

**Formal Institutions:
Economic, Political & Legal Systems**
(Mike Peng & Klaus Meyer, International Business)

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Special Topics in Internationalization

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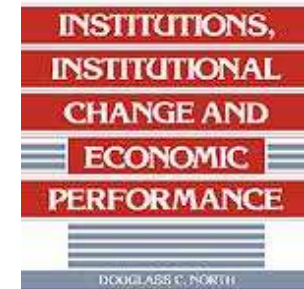
- ▶ **1. An Institution-Based View of IB**
- 2. Political Systems
- 3. Economic Systems
- 4. Legal Systems
- 5. Implications for Practice

An Institution-Based View of IB



■ Definition

❖ Douglass North defines institutions as:
‘the humanly devised constraints that structure human interaction’.



Political Economy
of Institutions and Decisions

❖ Firms doing business abroad encounter **various rules** in their home countries, in host countries, & in international & regional organizations (*e.g.*, WTO, EU, ILO etc.)

❖ Transaction costs economics (TCE)

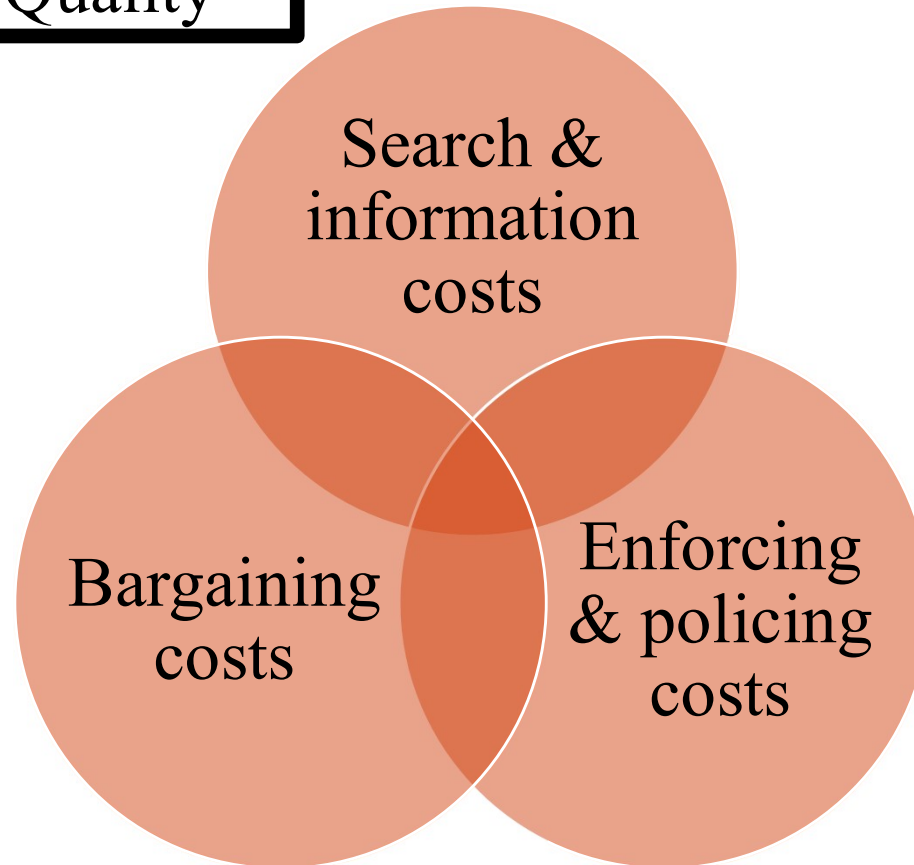
- It is costly to use the market mechanism & as a result economic actors organize themselves in less costly ways, notably by establishing firms.
- **The transaction costs** are, to a large extent, influenced by **the institutions governing the market.**

