7. Political and Legal Systems
Read chapter 7
Learning Objectives

1. The nature of country risk
2. Political and legal environments in int’l business
3. Political systems
4. Legal systems
5. Participants in political and legal systems
6. Types of country risk produced by political systems
7. Types of country risk produced by legal systems
8. Managing country risk
Agenda

The Nature of the Political Evolution

Political and Legal Systems

Types of Political Systems

Country Risks Produced by Political Systems

Types of Legal Systems

Country Risks Produced by Legal Systems

Managing Country Risk
The Nature of the Political Evolution

- Political and Legal Systems
  - Types of Political Systems
    - Country Risks Produced by Political Systems
  - Types of Legal Systems
    - Country Risks Produced by Legal Systems

Managing Country Risk
What is Country Risk?

Exposure to potential loss or adverse effects on company operations and profitability caused by developments in a country’s political and/or legal environments.

Also known as ‘political risk’

Each country has unique political and legal systems that often pose challenges for company performance.
Risks in International Business

Cross-Cultural Risk

Commercial Risk

Financial Risk

Country Risk

- Unstable political system
- Unfavorable laws and regulations
- Inadequate legal system
- Bureaucracy
- Government protectionism and barriers
- Failure of the national economy
Video: When political risk costs money?

https://www.youtube.com/watch?v=IrPdG386-tk

Financial Times, October 8, 2015
Actors in Political and Legal Systems

✧ The government, or the ‘public sector’, operating at national and local levels.

✧ International organizations such as the World Bank, World Trade Organization, and the United Nations

✧ Regional economic blocs, such as the European Union, NAFTA, and many others.

✧ Special interest groups such as labor unions and environmental advocates

✧ Local competing firms, which oppose foreign firms.
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Political Systems

A set of formal institutions that constitute a government.

Includes legislative bodies, political parties, lobbying groups, and trade unions.

Defines how these groups interact with each other.

Three major types of political systems:

- Totalitarianism
- Socialism
- Democracy
Totalitarianism

- Government controls all economic and political matters.

- A state party is led by a dictator. Membership is mandatory for those wanting to advance.

- Power is sustained via secret police, propaganda, regulation of free discussion and criticism.

- Today: Some countries in the Middle East and Africa; Cuba, North Korea.

- Ex-totalitarian states tend to have much government intervention and bureaucracy.

  - China (1949–1980s)
  - Germany (1933–1945)
  - Soviet Union (1918–1991)
  - Spain (1939–1975)
IF NORTH KOREA were not so tragic and dangerous, the scenes broadcast to the world after the funeral of Kim Jong Il would have been comic. Waves of mourners outdid each other in grief. Men, women and children tore at their clothes in homage to a man who for 17 years kept his people in a state of isolation, poverty and indoctrination unparalleled in the modern world.

*Source: The Economist, Dec 31st, 2011*
Socialism

- Capital is vested in the state and used primarily as a means of production for use rather than for profit.

- Group welfare outweighs individual welfare.

- Government’s role is to control the basic means of production, distribution, and commercial activity.

- Socialism occurs in much of the world as social democracy (e.g., Western Europe, Brazil, India).

- Government intervention in the private sector.

- Today: Bolivia, China, Egypt, India, Romania, Russia, Venezuela
Economic activity occurs freely, as per market forces.

Major features of democracy:

**Limited government:**

The government performs only essential functions that serve all citizens, such as national defense, maintaining law & order, foreign relations, and providing basic infrastructure.

**Private property rights:**

- The ability to own property and assets and to increase one’s asset base by accumulating private wealth.
- Property includes land, buildings, stocks, contracts, patents.
- Encourages initiative, ambition, innovation.

Today: Australia, Canada, Japan, New Zealand, U.S.
Democracy is associated with …

**Economic freedom**
- freely operated markets
- rule of law

**Political freedom**
- free and fair elections
- existence of a parliament or other legislative body
- freedom from domination by the military, foreign powers, or religious hierarchies
- self-determination for cultural, ethnic, and religious minorities
Freedom in the World 2016

Each country score is based on two numerical ratings—from 1 to 7—for political rights and civil liberties, with 1 representing the most free and 7 the least free.
Democracy = Openness

Openness = The lack of regulations and barriers to the entry of firms in foreign markets

The lack of regulations =

- Successful market entry
- Increased market demand
- Competition on quality, which improves overall product quality.
- Increased competition, leading to efficiencies and lower prices.
Political and Economic Systems

- **Totalitarianism** ≈ **command (planned) economies**
  The state makes all decisions on what to produce, how much to produce, and what prices to charge.

