

## Chapter 2

# UNDERSTANDING FORMAL INSTITUTIONS: POLITICS, LAWS, AND ECONOMICS

### Learning Objectives

After studying this chapter, you should be able to:

1. Identify two types of institutions – formal and informal.
2. explain how institutions reduce uncertainty.
3. identify the two core propositions underpinning an institution-based view of global business.
4. understand the differences between democracy and totalitarianism.
5. list the differences among civil law, common law, and theocratic law.
6. articulate the importance of property rights and intellectual property rights.
7. outline the differences among market economy, command economy, and mixed economy.
8. participate in two leading debates on politics, laws, and economics.
9. draw implications for action.

### General Teaching Suggestions

Politics, laws, and economics are fertile ground for heated debate. The Debates and Extensions at the end of the chapter may give you some ideas for the development of debate teams. If you regularly read the **Wall Street Journal**, you will likely find something that might be used as a tool to bring out some aspects of this chapter and might be effective simply because the topic is current.

### Opening Case Discussion Guide

*Adam Smith versus Deng Xiaoping* compares the 2008 bank bailouts in the US and Europe to trends prior to that time and to trends within China. Prior to 2008, in the western countries there was a movement toward deregulation and privatization. China also began to move in that direction. Although China continued to move toward greater economic freedom, the collapse and near collapse of U.S. banks resulted in fear of a financial disaster. That fear brought an end to moving toward laissez faire and a shift in the opposite direction, including government ownership or control of financial institutions.

This case can yield many questions for class discussion. Should the government have simply used the FDIC to protect depositors while allowing the failing banks to go under and be taken over by other private banks? Did the drastic actions taken in the U.S. and overseas to deal with the crisis actually stimulate more fear on the part of the public and business community? If so, did that fear result in reduced business investment and consumer spending which in turn produced a far greater economic downturn than would otherwise have been the case? Did the events of 2008 (as well as those in 2009 not covered by the case) mean that our economic system has been changed permanently – or temporarily?

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## CHAPTER OUTLINE: KEY CONCEPTS AND TERMS

### Sections I through VIII of Chapter 2

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#### I. FORMAL AND INFORMAL INSTITUTIONS

##### 1. *Key Concept*

Institutions are commonly defined as “the rules of the game.” Institutions have formal and informal components, each with different supportive pillars.

##### 2. *Key Terms*

- **Cognitive pillar** refers to the internalized, taken-for-granted values and beliefs that guide individual and firm behavior.
- **Formal institutions** include laws, regulations, and rules.
- **Informal institutions** include norms, cultures, and ethics.
- **Institutional framework** is made up of formal and informal institutions governing individual and firm behavior.
- **Institution-based view** requires firms to constantly monitor, decode, and adapt to the changing rules of the game to survive and prosper.
- **Institutions** are popularly known as “the rules of the game.”
- **Institutional transitions** are fundamental and comprehensive changes introduced to the formal and informal rules that affect firms as players.
- **Normative pillar** refers to how the values, beliefs, and actions of other relevant players—collectively known as **norms**—influence the behavior of local individuals and firms.
- **Regulatory pillar** is the coercive power of governments.

#### II. WHAT DO INSTITUTIONS DO?

##### 1. *Key Concept*

The key functions of institutions are to reduce uncertainty, curtail transaction costs, and combat opportunism.

##### 2. *Key Terms*

- **Institutional transitions**: defined as “fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect organizations as players.”
- **Opportunism**: defined as self-interest seeking.
- **Transaction costs**: defined as costs associated with economic transactions—or more broadly, costs of doing business.

#### III. AN INSTITUTION-BASED VIEW OF GLOBAL BUSINESS

##### 1. *Key Concepts*

Proposition 1: Managers and firms *rationaly* pursue their interests and make choices within formal and informal institutional constraints in a given institutional framework. Proposition 2: When formal constraints are unclear or fail, informal constraints will play a *larger* role.

#### IV. TWO POLITICAL SYSTEMS

##### 1. *Key Concepts*

Democracy is a political system in which citizens elect representatives to govern the country. Totalitarianism is a political system in which one person or party exercises absolute political control.