An Institution-Based View of IB



Transaction Costs

Institutional Quality



Example



An Institution-Based View of IB



■ Dimensions of Institutions

Degree of formality	Examples	Supportive pillars
1 Formal institutions	<ul style="list-style-type: none">> Laws> Regulations> Rules	<ul style="list-style-type: none">> Regulatory (coercive)
2 Informal institutions	<ul style="list-style-type: none">> Norms> Cultures> Traditions> Ethics	<ul style="list-style-type: none">> Normative> Cognitive

The institutional framework governing a particular context

❖ Examples

- **Anti-dumping rules** by the EU against Chinese products
- **Global financial crisis:** The norms of many financial organizations favored the aggressive attitudes of the traders, who desire to make profits.

An Institution-Based View of IB



■ What Do Institutions Do?

❖ The major role of institutions is:

- To **reduce uncertainty** (e.g., .expropriation, lack of trust in your JV partner)
- To influence individuals' & firms' decision-making by **signaling what conduct is legitimate & acceptable**.
- To **penalize** individuals' & firms' **illegitimate & opportunistic behavior**.

❖ *Uncertainty* increases **transaction costs**, which are defined as the costs associated with economic transactions.



- > The **absence** of the stable institutional frameworks => transaction costs (↑)
- > e.g., **Why rich Russians may purchase foreign assets** such as a football club in London or a seaside villa in Cyprus instead of investing in Russia?

An Institution-Based View of IB



■ '2' Core Propositions

Assumption

Description

Examples

1

Proposition 1

Managers & firms *rationally* pursue their interests & make choices within the **formal & informal constraints** in a given institutional framework.

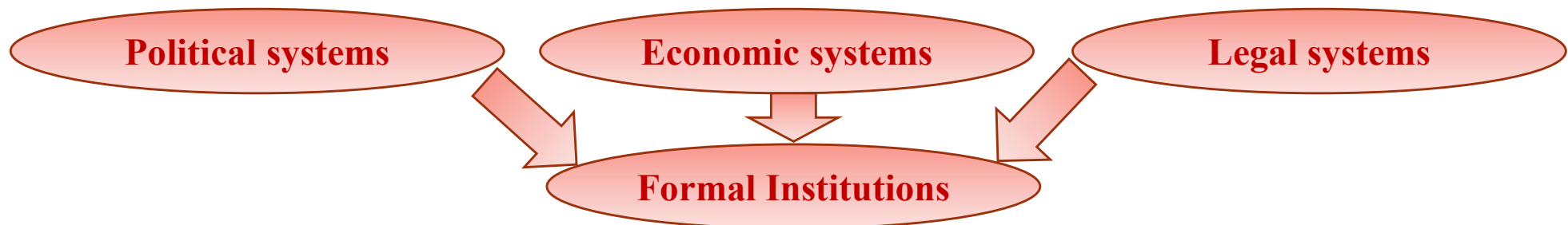
> **Labour laws:**
Firing people in the UK is easy but not in Germany.

2

Proposition 2

Although formal & informal institutions combine to govern firm behaviour, in situations where formal constraints fail, **informal constraints** will play a *larger role* in reducing uncertainty.

