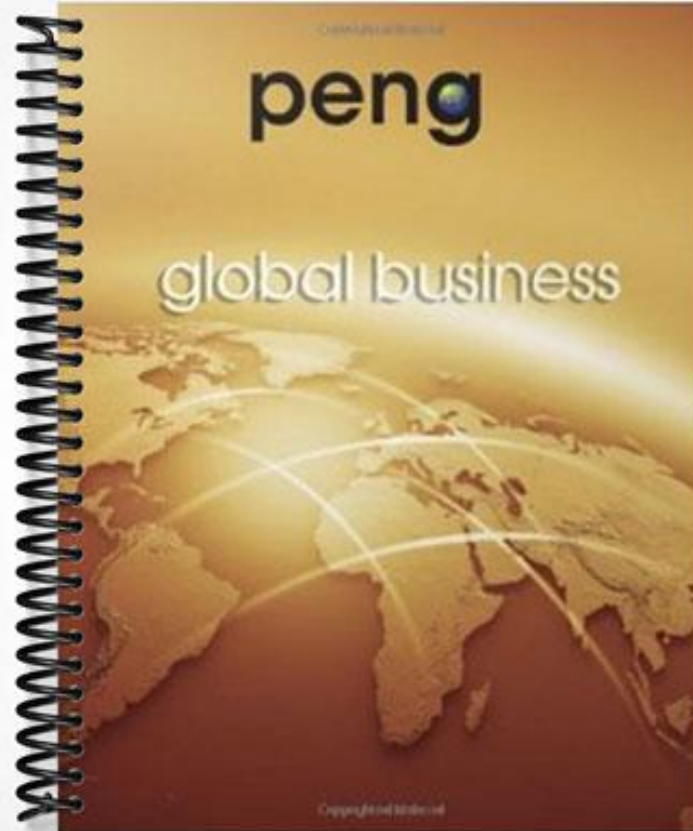


SOLUTIONS MANUAL



Chapter 2

UNDERSTANDING FORMAL INSTITUTIONS: POLITICS, LAWS, AND ECONOMICS

Learning Objectives

After studying this chapter, you should be able to

1. explain the concept of institutions and their key role in reducing uncertainty
2. articulate the two core propositions underpinning an institution-based view of global business
3. identify the basic differences between democracy and totalitarianism
4. outline the differences among civil law, common law, and theocratic law
5. understand the importance of property rights and intellectual property rights
6. appreciate the differences among market economy, command economy, and mixed economy
7. participate in three leading debates on politics, laws, and economics
8. draw managerial implications

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

Ask students whether any prosperity in South Africa is due to the government or in spite of the government. Is South Africa enjoying the level of prosperity that it might have if some of the government's policies were modified? On the other hand, is prosperity or social justice the primary objective? ("Man shall not live by bread alone.") Is South Africa achieving either objective to the degree that it is possible?

CHAPTER OUTLINE: KEY CONCEPTS AND TERMS

Sections I through VIII of Chapter 2

I. FORMAL AND INFORMAL INSTITUTIONS

1. *Key Concepts*

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.”
- **Normative pillar** refers to how the values, beliefs, and actions of other relevant players—collectively known as **norms**—influence the behavior of focal individuals and firms.
- **Regulatory pillar** is the coercive power of governments.

II. WHAT DO INSTITUTIONS DO?

1. *Key Concepts*

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** are 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 *rationally* 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. THREE LEGAL SYSTEMS

1. *Key Concepts*

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*

- **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. THREE ECONOMIC SYSTEMS

1. *Key Concepts*

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 Concepts*

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.
- **Path dependency**: the present choices of countries (as well as firms and individuals) are constrained by the choices made previously.

VIII. MANAGEMENT SAVVY

1. *Key Concepts*

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.

2. *Key Terms*

- **Herd mentality**—a behavior influenced by the movement of the crowd (or the herd) with little independent judgment.