##### 2. *Key Terms*

- **Communist totalitarianism** centers on a communist party.
- **Democracy** is a political system in which citizens elect representatives to govern the country on their behalf.
- **Political risk**—risk associated with political changes that may negatively impact domestic and foreign firms.
- **Political system** refers to the rules of the game on how a country is governed politically.
- **Right-wing totalitarianism** is characterized by its intense hatred of communism.
- **Theocratic totalitarianism** refers to the monopolization of political power in the hands of one religious party or group.
- **Totalitarianism (dictatorship)** is defined as a political system in which one person or party exercises absolute political control over the population.
- **Tribal totalitarianism** refers to one tribe or ethnic group (which may or may not be the majority of the population) monopolizing political power and oppressing other tribes or ethnic groups.
- **Political Risk** involves risk associated with political changes that may negatively impact domestic and foreign firms.

#### V. LEGAL SYSTEMS

##### 1. *Key Concept*

Civil law uses comprehensive statutes and codes as a primary means to form legal judgments. Common law is shaped by precedents and traditions from previous judicial decisions.

##### 2. *Key Terms*

- **Civil law** uses comprehensive statutes and codes as a primary means to form legal judgments.
- **Common law** is shaped by precedents and traditions from previous judicial decisions.
- **Copyrights** are the exclusive legal rights of authors and publishers to publish and disseminate their work.
- **Intellectual property** specifically refers to intangible property that results from intellectual activity (such as books, videos, and websites).
- **Intellectual property rights (IPRs)** are rights associated with the ownership of intellectual property. IPRs primarily include rights associated with (1) patents, (2) copyrights, and (3) trademarks.

- **Legal system** refers to the rules of the game on how a country's laws are enacted and enforced.
- **Patents** are legal rights awarded by government authorities to inventors of new products or processes, who are given exclusive rights to derive income from such inventions through activities such as manufacturing, licensing, or selling.
- **Piracy**: The unauthorized use of IPRs—is widespread, ranging from unauthorized sharing of music files to deliberate counterfeiting of branded products.
- **Property rights**: The legal rights to use an economic property (resource) and to derive income and benefits from it.
- **Theocratic law**: A legal system based on religious teachings.
- **Trademarks** are the exclusive legal rights of firms to use specific names, brands, and designs to differentiate their products from others.

## VI. ECONOMIC SYSTEMS

### 1. *Key Concept*

A pure market economy is characterized by *laissez faire* and total control by market forces. A pure command economy is defined by government ownership and control of all means of production. Most countries operate mixed economies with a different emphasis on market versus command forces.

### 2. *Key Terms*

- **Command economy**: Under this system, all factors of production should be government or state-owned and controlled, and all supply, demand, and pricing are planned by the government.
- **Economic system** refers to the rules of the game on how a country is governed economically.
- **Market economy** is a term referring to a system characterized by the “invisible hand” of market forces: government takes a hands-off approach known as the *laissez faire*.
- **Mixed economy**, by definition, is an economic system that has elements of both a market economy and a command economy.

## VII. DEBATES AND EXTENSIONS

### 1. *Key Concept*

Three leading debates: (1) What drives economic development? (2) What are the most effective and least disruptive institutional transitions toward more market competition? (3) How to best measure political risk?

### 2. *Key Terms*

- **Market transition debate** pertains to how to make the transitions work in a most effective and least disruptive way.
- **Moral hazard** refers to recklessness when people and organizations (including firms and governments) do not have to face the full consequences of their actions.
- **Path dependency**: the present choices of countries (as well as firms and individuals) are constrained by the choices made previously.

- **Washington Consensus** is a view centered on the unquestioned belief in the superiority of private ownership over state ownership in economic policymaking that is often spearheaded by two Washington-based international organizations: the International Monetary Fund and the World Bank.

## VIII. MANAGEMENT SAVVY

### 1. *Key Concept*

Managers considering working abroad should have a thorough understanding of the formal institutions before entering a country. In situations where formal constraints are unclear, managers can reduce uncertainty by relying on informal constraints, such as relationship norms.

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## END-OF-CHAPTER GUIDE

- \*Review Question Answers
- \*Critical Discussion Question Answers
- \*Global Action
- \*Video Case
- \*Closing Case

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## REVIEW QUESTION ANSWERS

1. In what ways do institutions influence individuals' and firms' behaviors? Explain your answer.  
*Institutional framework is made up of formal and informal institutions governing individual and firm behavior. Institution-based views require firms to constantly monitor, decode, and adapt to the changing rules of the game to survive and prosper.*
2. Define institutional transitions, and give three examples of where they can be found.  
*Institutional transitions are defined as "fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect organizations as players." China, Poland, and Russia are among the emerging economies moving from central planning to market competition.*
3. Explain the two core propositions behind the institution-based view of global business.  
*First, managers and firms rationally pursue their interests and make choices within institutional constraints. Second, formal and informal institutions combine to govern firm behavior but where formal constraints are unclear or fail; informal constraints play a larger role.*
4. Which are generally more significant: formal or informal constraints? Explain your answer.