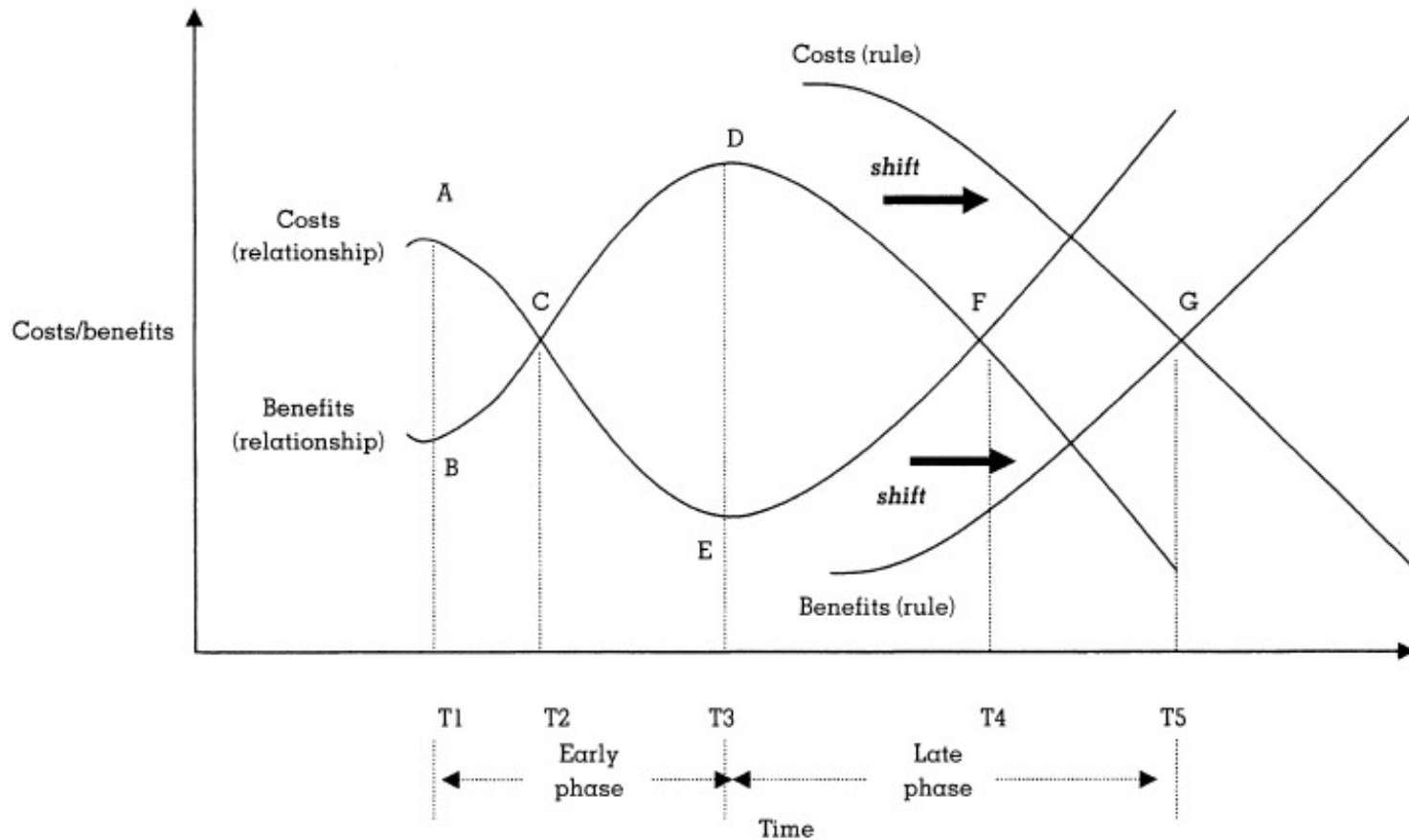
> **Personal networks matters:**
Blat or *guanxi* substitutes for formal institutions.



An Institution-Based View of IB



■ Peng's (2003) Two-Phase Model of Institutional Transition



Source: Peng, M. (2003: 281). 'Institutional Transition and Strategic Choice', *Academy of Management Review*.

