Politics and Law in Business

Learning Objectives

• Describe each main type of political system.

• Identify the origins of political risk and how managers can reduce its effects.

• List the main types of legal systems and explain how they differ.

• Describe the major legal and ethical issues facing international companies.

• Explain how international relations affect international business activities.

This chapter introduces various types of political and legal systems around the world. Several main political ideologies form the context in which international firms operate globally. Political risk is the likelihood that a government or society will undergo political changes that negatively affect local business activity. International companies manage political risk through adaptation, information gathering, and influencing local politics. A legal system is the set of laws and regulations, including the process by which a country’s laws are enacted and enforced. Three legal systems include common law, civil law, and theocratic law. Global legal issues include standardization across different legal systems, intellectual property, product safety and liability, taxation, and antitrust regulations. The positive or negative atmosphere of international relations is important to international companies. Favorable political relations lead to increased business opportunities and lower risk.
Lecture Outline

1. INTRODUCTION
   Understanding the nature of politics and laws in other nations lessens the risks of conducting international business. This chapter considers the basic differences between differing political and legal systems around the world. Disputes grounded in political and legal matters affect business activities, but companies can manage the associated risks.

2. POLITICAL SYSTEMS
   A political system includes the structures, processes, and activities by which a nation governs itself.

   A. Politics and Culture
      1. A nation’s political system derives from its history and culture.
      2. Factors such as population, age and race composition, and per capita income influence a country’s political system.

   B. Political Participation
      1. Participation occurs when people voice opinions, vote, and show general approval or disapproval of the system.
      2. Wide participation occurs when people who are capable of influencing the political system make an effort to do so. Narrow participation occurs when few people participate.

   C. Political Ideologies (PPT 1-3)
      Political systems fall on a continuum defined by three political ideologies. Anarchism is the belief that only individuals and private groups should control a nation's political activities. Totalitarianism is the belief that every aspect of people’s lives must be controlled in order for a political system to be effective. Pluralism is the belief that private and public groups belong in politics.

      i. Democracy (PPT 4)
      A democracy is a political system in which government leaders are elected directly by the wide participation of the people or their representatives. A pure democracy is one in which all citizens participate in the political process. It is more of an ideal than a workable system.

         a. Representative Democracy
         In representative democracies citizens elect individuals from their groups to represent their political needs and views.

         b. Representative democracies strive to provide: Freedom of expression; periodic elections; full civil and property rights; minority rights; and nonpolitical bureaucracies.

         c. Democracies tend to maintain stable business environments through laws protecting individual property rights. Although participative democracy, property rights, and free markets encourage economic growth, they do not always do so. Some countries achieve economic growth under non-democratic political systems.
2. Totalitarianism (PPT 5-6)

In a totalitarian system, individuals govern without the support of the people, government maintains control over many aspects of people’s lives, and leaders do not tolerate opposing viewpoints. Totalitarian governments share three features: imposed authority, lack of constitutional guarantees, and restricted participation.

a. Theocratic Totalitarianism

A Theocracy is a political system in which a country’s political leaders are religious leaders who enforce laws and regulations based on religious beliefs. Theocratic totalitarianism is a political system in which religious leaders govern without the support of the people and do not tolerate opposing viewpoints.

b. Secular Totalitarianism

Secular totalitarianism is a political system in which leaders rely on military and bureaucratic power.

i. Communism is the belief that social and economic equality can be obtained only by establishing an all-powerful Communist Party and by granting the government ownership and control over all types of economic activity. Socialism is the belief that social and economic equality is obtained through government ownership and regulation of the means of production.

ii. In tribal totalitarianism one tribe (or ethnic group) imposes its will on others with whom it shares a national identity. It characterizes the governments of many African nations (e.g., Burundi and Rwanda).

iii. In right-wing totalitarianism the government endorses private ownership of property and a market-based economy but grants few (if any) political freedoms. Leaders strive for economic growth while opposing left-wing totalitarianism, or communism. The Chinese political system is a mix of communist and right-wing totalitarianism.

c. Doing Business in Totalitarian Countries

International companies need not be concerned with political opposition outside the government. Doing business can be risky because the law is vague or nonexistent, and people in powerful government positions can interpret laws at will. Companies doing business in totalitarian nations are often criticized for lack of compassion for those hurt by oppressive political policies.

