CHAPTER 3
POLITICS, LAW, AND BUSINESS ETHICS

LEARNING OBJECTIVES:
1. Describe each main type of political system.
2. Identify the origins of political risk and how managers can reduce its effects.
3. List the main types of legal systems and explain how they differ.
4. Describe the major legal and ethical issues facing international companies.
5. Explain how international relations affect international business activities.

CHAPTER OUTLINE:

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Political Systems
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   Political Participation
   Political Ideologies
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         Representative Democracy
         Doing Business in Democracies
      Totalitarianism
         Theocratic Totalitarianism
         Secular Totalitarianism
         Communist Totalitarianism
         Tribal Totalitarianism
         Right-Wing Totalitarianism
         Doing Business in Totalitarian Countries
   Political Systems in Times of Change
Political Risk
   Types of Political Risk
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      Terrorism and Kidnapping
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         Nationalization
   Policy Changes
      Local Content Requirements
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Legal Systems
Types of Legal Systems
  Common Law
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  Intellectual Property
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Business and International Relations
  The United Nations
Bottom Line For Business
  Implications for Doing Business in Democracies
  Implications for Doing Business in Totalitarian Nations
  Which Government Is Best for Business?
  Implications of Legal Issues for Companies

A comprehensive set of specially designed PowerPoint slides (designated ‘PPT’ below) is available for use with Chapter 3. These slides and the lecture outline below form a completely integrated package that simplifies the teaching of this chapter’s material.

**Lecture Outline**

1. **INTRODUCTION**
   This chapter considers the basic differences between 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 (PPT #1-2)**
   Political system: 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 #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.

1. Democracy (PPT #4)

   **Democracy**: Political system where government leaders are elected directly by the wide participation of the people or their representatives.

   a. 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.

2. Totalitarianism (PPT #5-6)

   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**: political system in which religious leaders govern without the support of the people and do not tolerate opposing viewpoints.

   b. **Secular totalitarianism**: political system in which leaders rely on military and bureaucratic power.

      i. **Communism**: obtain social and economic equality only by establishing an all-powerful Communist Party and by granting the government ownership and control over all types of economic activity.

      ii. **Socialism**: obtain social and economic equality through government ownership and regulation of the means of production.

      iii. **Tribal totalitarianism**: one tribe (or ethnic group) imposes its will on others with whom it shares a national identity.

      iv. **Right-wing totalitarianism**: government endorses private ownership of property and a market-based economy but grants few (if any) political freedoms. Leaders strive for economic growth but oppose left-wing totalitarianism, or communism.

   c. Doing Business in Totalitarian Countries: Companies need not be concerned with political opposition outside the government. Doing business can be risky because the law is vague or
3. Nonexistent, and people in powerful government positions can interpret laws at will.

Implications

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 growth.

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 playing a role.

3. POLITICAL RISK (PPT #7)

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

A. Types of Political Risk (PPT #8-11)

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. Can arise from resentment toward the government. When dispute resolution fails, violent attempts to change political leadership may ensue.
   c. Can arise from territorial disputes.
   d. Can arise from ethnic, racial, and religious disputes.

2. Terrorism and Kidnapping
   a. Used to make political statements. Groups dissatisfied with current political or social situations try to force change through fear and destruction.
   b. Kidnapping and hostage-taking can fund terrorism.

3. Property Seizure
   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. 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. Specify an amount of a product to be supplied locally. Fosters local business activity and creates jobs.
   b. 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 manage political risks that threaten operations and future earnings.

1. Adaptation: Incorporate risk into business strategies, often with the help of local officials.
   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: Predict and manage political risk. Sources include employees with information and political risk agencies.

3. Influencing local politics: Deal 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. 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” 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.”
4. **LEGAL SYSTEMS (PPT #15)**
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 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. Practiced in Australia, Britain, Canada, Ireland, New Zealand, the United States, and some nations in Asia and Africa.

2. **Civil Law**
   a. Based on a detailed set of written rules and statutes that constitute a legal *code*. Can be traced to Rome in the fifth century B.C. and is the oldest and most common legal tradition.
   b. 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. Practiced in Cuba, Puerto Rico, Quebec, Central and South America, most of Western Europe, and parts of Asia and Africa.

3. **Theocratic Law**
   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. It 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. Must 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 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. Results from intellectual talent and abilities such as 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. Nations vary in such laws and their enforcement.
   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 can (1) reproduce the copyrighted work, (2) derive new works from it, (3) sell or distribute it, (4) perform it, and (5) 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 U.S. and Europe have the toughest product liability laws. 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 #18-19)

   International 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 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.

7. BUSINESS AND INTERNATIONAL RELATIONS (PPT #20)

   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. 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. Receives funding from member contributions based on gross national product (GNP). Entire world is involved with the UN in some manner.

3. 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.