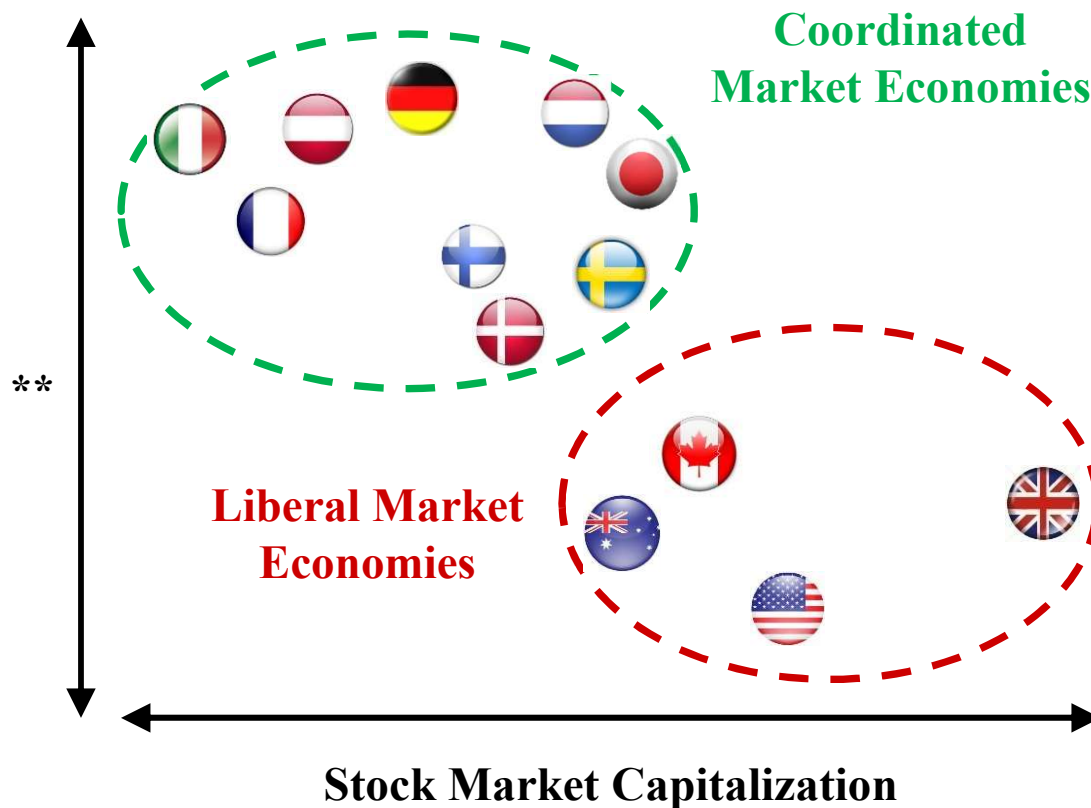


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■ Varieties of Capitalism (**Employment Protection)

The Elements of LMEs & CME (P&M, 2011: 46)



COMMENTS

- > **LMEs**
 - Companies respond sensitively to **price signals of the market**.
 - Labor markets are **flexible**.
 - Companies are financed by **shares**.
 - **Less job protection**.
- > **CMEs**
 - Businesses, governments, unions & industry associations coordinate their actions through **a variety of mechanisms**.
 - Less opportunities to raise capital through the stock market.
 - Employees have **representatives on corporate boards**.



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- ▶ 2. **Political Systems**
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■ '4' Types of Political Risks

1

Systemic Risks

- > Expropriation
- > Nationalization
- > Policy shifts



2

Procedural Risks

- > Government corruption
- > A partisan judicial system



- > Increases in tax rates on profits
- > Barriers to transferring profits out of the country



Distributive Risks

3

- > Military action
- > Ethnic discord
- > Illegal regime change
- > Civil disorder
- > Insurrection



Catasrophic Risks

4



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■ Types of Legal Systems

- **Common Law:** Existing **case law** guides dispute resolution.
- **Civil Law:** Judges **apply existing legal & procedural codes** to resolve disputes (e.g., Germany).
- **Theocratic Law:** **Religious** doctrine, precepts, & beliefs define the legal environment.
- **Customary Law:** **Local spiritual legacies & philosophical traditions** are key elements in a customary law system.
- **Mixed System:** A legal systems consist of **two or more of the legal systems.**