*In situations where formal constraints are unclear or fail, informal constraints play a larger role in reducing uncertainty and providing constancy to managers and firms.*

5. Suppose your firm has an opportunity to expand into a totalitarian state. What are some of the issues that you may consider (other than profitability) before taking advantage of the opportunity?  
*To what extent is there opposition to the government in that nation and could that lead to an overthrow of the government but also confiscation of your property? To what extent are there positive relations between your country and that nation and how likely are such relations to continue or could there be a breakdown between the two countries that might threaten your operations in that country? To what extent are there groups who might boycott your products if you do business in that country?*
6. To what extent should your firm become involved in politics within another country?  
*This question should stimulate some interesting thought. Many students will likely point to potential resentment on the part of the general population as well as the dangers of creating political enemies. On the other hand, it can be argued that a firm may need to argue its case before government leaders who are considering laws or policies that could threaten the company.*
7. Compare Maps 1.1 and 1.2 with Map 1.3. To what extent does there appear to be a relationship between political freedom and a country's economic development and power as reflected in its G-20 status? Are there any exceptions to the rule?  
*Some point out that there are many factors that affect economic development in addition to democracy. Although democracies may allow greater economic freedom that can produce innovation and growth, it is possible that a democratically elected government may pursue policies that inhibit growth or it may simply lack the needed resources. Also, it is possible that a totalitarian state may have the resources needed for development and may pursue effective policies in the use of those resources.*
8. Describe the differences among the three types of legal systems.  
*The three systems: Civil Law, Common Law, and Theocratic Law. Civil law uses comprehensive statutes and codes as a primary means to form legal judgments. Common law is shaped by precedents and traditions from previous judicial decisions. Theocratic law is a legal system based on religious teachings.*
9. Give an example of how theocratic law affects daily business operations.  
*There are many possible examples. In Saudi Arabia, McDonald's operates "ladies only" fast-food restaurants and banks have to maintain two retail branches: one for male customers staffed by men and another for female customers staffed by women. These requirements obviously increase costs.*
10. Describe intellectual property and explain its importance.  
*Intellectual property rights (IPRs) primarily include rights associated with (1) patents, (2) copyrights, and (3) trademarks. Patents are legal rights awarded by government authorities to inventors of new products or processes, who are given*

*exclusive (monopoly) rights to derive income from such inventions through activities such as manufacturing, licensing, or selling. Copyrights are the exclusive legal rights of authors and publishers to publish and disseminate their work. Trademarks are the exclusive legal rights of firms to use specific names, brands, and designs to differentiate their products from others.*

11. Is intellectual property easier or more difficult to protect than other types of property and why?

*There is a difference in the mobility of physical property and intellectual property. It is possible to steal intellectual property and transport it to a different part of the world at the speed of light via the Internet. It is possible to use security systems to protect physical property but the protection of intellectual property sometimes can be done through secrecy (in the case of certain processes or formulas) but intellectual property largely involves legal protections. Those protections may exist within a country and they may be recognized by other countries but it takes time and money to pursue issues in court and there is no assurance that a firm will ultimately prevail in all countries.*

12. Name and describe the three economic systems.

- *Command economy: under this system, all factors of production should be government or state-owned and controlled, and all supply, demand, and pricing are planned by the government.*
- *Market economy is a term referring to a system characterized by the “invisible hand” of market forces: government takes a hands-off approach known as the laissez faire.*
- *Mixed economy, by definition, is an economic system that has elements of both a market economy and a command economy.*

13. Which economic system is the most common and why?

*Overall, the economic system of most countries is a mixed economy. In practice, when we say a country has a market economy, it is really a shorthand version for a country that organizes its economy mostly (but not completely) by market forces and that still has certain elements of a command economy.*

14. Generally speaking, what is the result of strong, effective, market-supporting formal institutions?

*Formal institutions include laws, regulations, and rules and are essential to the growth of global business. Markets are very much affected by stability and predictability. Uncertainty and potential chaos discourage investment in a given nation and tend to shift such expansion and the resulting economic development to those nations in which the formal institutions are supportive of markets.*