- **Democracy** ≈ **market economies**
  Decisions are largely left to market forces, that is, supply and demand.

- **Socialism** ≈ **mixed economies**
  Features of both market and command economies, combining state intervention and market mechanisms.
Example: Economic Systems

Pure Centrally Planned Economy

Pure Market Economy

Cuba
N. Korea

China

India

Brazil

France

United Kingdom

Canada

United States

Key Takeaways: Ch7-Part 1

- Collectivist
- Individualist

- Totalitarian
- Socialist
- Democracy

- Planned (Command)
- Mixed
- Free Market

Society

Political Organization

Economic System
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Managing Country Risk
Country Risk Produced by Political Systems

1) Government takeover of corporate assets
2) Creeping expropriation
3) Embargoes and sanctions
4) Boycotts against firms and nations
5) Wars, insurrection, and violence
1) Government Takeover

- **Confiscation**: Seizure of corporate assets without compensation.

- **Expropriation**: Seizure of corporate assets with compensation.

- **Nationalization**: Takeover of an entire industry, with or without compensation.

**Examples**

- In Venezuela, President Hugo Chavez confiscated an oil field owned by the French petroleum firm Total.

- In Bolivia in 2006, the Bolivian government nationalized the oil and gas industry.
2) Creeping Expropriation

- The most common expropriation today.
- The government gradually modifies regulations and laws after foreign MNEs have made big local investments in property and plants.
- Abrupt termination of contracts.
- Creation of laws that favor local firms.

Example:
Argentina would expropriate and nationalize 51% of YPF, the former state oil company, which had been sold to Repsol, a Spanish firm, in 1999. Of the confiscated portion, 51% will go to the national government and 49% to Argentina’s oil-producing provinces.

Source: Economist, April 16, 2012, “Argentina’s oil industry: Feed me, Seymour”
3) Embargoes and Sanctions

Governments may respond to offensive activities of foreign countries by imposing embargoes and sanctions.

**Sanctions** are bans on international trade, usually undertaken by a country, or a group of countries, against another judged to have jeopardized peace and security.

**Embargoes** are bans on exports or imports that forbid trade in specific goods with specific countries.

Example: The U.S. has enforced embargoes against Cuba, Iran, and North Korea, labeled as state sponsors of terrorism.
Examples for embargoes and sanctions

Embargoes in selected economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>Cancellation of export licensing administration on silk worm cocoon, and certain silk products.</td>
</tr>
<tr>
<td>India</td>
<td>Increase of export tax (from 5% to 20%) on iron ore fines.</td>
</tr>
<tr>
<td>Viet Nam</td>
<td>Procedures for rice exports: requirement of at least one warehouse with a storage capacity of 5,000 tonnes, and a 10 tonnes/hour processing milling facility.</td>
</tr>
</tbody>
</table>
4) Boycotts and 5) Violence

4) Boycotts: Voluntary refusal to engage in commercial dealings with a nation or a company.

5) Violence:

War and insurrection: Indirect effects can be disastrous for company activities.

Terrorism: The threat or actual use of force or violence to attain a political goal through fear and intimidation. Terrorism particularly affects certain industries – tourism, hospitality, aviation, finance, retailing.
Key Takeaways: Ch7-Part 2

1) Government takeover of corporate assets
2) Creeping expropriation
3) Embargoes and sanctions
4) Boycotts against firms and nations
5) Wars, insurrection, and violence
Agenda

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Types of Legal Systems
A system for interpreting and enforcing laws.

The laws, regulations, and rules establish norms for conduct.

Incorporates institutions and procedures for:
- ensuring order,
- resolving disputes in commercial activities,
- protecting intellectual property,
- taxing economic output.

Four major types of legal systems:

- Common Law
- Civil Law
- Religious Law
- Mixed Systems
The Rule of Law

- Existence of a legal system where rules are clear, publicly disclosed, fairly enforced, and widely respected by individuals, organizations, and the government.

- Common in the advanced economies.

- The legal system is:
  - applied to all citizens equally;
  - issued via recognized government authorities;
  - enforced fairly and systematically by police forces and formally organized judicial bodies.

- Economic activity suffers and uncertainty increases when the rule of law is weak.
A legal system that originated in England and spread to Australia, Canada, USA, and other former members of the British Commonwealth (also known as case law).

The basis of law is tradition, past practices, and legal precedents set by courts via interpretation of statutes, legislation, and past rulings.