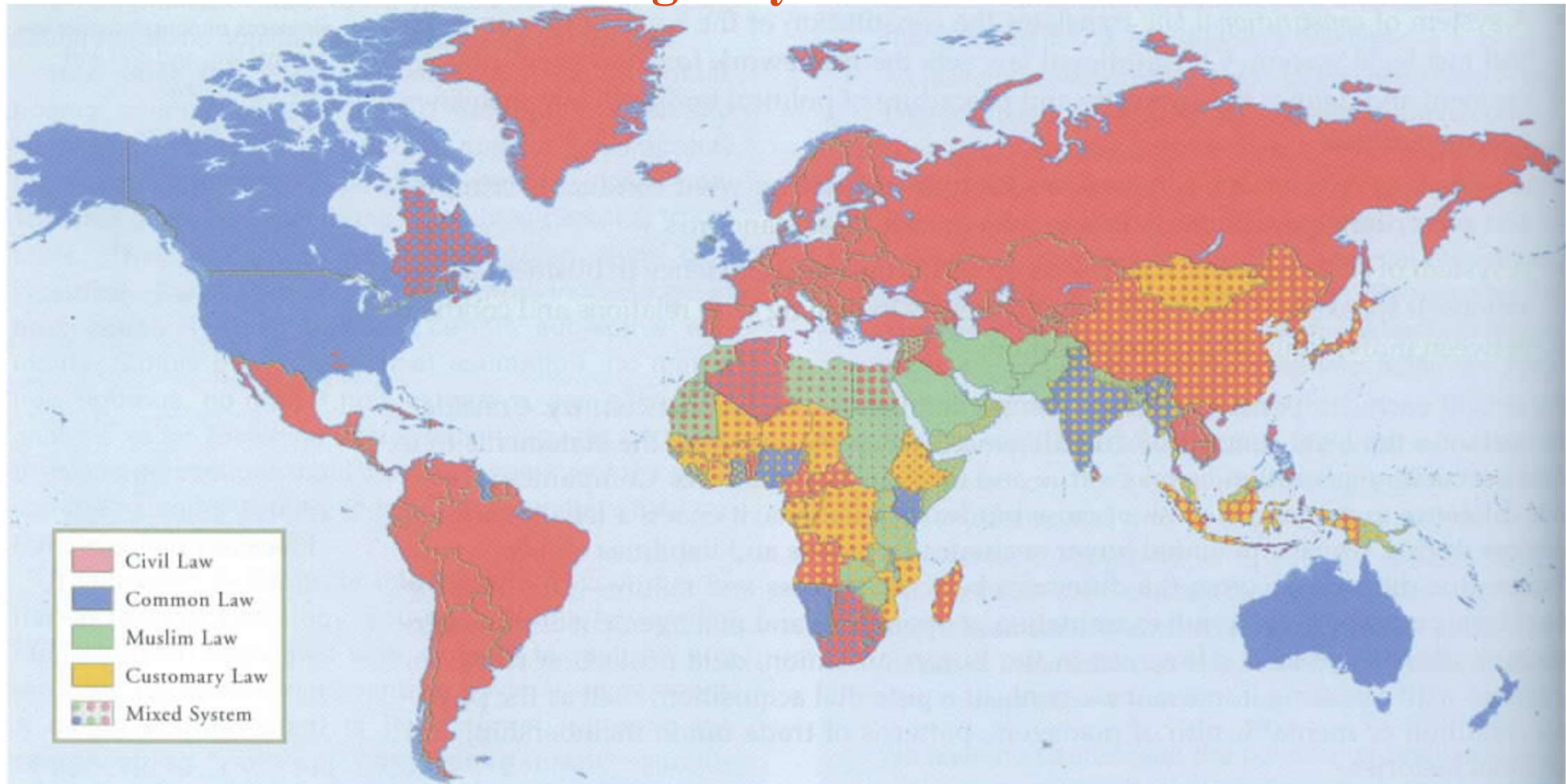
■ Civil Law vs Common Law

	Civil Law	Common Law
▶ Historical origins	Roman law & French code civil of 1804	English customary law
▶ Primary sources of laws	Codified in books of law, scholarly conceptualization	Statues, customs, court decisions
▶ Court proceedings	Judges lead the proceedings, incl. asking questions & deciding	Judges as arbitrators, lawyers dominate proceedings & juries as decision makers
▶ Business practice	Contracts & codes of practice comparatively brief, traditionally more protection of employees & customers	Greater freedom to design contracts & codes of practice; detailed contracts filling gaps in the legal framework; extensive use of lawyers