3. Implications

Which system provides a more stable business environment? Democracies strive to guarantee civil and property rights whereas totalitarian governments can repeal them. Democracy does not guarantee rapid economic growth nor does totalitarianism ensure slow economic growth. Important are country’s tax system, encouragement of investment, capital availability, and openness to trade and investment.
D. Political Systems in Times of Change
People around the world are demanding greater participation in politics and many nations are abandoning totalitarianism. Globalization is causing changes in values and attitudes.

3. POLITICAL RISK (PPT 7-8)
Political risk is the likelihood that a government or society will undergo political changes that negatively affect local business activity. It can threaten an exporter’s market, manufacturing facilities, and the ability to repatriate profits. Political risk arises from:
- Corrupt or poor political leadership
- Frequent changes in the form of government
- Political involvement of religious or military leaders
- An unstable political system
- Conflict among races, religions, or ethnic groups
- Poor relations with other countries

To reduce political risk, managers should understand local values, customs, and traditions. (Map 3.2 shows political risk levels around the world).

A. Types of Political Risk (PPT 9-11)
Macro risk threatens all companies regardless of industry and affects all companies equally in a country, both domestic and international. Micro risk threatens companies within a particular industry or even smaller groups. Five events can cause political risk:

1. Conflict and Violence
   a. Local conflict discourages international investment. Violent disturbances hinder manufacturing, obtaining materials and equipment, and recruiting talented personnel.
   b. Conflict can arise from resentment toward the government. When dispute resolution fails, violent attempts to change political leadership may ensue.
   c. Conflict can arise from territorial disputes.
   d. Disputes among ethnic, racial, and religious groups can erupt in conflict.

2. Terrorism and Kidnapping
   a. Kidnapping and other terrorist activities are used to make political statements. Groups dissatisfied with current political or social situations resort to terrorist tactics aimed at forcing change through fear and destruction.
   b. Kidnapping and hostage taking fund terrorism.

3. Property Seizure
Seizure of assets falls into three categories.
   a. **Confiscation** is the forced transfer of assets from a company to the government without compensation. There is no framework for legal appeal, and compensation is far below market value.
b. **Expropriation** is the forced transfer of assets from a company to the government with compensation.

c. **Nationalization** involves government takeover of an *entire* industry and is more common than confiscation and expropriation. It is used 1) to obtain control over cash flows, 2) for ideological reasons, 3) as a political tool, and 4) to support industries in which private companies do not invest.

4. Policy Changes
   a. Government policy changes result from newly empowered political parties, pressure from special interests, and civil or social unrest.
   b. One policy tool restricts ownership to domestic companies or limits ownership by non-domestic firms to a minority stake.
   c. Other policies relate to investments made across borders.

5. Local Content Requirements
   a. **Local content requirements** stipulate that a specified amount of a good or service be supplied locally. They ensure that companies foster local business activity and ease unemployment.
   b. These requirements force companies to use local raw materials, procure parts from local suppliers, or employ local workers. They can force a firm to take on poorly trained or excess workers, and local raw materials could increase costs or reduce quality.

---

**B. Managing Political Risk (PPT 12-14)**

Companies must try to manage political risks that threaten operations and future earnings. There are three methods of managing political risk.

1. **Adaptation**, which means incorporating risk into business strategies, often with the help of local officials. Companies can incorporate risk in several ways.
   a. **Local equity and debt** involves financing local business activities with the help of local firms, trade unions, financial institutions, and government.
   b. **Localization** entails modifying operations, the product mix, or other element to suit local tastes and culture.
   c. **Development assistance** allows an international business to assist the host country in developing distribution and communications networks and improving the quality of life for locals.
   d. **Partnerships** can be used to leverage expansion plans through informal arrangements or joint ventures, strategic alliances, and cross-holdings of company stock.
   e. **Insurance** can be used to protect companies against losses and can provide project financing.

2. **Information gathering** helps international firms to predict and manage political risk. Sources of information include current employees with relevant information, and political risk service agencies.