Judges have much power to interpret laws based on the circumstances of individual cases. Thus, common law is relatively flexible.
Found in France, Germany, Italy, Japan, Turkey, and much of Latin America.

Based on an all-inclusive system of laws that have been “codified”—clearly written by legislative bodies.

Laws are more ‘cast in stone’ and not strongly subject to interpretation by courts.
## Differences Between Common Law and Civil Law

<table>
<thead>
<tr>
<th>Legal Issues</th>
<th>Civil Law</th>
<th>Common Law</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership of intellectual property</td>
<td>Determined by registration.</td>
<td>Determined by prior use.</td>
</tr>
<tr>
<td>Enforcing agreements</td>
<td>Commercial agreements become enforceable only if properly notarized or registered.</td>
<td>Proof of agreement is sufficient for enforcing contracts.</td>
</tr>
<tr>
<td>Specificity of contracts</td>
<td>Contracts tend to be brief because many potential problems are already covered in the civil code.</td>
<td>Contracts tend to be very detailed, with all possible contingencies spelled out. Usually more costly to draft a contract.</td>
</tr>
<tr>
<td>Compliance with contracts</td>
<td>Noncompliance is extended to include unforeseeable human acts such as labor strikes and riots.</td>
<td>Acts of God (floods, lightning, hurricanes, etc.) are the only justifiable excuses for noncompliance with the provisions of contracts.</td>
</tr>
</tbody>
</table>
- Strongly influenced by religious beliefs, ethical codes, and moral values.

- Most important religious legal systems are based on Hindu, Jewish, and Islamic law.

- Example: Islamic law spells out norms of behavior regarding politics, economics, banking, contracts, marriage, and many other social and business issues.
Two or more legal systems operating together.

The contrast between civil and common law has become blurred as countries combine both systems.

Totalitarianism is most associated with religious law and socialist law.

Democracy is associated with common law, civil law, and mixed systems.

Example: Legal systems in Lebanon, Morocco, and Tunisia share elements of civil law and Islamic law.
Dominant Legal Systems

Source: http://www.juriglobe.ca/eng/index.php
### Key Takeaways: Ch7-Part 3

<table>
<thead>
<tr>
<th>Common Law</th>
<th>Civil Law</th>
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</thead>
<tbody>
<tr>
<td><strong>Case law</strong></td>
<td><strong>Codified</strong></td>
</tr>
<tr>
<td><strong>Past practices, Interpretation</strong></td>
<td><strong>Legislative</strong></td>
</tr>
<tr>
<td><strong>Judicial</strong></td>
<td><strong>EU, Turkey, Latin America</strong></td>
</tr>
<tr>
<td><strong>Court decision</strong></td>
<td></td>
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<tr>
<td><strong>U.S., Australia, Canada, UK</strong></td>
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</table>

<table>
<thead>
<tr>
<th>Religious Law</th>
<th>Mixed Systems</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Religious beliefs, ethical codes, and moral values</strong></td>
<td><strong>Two or more legal systems operating together</strong></td>
</tr>
<tr>
<td><strong>Mostly associated with Totalitarianism</strong></td>
<td></td>
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</table>
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Managing Country Risk
### Types of Country Risk
Produced by Legal Systems

<table>
<thead>
<tr>
<th>Due to the <strong>host</strong> country legal environment</th>
<th>Due to the <strong>home</strong> country legal environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Foreign investment laws</td>
<td>• Environmental laws</td>
</tr>
<tr>
<td>• Controls on operating forms and practices</td>
<td>• Contract laws</td>
</tr>
<tr>
<td>• Marketing and distribution laws</td>
<td>• Inadequate legal systems</td>
</tr>
<tr>
<td>• Laws regarding income repatriation</td>
<td>• Internet and e-commerce regulations</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Due to the <strong>home</strong> country legal environment</td>
<td></td>
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<tr>
<td>• The Foreign Corrupt Practices Act (FCPA)</td>
<td></td>
</tr>
<tr>
<td>• Anti-boycott regulations</td>
<td></td>
</tr>
<tr>
<td>• Accounting and reporting laws</td>
<td></td>
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<tr>
<td>• Transparency in financial reporting</td>
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</tbody>
</table>
Risks due to the host country legal environment

**Foreign Investment Laws:** affect FDI-based entry.

Ex. Mexico – Foreign oil companies cannot obtain 100% ownership of Mexican oil firms.

**Controls on Operating Forms and Practices:** Laws and regulations on how firms can conduct production, marketing, and distribution activities.