Source: Peng & Meyer (2011: 48)



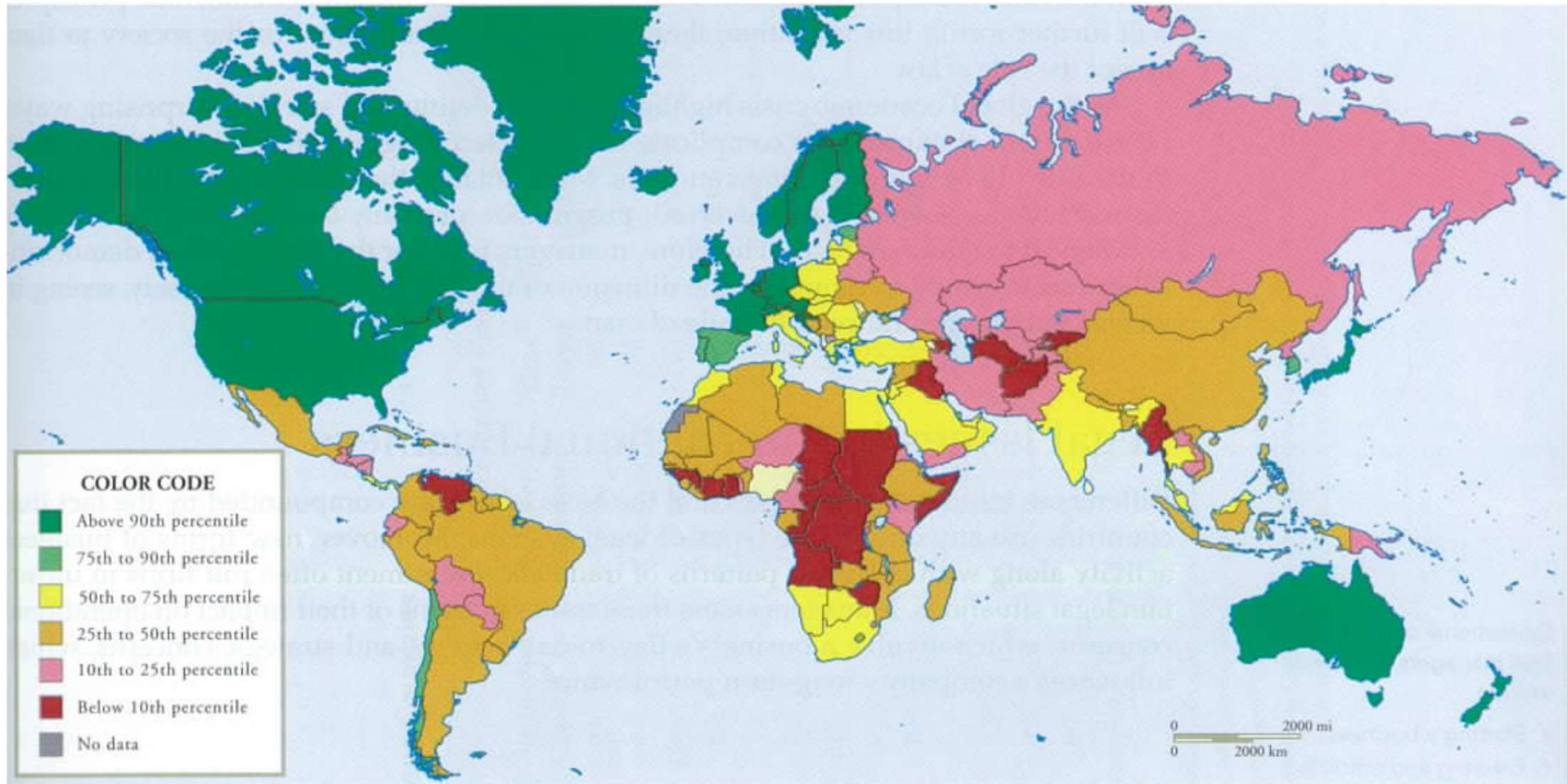
■ The Wide World of Legal Systems



Source: Daniels, Radebaugh and Sullivan (2010: 154)



■ The Rule of Law vs. The Rule of Man



Source: Daniels, Radebaugh and Sullivan (2010: 157)



■ Intellectual Property Rights

- **Intellectual property:** *“the creative ideas, innovative expertise, or intangible insights that give an individual, company, or country a competitive advantage”*.
- IP is difficult to conceive but **easy to copy**.
- The role of transnational institutions like the **WTO** & **WIPO** in protecting patents, copyrights & trademarks.
- **Most counterfeit goods** are made in markets in which **the rule of man** is the basis of the legal system.
- **Quality of legal protection** of intellectual property:
 - Wealthier countries > poorer countries



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- ▶ 5. **Implications for Practice**



■ What Should Managers Care About?



> Do as Romans do !

- Managerial choices should be made rationally within the constraints of a given institutional framework.
- A superficial understanding may cause miscommunication and danger.



> Understand that formal institutions are changeable !

- A tariffs or taxation
- Firms may be able to influence different economic, political & legal changes through lobbying at the appropriate places.

关系
guānxi

> Informal constraints (e.g., relationship norms) matter !

- When doing business in countries with a strong propensity for informal, relational exchanges, insisting on formalizing the contract right away may back fire.

Case Interview Preparation

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Questions About You



Strong communication skills



Ability to be a team player



Leadership ability & initiative



Energy, morals, & ethics

Source: Marc P. Cosentino (2011) Case in Point, Burgee Press

