indonesia is hobbled by its poor infrastructure. Public infrastructure investment has been declining for years. It was about $3 billion in 2003, down from $16 billion in 1996. The road system is a mess, half the country's population has no access to electricity, the number of brownouts is on the rise as the electricity grid ages, and nearly 99 percent of the population lacks access to modern sewerage facilities. The tsunami that ravaged the coast of Sumatra in late 2004 only made matters worse. Mirroring the decline in public investment has been a slump in private investment. Investment in the country's all-important oil industry fell from $3.8 billion in 1996 to just $187 million in 2002. Oil production has declined even though oil prices are at record highs. Investment in mining has also fallen from $2.6 billion in 1997 to $177 million in 2003.

According to a World Bank study, business activity in Indonesia is hurt by excessive red tape. It takes 151 days on average to complete the paperwork necessary to start a business, compared to 30 days in Malaysia and just 8 days in Singapore. Another problem is the endemically high level of corruption. Transparency International, which studies corruption around the world, ranks Indonesia among the most corrupt, listing it 137 out of the 158 countries it tracked in 2005. Government bureaucrats, whose salaries are very low, inevitably demand bribes from any company that crosses their path—and Indonesia's penchant for bureaucratic red tape means a long line of officials might require bribes. Abdul Rahman Saleh, the attorney general in Indonesia, has stated that the entire legal system, including the police and the prosecutors, is mired in corruption. The police have been known to throw the executives of foreign enterprises into jail on the flimsiest of pretexts, although some well-placed bribes can secure their release. Even though Indonesia has recently launched an anticorruption drive, critics claim it lacks any teeth. The political elite are reportedly so corrupt that it is not in their interests to do anything meaningful to fix the system.[72]

Case Discussion Questions

1. What political factors explain Indonesia's poor economic performance? What economic factors? Are these two related?
2. Why do you think foreign firms have been exiting Indonesia in recent years? What are the implications for the country? What is required to reverse this trend?
3. Why is corruption so endemic in Indonesia? What are its consequences?
4. What are the risks facing foreign firms that do business in Indonesia? What is required to reduce these risks?

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