Ex. Requirements for foreign investors to seek joint ventures with local firms to access foreign capital and technology.

**Marketing and Distribution Laws:** regulate practices in advertising, promotion, and distribution.

Ex. Prohibits for advertising including sex, alcohol, tobacco, comparison with a competing brand, etc.
Risks due to the host country legal environment

Laws on income repatriation: limit the amount of net income or dividends that firms can bring back to the home country.

Environmental laws: aim to preserve natural resources, combat pollution, and ensure safety. Ex. In Germany, firms are responsible for recycling product packaging.

Contract laws: affect the sale of goods and services, intermediary agreements, licensing and franchising, foreign direct investment, and joint ventures.

Inadequate or underdeveloped legal systems: poor enforcement of existing laws regarding intellectual property, pollution, consumer protection, and other areas.
Types of Country Risk Produced by Legal Systems

Due to the **home** country legal environment

- The Foreign Corrupt Practices Act (FCPA)
- Antiboycott regulations
- Accounting and reporting laws; Transparency in financial reporting
Extraterritoriality: the application of home-country laws to other countries. For example, the European Union pursued Microsoft for monopolistic practices.

The Foreign Corrupt Practices Act (1977; U.S.) made it illegal to offer bribes to foreign parties. But the act may harm U.S. firms because foreign competitors are usually not so constrained.
Accounting and Reporting Laws

- differ widely around the world.

Two examples:

- **Physical asset valuations**: Canada and the U.S. use historical costs. Some Latin American countries use inflation-adjusted market value.

- **R&D costs**: expensed as incurred in most of the world; Capitalized in South Korea and Spain. Belgium, Malaysia, and Italy use both conventions.

- **Transparency in financial reporting** is the degree to which firms regularly reveal substantial financial and accounting information. Varies worldwide.
### Key Takeaways: Ch7-Part 4

#### Risks due to the **HOST** country legal environment
- Foreign investment laws
- Controls on operating forms and practices
- Marketing and distribution laws
- Laws regarding income repatriation
- Environmental laws
- Contract laws
- Inadequate legal systems
- Internet and e-commerce regulations

#### Risks due to the **HOME** country legal environment
- The Foreign Corrupt Practices Act (FCPA)
- Antiboycott regulations
- Accounting and reporting laws
- Transparency in financial reporting
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Country Risks Produced by Legal Systems

Managing Country Risk
Video: Mitigating the unpredictability of geopolitical risks
Risk Mitigation Strategies

- Proactive environmental scanning
- Strict adherence to ethical standards
- Alliances with qualified local partners
- Protection through legal contracts
Proactive Environmental Scanning

✧ Management should develop a comprehensive understanding of the political and legal environment in target countries.

✧ Scanning – ongoing assessment of potential risks and threats to the firm, via intelligence sources such as:

  - Employees working in the host country
  - Embassy and trade association officials
  - Consulting firms, such as Business Entrepreneurial Risk Intelligence (http://www.beri.com)

✧ Minimize exposure to country risks.
• **Strict adherence to ethical standards**: Firms that engage in questionable practices or operate outside the law invite redress from the governments of the host countries where they do business.

• **Alliances with qualified local partners**: For example, firms often enter China and Russia by partnering with local firms who assist in navigating the complex legal and political landscape.
Protection through legal contracts

- Contract law varies widely. The firm must follow the law in each country.
- Three approaches for resolving contract disputes:
  - **Conciliation** is a formal process of negotiation whose objective is to resolve differences in a friendly manner. It is the least adversarial method. Common in China.
  - In **arbitration**, a neutral third party hears both sides of a case and decides in favor of one party or the other, based on an objective assessment of the facts.
  - **Litigation** occurs when one party files a lawsuit against another. The most adversarial approach, it is common in the United States.
Key Takeaways: Ch 7-In general

The nature of country risk
⇒ Political and legal systems

Types of political systems:
  - Totalitarianism
  - Socialism
  - Democracy

Country risks due to political systems:
  - Government takeover of corporate assets
  - Creeping expropriation
  - Embargoes and sanctions
  - Boycotts against firms and nations
  - Wars, insurrection, and violence

Types of legal systems:
  - Common Law
  - Civil Law
  - Religious Law
  - Mixed Systems

Country risks due to legal environment:
  - Risks due to the host country legal environment
  - Risks due to the home country legal environment

Risk mitigation strategies:
  - Proactive environmental scanning
  - Strict adherence to ethical standards
  - Alliances with qualified local partners
  - Protection through legal contracts
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