3. **Influencing local politics** involves dealing with local lawmakers and politicians directly or through lobbyists.
a. Corruption
   i. Bribes are one method of gaining political influence and are routinely used to get distributors and retailers to push a firm’s products through distribution channels.
   ii. The Foreign Corrupt Practices Act forbids U.S. companies from bribing government officials or political candidates in other countries (unless a person’s life is in danger). A bribe constitutes “anything of value”—money/gifts—and cannot be given to any “foreign government official” empowered to make a “discretionary decision” that may be to the payer’s benefit.
   iii. Corruption leads to the misallocation of resources, hurts economic development, distorts public policy, and damages the integrity of “the system” (Table 3.1).

4. LEGAL SYSTEMS (PPT 15, 18)
   A country’s legal system is the set of laws and regulations, including the process by which laws are enacted and enforced and the ways in which courts hold parties accountable for their actions. It is influenced by cultural variables, including class barriers, religious beliefs, emphasis on individualism or conformity, and the political system. Totalitarian governments favor public ownership and enact laws limiting entrepreneurial behavior; democracies encourage entrepreneurial activity and protect businesses with strong property-rights laws.

A. Types of Legal Systems
   1. Common Law
      • **Tradition**: Country’s legal history.
      • **Precedent**: Past cases that have come before the courts.
      • **Usage**: Ways in which laws are applied in specific situations.
      a. Originated in England in the eleventh century and was adopted in its territories worldwide.
      b. Business contracts tend to be lengthy because they consider many contingencies and possible interpretations in case of dispute. Common law systems are flexible, taking into account particular situations and circumstances.
      c. Common law is practiced in Australia, Britain, Canada, Ireland, New Zealand, the United States, and some nations in Asia and Africa.
   2. Civil Law
      a. Civil law is based on a detailed set of written rules and statutes that constitute a legal code. This system can be traced to Rome in the fifth century B.C. and is the oldest and most common legal tradition.
      b. Civil law can be less adversarial than common law because it is not interpreted according to tradition, precedent, and usage. Because laws are codified and concise, parties are concerned
with the explicit wording of the code; obligations, responsibilities, and privileges follow the relevant code.
c. Civil law is practiced in Cuba, Puerto Rico, Quebec, all of Central and South America, most of Western Europe, and in parts of Asia and Africa.

3. Theocratic Law
   a. Theocratic law is a legal tradition based on religious teachings (e.g., Islamic, Hindu, and Jewish law).
   b. Islamic law is the most widely practiced theocratic legal system today. Islamic law was initially a code governing moral and ethical behavior and was later extended to commercial transactions. It restricts investments and sets guidelines for business conduct.
   c. Firms operating in countries with theocratic legal systems must be sensitive to local values and beliefs. They should evaluate business activities, including hiring practices and investment policies, to ensure compliance with the law, local values, and beliefs.

5. GLOBAL LEGAL ISSUES (PPT 16-17)
   Laws related to product quality, product liability, environmental pollution, and employee treatment are far tougher in European countries and the United States than in Africa, Asia, and Latin America. Legal differences can develop into ethical issues.

A. Intellectual Property
   1. Intellectual property results from people’s intellectual talent and abilities: Includes graphic designs, novels, computer software, machine-tool designs, and secret formulas.
   2. Property rights are the legal rights to resources and any income they generate. Intellectual property can be traded, sold, and licensed in return for fees and/or royalty payments.
   3. Although intellectual property laws compensate people whose rights are infringed, nations vary in such laws and their enforcement (Figure 3.1).
      a. Industrial Property includes patents and trademarks—often a firm’s most valuable assets. Laws protecting industrial property are designed to reward inventive and creative activity.
         i. A patent is a right granted to the inventor of a product or process that excludes others from making, using, or selling the invention. WTO grants patents for 20 years.
         ii. Trademarks are words or symbols that distinguish a product and its manufacturer. Trademark protection lasts indefinitely, provided the word or symbol continues to be distinctive.
      b. Copyrights give creators of original works the freedom to publish or dispose of them as they choose.
         i. Copyright holder has the right to:
            • Reproduce the copyrighted work
            • Derive new works from it
• Sell or distribute it
• Perform it
• Display it publicly.

ii. Copyrights are protected under the Berne Convention and the 1954 Universal Copyright Convention.

B. Standardization
1. Standardization refers to uniformity in interpreting and applying laws in more than one country, not to the standardizing of entire legal systems.
2. Treaties and agreements already exist in intellectual property rights, antitrust (antimonopoly) regulation, taxation, contract arbitration, and general matters of trade.
3. International organizations that promote standardization: the UN, OECD, and International Institute for the Unification of Private Law.
4. The EU is standardizing some areas of its nations’ legal systems.

