# STUDY GUIDE

## 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 two leading debates concerning politics, laws, and economics.
8. Draw implications for action.

### Chapter Outline: Key Concepts and Terms

**I.** UNDERSTANDING 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 *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.** 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.

**State-owned enterprises** (**SOEs**)—firms that are at least 10% owned by the state. A **Sovereign wealth fund (SWF)** is a state owned investment fund.

## **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.