Commonly Asked Interview Questions

■ Can You Answer the Following Questions?

- ❖ Tell me about **yourself**.
- ❖ **Why** did you pick **your University**?
- ❖ **Why** would you choose **our firm** over our competitors?
- ❖ How are your **quantitative skills**?
- ❖ Tell me of a time you showed **leadership skills**.
- ❖ Tell me of a time you were a **team player**.
- ❖ Tell me about a time you took the **initiative** to start something.
- ❖ What **experience/skills** do you feel are particularly transferable to our organization?
- ❖ **Why** should I **hire you**?

Source: Marc P. Cosentino (2011) Case in Point, Burgee Press

Understanding the Company



■ How to Research?

- ❖ Attend **career fairs** & speak to the **firm representatives**.
- ❖ Check the **company's website** & read its **annual report**.
- ❖ Collect financial information by **Orbis**.
- ❖ Talk to **alumni** & **graduate school students** who used to work for the companies that you are interviewing with.
- ❖ Attend company **information meetings**.
- ❖ Search ***The Financial Times*** & the **Internet** for articles & information on the firm.

Source: Marc P. Cosentino (2011) Case in Point, Burgee Press

Purpose of the Case Question



■ Interviewers Ask Case Questions Because They Want To:

- ❖ To probe your **intellectual curiosity**.
- ❖ To test your **analytical ability**.
- ❖ To test your ability to **think logically** & organize your answer.
- ❖ To observe your **thought process**.
- ❖ To discover your **personality**.
- ❖ To see if you are genuinely intrigued by **problem-solving**.
- ❖ To ensure whether the job you want to get is a good **“fit”** for you.

Source: Marc P. Cosentino (2011) Case in Point, Burgee Press

Types of Case Questions



■ Market-Sizing Questions

- ❖ How many gas stations are there in the US?
- ❖ How many garden hoses were sold in the UK last year?
- ❖ What is the length of highways in Germany?