END-OF-CHAPTER GUIDE

- *Review Question Answers
- *Critical Discussion Question Answers
- *Video Case
- *Closing Case
- *Integrative Case

REVIEW QUESTION ANSWERS

1. Name and describe the one pillar that supports formal institutions and the two additional pillars that support informal institutions.
The formal and primary pillar is the regulatory pillar: it is the coercive power of governments. The informal pillars consist of the following: (1) the cognitive pillar which refers to the internalized, taken-for-granted values and beliefs that guide individual and firm behavior and the normative pillar which refers to how the values, beliefs, and actions of other relevant players—collectively known as norms—influence the behavior of focal individuals and firms.

2. 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.

3. 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.

4. 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.

5. 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.

6. What fundamental aspect of democracy is relevant to the effective conduct of global business?

A fundamental aspect of democracy that is relevant to the effective conduct of global business is an individual's right to freedom of expression and organization. In most modern democracies, this right to organize economically has not only been extended to domestic individuals and firms but also to foreign individuals and firms that come to do business.

7. Name and describe the four types of totalitarianism.

- *Communist totalitarianism centers on a communist party.*
- *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.*
- *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.*

8. How does political risk affect global business?

Political risk by definition is risk associated with political changes that may negatively impact domestic and foreign firms. When the risk is very high in a given country, it is not surprising that companies would rather go to “greener pastures” elsewhere.

9. 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.
10. 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 restaurant 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.
11. Name three types of economic property, and explain how they could be used in business.
Economic property includes tangible economic resources (homes, offices, factories), intangible economic resources (3 kinds: patents, copyrights, trademarks) and the right to obtain income and benefits from those resources.
12. Name three types of intellectual property, and explain how they could be used in business.
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.
13. What is TRIPS?
TRIPS refers to the Agreement on Trade-Related Aspects of Intellectual Property Rights. Given the global differences in the formal rules, much stricter IPR protection is provided by TRIPS. Once countries join TRIPS, firms are often forced to pay more attention to innovation.
14. 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.*
- 15. 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.
- 16. Our current system of intellectual property protection stems from what early patent law?
The Statute of Monopolies enacted in Great Britain in 1624 was the world's first patent law to formally protect the IPRs of inventors and make innovation financially lucrative.
- 17. Describe two contrasting examples of market transitions.
Market transition debate pertains to how to make the transitions work in a most effective and least disruptive way. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.
- 18. Explain path dependency, how a country's present choices are often constrained by earlier choices.
Path dependency: the present choices of countries (as well as firms and individuals) are constrained by the choices made previously.
- 19. Which do you think offers a more accurate measure of political risk: one based on perception or one based on political and regulatory structures? Explain your answer.
Perceptions can be inaccurate but they affect what people and firms do. The important thing is not so much the answer as the extent to which the student demonstrates thought in providing the answer.
- 20. 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.
- 21. 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.
- 22. If formal constraints are unclear or ineffective, what else can managers use to reduce uncertainty?

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.

CRITICAL DISCUSSION QUESTION ANSWERS

1. Without looking at any references, please identify the top-three countries with the most significant change in political risk in the last five years. Then consult references based on both perception and objective measures. How do your own intuition and the two kinds of measures differ?

This is a question in which the answer is not as important as the thought process and the ability to clearly articulate.

2. **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 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.

3. **ON ETHICS:** Your multinational is the largest foreign investor and enjoys good profits in (1) Sudan, where government forces are reportedly cracking down on rebels and killing civilians, and (2) 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.

VIDEO CASE: "MONITOR YOUR BUSINESS ENVIRONMENT AND ANTICIPATE CHANGE" BY PAUL SKINNER OF RIO TINTO.

- **Introduction:**

the case demonstrates the value of contingency planning and it shows how institutions (the government) can affect an organization. In discussing the case, point out that it is not only good to consider what is likely to happen as a result of government action and develop contingency plans for such an outcome but consider how the firm may help bring about the action that it wants. Help students to go beyond lobbying and consider how certain positive actions might affect the public and in turn legislators.