15. Why should managers guard against a herd mentality?

*It is important to use independent judgment rather than simply doing what everyone else is doing since there may be a better way than what others are doing.*

16. If formal constraints are unclear or ineffective, what else can managers use to reduce uncertainty?

*It is important to recognize the informal constraints that sometimes can be more significant than the formal constraints.*

### CRITICAL DISCUSSION QUESTION ANSWERS

1. How do you explain your country's economic success (or failure)?  
*Encourage students to answer this question by focusing on concepts brought forth in this chapter (political systems, laws, economic systems) and avoid using the question to expound favor or opposition to a politician or ideology. However, this is a question in which the answer is not as important as the thought process and the ability to clearly articulate.*
2. What is your view on the debate between private ownership and state ownership?  
*The response will likely be the result of ideology but this is a question in which the answer is not as important as the thought process and the ability to clearly articulate.*
3. *ON ETHICS:* As manager, you discover that your firm's products are counterfeited by small family firms that employ child labor in rural Bangladesh. You are aware of the corporate plan to phase out these products soon. You also realize that once you report the counterfeiting to the authorities, these firms will be shut down, employees will be out of work, and families and children will be starving. How would you proceed?  
*This is a question in which the answer is not as important as the thought process and the ability to clearly articulate. However, since you plan to phase out the product you may choose to ignore the counterfeiting. Even though child labor is involved, since child starvation is worse, you might offer advice to the family firms as to how to be more successful.*
4. *ON ETHICS:* Your multinational is the largest foreign investor and enjoys good profits in Sudan, where government forces are reportedly cracking down on rebels and killing civilians, and Vietnam, where religious leaders are reportedly being prosecuted. As country manager, you understand that your firm is pressured by activists to exit these countries. The alleged government actions, which you personally find distasteful, are not directly related to your operations. How would you proceed?  
*Although this is also a question in which the answer is not as important as the thought process and the ability to clearly articulate, there are some things that should be considered even by students who really do not care about social/humanitarian issues and are only concerned about the bottom line. In a global economy with instant global communication of news, the policies of a given country might not affect a firm's operations in that country but it might affect the firm's sales and problems with legislative initiatives in other countries.*

## GLOBAL ACTION

1. Evaluating political risk is an important element of country risk analysis. In fact, your personal interest relates to countries in the Middle East and North Africa region that have a high political risk. Provide a brief overview of the region and the reasoning behind assessing these countries that have been assessed with high political risk. From this list, which country has the highest overall country risk?

### **Exercise 1 Answers**

One resource which can be used is “*A.M. Best Country Risk Ratings*”. This website can be found by entering the search term “country risk analysis” at the globalEDGE™ Resource Desk search box located at <http://globaledge.msu.edu/resourceDesk/>. Once at the A.M. Best Country Risk Ratings website, click on the “AMB Country Risk Report: Global Summary” link (located in the middle). Answers may vary based on the specific report used (the September 2009 report was used for the purposes of this exercise). After reading through the available report, the 5 countries in the Middle East and North Africa which are indicated as high political risk are: Egypt, Jordan, Morocco, Turkey, and Lebanon. To assess which country has the highest overall country risk, each of these 5 countries can be related back to the Country Risk Tier (CRT) list. As such, only Lebanon is listed in the lowest category (CRT-5). Therefore, as of September 2009, Lebanon could be considered to have the highest overall country risk.

**Search Term:** “country risk analysis”

**Resource Name:** *A.M. Best Country Risk Ratings*

**Website:** <http://www3.ambest.com/ratings/cr/crisk.aspx>

**globalEDGE™ Tag:** Country Level

2. Since you work for a diversified multinational corporation, economic risk across different sectors of the world economy is an integral part of analysis as it indicates the future business prospects for specific industries. Evaluate the risk assessment of three industry sectors that are available to analyze. Prepare a report and provide a recommendation concerning which industry and region would be most beneficial to your company.

