# Purpose and Perspective of the Chapter

The purpose of this chapter is to explore the concept of institutions, popularly known as the “rules of the game.” As economic players, firms play by these rules. However, institutions are not static. They may change, resulting in institutional transitions — ” fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect firms as players.” Firms must respond to these changes.

Overall, the success and failure of a firm around the globe are, to a large extent, determined by its ability to understand and take advantage of the different rules of the game. In other words, how firms play the game and win (or lose), at least in part, depends on how the rules are made, enforced, and changed. This calls for firms to constantly monitor, decode, and adapt to the changing rules of the game in order to survive and prosper. As a result, such an institution-based view has emerged as a leading perspective on global business. This chapter first introduces this view. Then, it focuses on *formal* institutions (such as politics, laws, and economics). *Informal* institutions (such as cultures, ethics, and norms) will be discussed in Chapter 3.

1. UNDERSTANDING INSTITUTIONS (LO 2-1, PPT Slides 3–6)
   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**
      * **Institutional transition**: Fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect firms as players
      * **Institution-based view**: A leading perspective in global business that suggests that the success and failure of firms are enabled and constrained by institutions
      * **Institution**: Formal and informal rules of the game
      * **Institutional framework**: Formal and informal institutions that govern individual and firm behavior
      * **Formal institution**: Institution represented by laws, regulations, and rules
      * **Regulatory pillar**: The coercive power of governments
      * **Informal institution**: Institution represented by cultures, ethics, and norms
      * **Normative pillar**: The mechanism through which norms influence individual and firm behavior
      * **Norms**: Values, beliefs, and actions of relevant players that influence the focal individuals and firms
      * **Cognitive pillar**: The internalized (or taken-for-granted) values and beliefs that guide individual and firm behavior
2. WHAT DO INSTITUTIONS DO? (LO 2-1, PPT Slides 7–8)
   1. **Key Concepts**
      * The key function of institutions is to reduce uncertainty.
   2. **Key Terms**
      * **Transaction cost**: The cost associated with economic transactions or, more broadly, the cost of doing business
      * **Opportunism**: The act of self-interest seeking with guile
      * **Transition economy**: Label for a subset of emerging economies, particularly those moving from central planning to market competition (such as China, Poland, Russia, and Vietnam)
3. AN INSTITUTION-BASED VIEW OF GLOBAL BUSINESS (LO 2-2, PPT Slides 9–12)
   1. **Key Concepts**
      * Proposition 1: Managers and firms rationally pursue their interests and make choices within the formal and informal institutional constraints in a given institutional framework.
      * Proposition 2: While formal and informal institutions combine to govern firm behavior, in situations where formal constraints are unclear or fail, informal constraints will play a larger role in reducing uncertainty and providing constancy to managers and firms.
   2. **Key Terms**
      * **Bounded rationality**: The necessity of making rational decisions in the absence of complete information
      * **Nonmarket (political) strategy**: A strategy that centers on leveraging political and social relationships
      * **Institutional work**: Purposive action aimed at creating, maintaining, and disrupting institutions
4. POLITICAL SYSTEMS (LO 2-3, PPT Slides 13–15)
   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 over the population.
      * Authoritarianism is a political system in which political plurality is undermined and concentrated government power is imposed.
      * While the degree of hostility toward business varies among different types of totalitarianism and authoritarianism (some are more probusiness than others), totalitarianism and authoritarianism in general are not as good for business as democracy.
      * As the forces of deglobalization march around the world, firms must be prepared to deal with geopolitical risk.
   2. **Key Terms**
      * **Political system**: The rules of the game on how a country is governed politically
      * **Democracy**: A political system in which citizens elect representatives to govern the country on their behalf
      * **Totalitarianism (dictatorship)**: A political system in which one person or party exercises absolute political control over the population
      * **Authoritarianism**: A political system in which political plurality is undermined and concentrated government power is imposed
      * **Political risk**: Risk associated with political changes that may negatively impact domestic and foreign firms
      * **Geopolitics**: International political relations
5. LEGAL SYSTEMS (LO 2-4 and 2-5, PPT Slides 16–20)
   1. **Key Concepts**
      * Laws in different countries are transplanted from three legal traditions.
      * 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.
   2. **Key Terms**
      * **Legal system**: The rules of the game on how a country’s laws are enacted and enforced
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      * **Theocratic law**: A legal system based on religious teachings
      * **Property right**: The legal right to use an economic property (resource) and to derive income and benefits from it
      * **Intellectual property (IP)**: Intangible property that is the result of intellectual activity
      * **Intellectual property rights (IPR)**: Right associated with the ownership of intellectual property
      * **Patent**: Exclusive legal right of inventors of new products or processes to derive income from such inventions
      * **Copyright**: Exclusive legal right of authors and publishers to disseminate their work
      * **Trademark**: Exclusive legal right of firms to use specific names, brands, and designs to differentiate their products from others
      * **Piracy**: Unauthorized use of intellectual property
6. ECONOMIC SYSTEMS (LO 2-6, PPT Slides 21–23)
   1. **Key Concepts**
      * An economic system refers to the rules of the game on how a country is governed economically.
      * 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**
      * **Economic system**: Rules of the game on how a country is governed economically
      * **Market economy**: An economy that is characterized by the “invisible hand” of market forces
      * **Command economy**: An economy that is characterized by government ownership and control of factors of production
      * **Mixed economy**: An economy that has elements of both a market economy and a command economy
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8. DEBATES AND EXTENSIONS (LO 2-7, PPT Slides 24–27)
   1. **Key Concepts**
      * Two leading debates are(1) drivers of economic development and (2) private ownership versus state ownership.
   2. **Key Terms**
      * **State-owned enterprise (SOE)**: A firm owned and controlled by the state (government)
      * **Moral hazard**: Recklessness when people and organizations (including firms and governments) do not have to face the full consequences of their actions
      * **State capitalism**: A capitalist, market-based system with substantial state ownership
      * **Hybrid organization**: An organization that incorporates elements from different institutional logics