- **Questions and Answers:**

1. How did formal institutions impact Mr. Skinner's organization?
Government regulation maintained tight controls over pricing, ownership of retail operations, and other aspects of the industry thus limiting options and opportunities.
2. How did his contingency planning give him an advantage over those with a herd mentality and enable his firm to profit from the change in formal institutions?
His organization had been tracking changes that would ultimately result in deregulation. The firm thus developed a contingency plan to deal with the changes once they occurred so that it would be able to exploit those changes faster and more effectively than competitors.
3. Based on Mr. Skinner's experience, how does the economic system and the regulatory pillar interact in affecting the organization?
New Zealand had a mixed economy but the mix tilted toward government control and as a result the regulatory pillar had a far greater impact on what a business could do than later when the "mix" in that economy shifted toward more private control.
4. According to this chapter, "managers and firms *rationally* pursue their interests and make choices within institutional constraints." Based on that, how might firms in Mr. Skinner's industry maximize their position before and after deregulation?
Students may have various suggestions. Some may point out that in view of government controls, prior to deregulation there would have been incentive to lobby the government and seek favorable rules from regulators. After deregulation, firms would need to place greater focus on being more effective than competitors in seeking a favorable response from customers.

CLOSING CASE

- **Closing Case Discussion Guide**

This case can be discussed with current news paper (including Online editions) or clips of TV news. In 2008 when oil hit \$100 a barrel and Russian leadership was becoming less democratic, the oil rich country was enjoying increased prosperity, some of which was going into rebuilding its military and trying to regain its status as a major world power. However, that reality ties directly into a discussion of question number one below.

- **Closing Case Discussion Question Answers**

1. Does the Russian experience support or refute the claim that democracy is conducive to economic growth?
You can point out that Russia has experienced economic growth both with and without "democracy" – in the case of Russia, democracy is relative.
2. Although a stable legal framework that protects property rights reportedly can remove uncertainty and thus facilitate economic growth, the government's

protection of oligarchs is not without controversies. If you were to advise the Russian government on property rights reforms, what would be your advice?
This is a question in which the answer is not as important as the thought process and the ability to clearly articulate.

3. If you were a board member at one of the major Western multinational retailers (such as Carrefour, IKEA, Metro, or Wal-Mart), would you vote yes or no for a new project to set up your firm's first major store in Russia?
This is a question in which the answer is not as important as the thought process and the ability to clearly articulate.

INTEGRATIVE CASE 1.2 DP WORLD

Analysis: one of the concerns often raised to oppose trade or international investment, is the national security argument. It is the idea that some activity is so vital to our survival, especially in time of war, that it must be under U.S. control. This case is an example of that concern.

Answers to Questions:

1. From a resource-based view, why was DP World interested in acquiring US ports? What advantages did it have or was interested in acquiring?
If the students have difficulty answering that question, ask them to consider what was the main business of DP World and to what extent is the U.S. a player in international trade?
2. From an institution-based view, did this acquisition violate any formal laws, rules, and regulations?
It is difficult to make a case for formal violation.
3. Also from an institution-based view, what informal rules and norms did this acquisition "violate" that triggered such a strong negative reaction in the United States?
The informal "rules and norms" were ones that came about over the past decade and became more potent in the 21st century. Ask the student whether they think that there would have been the same level of objection in the 1980's and why they feel that way.
4. Did DP World and its American lawyers and other advisors do enough homework?
This is a question in which the answer is not as important as the thought process and the ability to clearly articulate.
5. Combining the institution- and resource-based views, what advantages did Eller have that DP did not have? Did Eller's political strategy make sense?

Students will probably point out that Eller had the advantage of not being Middle Eastern and that whether its strategy made sense, it was effecting in killing the DP deal.

6. If you were CEO of Hong Kong's Hutchison Whampoa, Singapore's PSA, Denmark's Maersk, or Germany's Eurogate, what lessons would you draw from this case when entertaining the idea of acquiring US port operations?
This should not be a difficult question for students to answer – in the negative. However, challenge them to see that being a firm that is located overseas may not always be a problem. For example, an operation based in North Korea would likely be rejected outright but one based in South Korea might at least be given some consideration.