■ Business Case Questions

Number cases

- ❖ Our total costs are \$75,000. Labor costs make up 25% of the total costs. How much are our labor costs?
- ❖ 13% of 19=?

Business strategy & operation cases

- ❖ Our client has developed a new Hollywood screenwriting software package. How are we going to price it? What is our strategy & why?
- ❖ A company is having a cash flow problem & needs to reduce its costs. How should the company proceed?

Source: Marc P. Cosentino (2011) Case in Point, Burgee Press

Experience Interview



The screenshot shows a web browser window with the URL <https://www.mckinsey.com/careers/interviewing> highlighted in a red box. The page features the McKinsey & Company logo, a navigation menu with options like Home, Search Jobs, Explore, Our People, Interviewing, Students, and Experienced Professionals, and a search icon. Below the navigation is a video player showing two people in an interview setting. The video player has a play button and a search icon with the text "FIND YOUR IDEAL JOB". Below the video player, there is a link that says "Already started your application? [Sign in here.](#)". The browser's address bar shows the URL, and the Windows taskbar is visible at the bottom with various application icons and system tray information including the date 2022/03/06 and time 8:30.

Case Studies

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Case 1: Carlsberg Faces Political Risk in Russia

■ Questions

- ❖ **WHAT** is the key motivation for Western firms to invest in Russia?
- ❖ **WHY** is it so difficult for foreign firms to set up & manage their local operations in emerging economies like Russia in general?
- ❖ **HOW** did institutional change in Russia affect Carlsberg's performance?
- ❖ **HOW** should MNCs respond to economic volatility & institutional instability in the foreign market where they are in operation?
- ❖ If you were a board member of Carlsberg, would you vote 'yes' or 'no' for a new project to acquire a local company in Russia? If yes, **WHY**? If no, **WHY** not?

Case 2: Managing Business Risks in Turkey

■ Questions

- ❖ **WHAT** is this case all about?
- ❖ Identify **HOW** Turkey's market environment looks like.
- ❖ **WHAT** factors are responsible for shaping Turkey's business system & institutional infrastructure?
- ❖ Discuss **HOW** Turkey's institutional quality looks similar to or different from its counterparts.
- ❖ Would you invest in Turkey **IF** your company tries to expand?
- ❖ **WHAT** is your conclusive remarks? **WHAT** managerial implications can you draw from this case?

Case 2: Managing Business Risks in Turkey



■ Institutional Environments - Turkey vs. Benchmark Nations

	Turkey	Spain	Italy	Hungary	Romania	Russia	India	China
Quality of education & research institutions	45.5	48.9	46.3	39.5	30.5	50.0	32.3	49.2
Quality of technology infrastructure	45.7	64.3	61.8	52.3	55.1	47.5	44.1	57.9
Openness & effectiveness of markets	47.8	59.0	52.6	41.5	44.2	47.1	51.9	54.7
Cost & time of procedures to start a business	87.6	86.7	89.4	87.6	89.7	93.0	75.4	85.5
Cost & time of procedure to enforce a contract	68.9	70.0	54.8	73.8	72.3	72.2	40.8	78.2
Strength of the legal protection of minority shareholders	71.7	70.0	58.3	50.0	60.0	61.7	80.0	48.3
Transparency (absence of corruption)	41.0	58.0	47.0	48.0	48.0	29.0	40.0	40.0
Constraints on political power	37.3	83.6	75.7	73.3	73.5	73.1	70.2	N/A

Source: Peng & Meyer (2019:29).

Reading Assignments



■ Informal Institutions

❖ “*Limitations of Hofstede’s Framework*” (p.67 in P&M).

❖ “*Multilinguists in MNEs*” (p.70 in P&M).

➔ Please make sure that you understand the content of these articles & summarize your opinions.

The End of Today's Lecture



ご清聴有難う御座いました。

Thank you so much!

Vielen Dank für Ihre Aufmerksamkeit!

Grazie mille !

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