C. Product Safety and Liability
1. Most countries have product safety laws that lay down standards to be met by manufactured products. Product liability holds manufacturers, sellers, and others, including individual company officers, responsible for damage, injury, or death caused by defective products.
2. The United States has the toughest product liability laws in the world, with Europe a close second. Less-developed and emerging countries have the weakest laws.

D. Taxation
1. Tax revenues needed to pay government salaries, build military capacity, and shift earnings from people with high incomes to the poor.
2. Consumption taxes are indirect taxes that help pay for consequences of using a particular product and to make imports more expensive.
3. A value added tax (VAT) is a tax levied on each party that adds value to a product throughout its production and distribution.

E. Antitrust Regulations
1. Antitrust (antimonopoly) laws are designed to prevent companies from fixing prices, sharing markets, and gaining unfair monopoly advantages. Such laws provide a wide variety of products at fair prices.
2. The United States and European Union have strict antitrust regulation and are strict enforcers. In Japan, the Fair Trade Commission enforces antitrust laws, but it is often ineffective because absolute proof of wrongdoing is needed to bring charges.
3. In strict antitrust countries, companies see a disadvantage against competitors whose home countries condone market sharing, whereby competitors agree to serve only designated market segments.

6. ETHICS AND SOCIAL RESPONSIBILITY (PPT 19-20)
In international business, managers are exposed to different conceptions of ethical behavior and guidelines for socially responsible behavior. Child labor, human rights, the environment, and plant closings are the heart of debates over impact of multinationals. Managers must monitor behavior of themselves, employees, and business partners.

1. Ethical Behavior
   a. **Ethical Behavior** is personal behavior that is in accordance with rules or standards for right conduct or morality.
   b. No right or wrong decisions, but there are alternatives, each of which may be equally valid, depending on one’s perspective.
   c. One view is that home-country policies should be implemented. Another view says, “When in Rome, do as the Romans.”
   d. Enron’s failure sent a shockwave around the world. Energy trading markets were in chaos and many lost jobs worldwide.
   e. Governments, accounting boards, and regulators called for higher accounting standards and more transparent financial reporting.
   f. In 2002, the U.S. Congress passed the Sarbanes-Oxley Act, which set more stringent accounting standards and reporting practices.

2. Social Responsibility
   a. **Social Responsibility** is the practice of companies going beyond legal obligations to actively balance commitments to investors, customers, other companies, and communities.
   b. Governments, labor unions, consumer groups, and human rights activists force apparel companies to implement codes of conduct and monitoring principles in international production.
   c. These include trade initiatives with developing nations (government issue), the relocation of home-country factories abroad (labor issue), and the treatment of workers by contractors abroad (human rights issue).
   d. Business leaders realize that the future rests on healthy workforces and environments (e.g., Starbucks’ “fair-trade coffee”).

7. BUSINESS AND INTERNATIONAL RELATIONS (PPT 22)
Favorable political relationships foster stable business environments and increase international cooperation. Stable environment requires a strong legal system to resolve disputes quickly and fairly. *Multilateral agreements* are treaties concluded among several nations, each of which agrees to abide by treaty terms even if tensions develop.

A. The United Nations
   1. The **United Nations** was formed after the Second World War to provide leadership in fostering peace and stability around the world. The UN and its many agencies provide food and medical supplies, educational supplies and training, and financial resources to poor member nations.
   2. The UN receives funding from member contributions based primarily on gross national product (GNP). Entire world is involved with the UN in some manner (Figure 3.2).
   3. The UN system consists of six main organs; (1) General Assembly; (2) Security Council; (3) Economic and Social Council; (4) Trusteeship Council; (5) International Court of Justice; and (6) the Secretariat.
4. Within the UN Economic and Social Council is the United Nations Conference on Trade and Development (UNCTAD). The organization has a broad mandate in international trade and economic development.

8. **BOTTOM LINE FOR BUSINESS**
Differences in political and legal systems present both opportunities and risks for international companies. Understanding differences in culture, politics, and law is the first step for any company that hopes to manage the risks of doing business in unfamiliar environments. Managers of international companies also need to understand how global legal issues, including intellectual property, product safety, and antitrust laws, affect operations and strategy.