### **Exercise 2 Answers**

One resource which can be used is “@rating”. This website can be found by entering the search term “different sectors” at the globalEDGE™ Resource Desk search box located at <http://globaledge.msu.edu/resourceDesk/>. Once at the @rating website, use the dropdown box for Sectorial Risk (located on the right side). Answers may vary based on the specific industries chosen. However, if Chemicals, Mass Distribution, and Pharmaceuticals are chosen, then the evaluation may follow a specific format. The worldwide evaluation for each sector is: Chemicals (B+), Mass Distribution (B+), and Pharmaceuticals (A-). In general, this appears positive. In addition, the highest ranking regions (e.g., regions with low industry risk) for each region are as follows: Chemicals (Middle East/North Africa and Japan), Mass Distribution (Middle East/North Africa, CIS,

Japan, Emerging Asia, and Latin America), and Pharmaceuticals (Emerging Asia, North America, Western Europe, and Latin America). This may lead to a discussion concerning the ideal regions for their company. For instance, according to the analysis of the Chemicals, Mass Distribution, and Pharmaceuticals industries, it would appear that the Middle East/North Africa, Japan, and Latin America may be the most beneficial for the company.

**Search Term:** “different sectors”

**Resource Name:** @rating

**Website:** <http://www.trading-safely.com/>

**globalEDGE™** Tag: Country Level

## VIDEO CASE

Watch “Entering the Chinese Market” by Eric Tarchoune of Dragonfly Groupe, Ltd.

1. In what ways did Tarchoune’s knowledge of the Chinese language contribute to his success? Why was it particularly important given the areas of China where he went?

*He went to remote areas of China where there were few western people. His knowledge of both spoken and written Chinese enabled him to survive as well as become an object of curiosity that in turn enabled him to develop contacts and gain recognition.*

2. Western businesses depend on documents and written contracts. What challenge did Tarchoune encounter and how did he cope?

*Some Chinese were concerned that a contract would reveal confidential information. Trust was more important than a written contract.*

3. What did he mean when he said that the rules were “not written on the wall”? What does that suggest when doing business in other countries and cultures?

*He felt that the complexities of the culture and relationships were such that one must learn by doing. That may indicate the need for patience when doing business in an unfamiliar culture.*

4. In many parts of Asia, respect is gained with age but Tarchoune was quite young when he went to China. If a young foreign manager were to be sent to China, what could he or she do to improve his or her managerial effectiveness in that country?

*Understanding both the spoken and written language plus acting like a Chinese person enabled him to gain acceptance and respect – thus providing a model for others in a similar situation.*

5. Tarchoune indicated that there would be some differences in doing business in the larger modern cities of China as compared to where he went. To what extent do you think that such might be the case in other parts of the world? Do you think that Western business people may have a preference for cities that may cause them to ignore opportunities in rural areas? Why?

*Generally western business people tend to favor larger cities where the environment and ways of doing business are likely to be somewhat more similar to their home country. Students may have a variety of viewpoints concerning the impact on opportunities.*

## CLOSING CASE

- **Closing Case Discussion Guide**

Changes in a society and an economy can sometimes occur through natural forces and the use of persuasion but that may take a long time as opposed to making something happen now by simply passing laws. The South African government has sought to use laws as a means of achieving what it views as social and economic justice. However, we live in a global economy where firms around the world can shift where they do business and the rules of the game in any given country are issues that are of concern. In discussing the case, it may be worth discussing whether the net effect of South Africa's are likely to be positive or negative over the long run.

- **Closing Case Discussion Question Answers**

1. How do firms in South Africa play the game when the rules are uncertain?

*Many firms have tried to comply with the rules as they understand them as of a given point in time but they have also tried to lobby or negotiate changes in those rules. As pointed out elsewhere in the text, many such firms have chosen to expand their operations in other parts of the world that offer greater certainty and profitability.*

2. There is a proposition that democracy usually goes hand in hand with a functioning market economy. Does the government's insistence on BEE, often involving nonmarket-based quotas and below-market prices for equity sales to black firms and investors, support or refute this proposition?

*One can point to democracies that have market economies but a democracy involves majority rule and majority rule does not necessarily require a given economic system. Those refuting the proposition might point out that there is a potential threat to a market economy if the "have nots" are a majority and the "haves" are a minority. Those supporting the proposition might point out that in spite of many problems, South Africa has a political and economic system that is much more of democracy and market oriented than some of its neighbors.*

3. Should foreign firms be interested in entering South Africa? Why or why not?

*Some foreign firms may find black entrepreneurs and enterprises with specific talents and market access that offer a more profitable opportunity than is available than in any other nation where they might expand. In such cases, it would make sense to enter the country but if opportunities elsewhere in the world offer even better opportunities then it would make sense to not enter South Africa unless the firm's objectives are more driven by societal values than economic objectives.*

