

2.3: Political and Legal Factors That Impact International Trade

Learning Objectives

1. Know the different political systems.
2. Identify the different legal systems.
3. Understand government-business trade relations and how political and legal factors impact international business.

Why should businesses care about the different political and legal systems around the world? To begin with, despite the globalization of business, firms must abide by the local rules and regulations of the countries in which they operate. In the case study in Chapter 1, you discovered how US-based Google had to deal with the Chinese government's restrictions on the freedom of speech in order to do business in China. China's different set of political and legal guidelines made Google choose to discontinue its mainland Chinese version of its site and direct mainland Chinese users to a Hong Kong version.

Until recently, governments were able to directly enforce the rules and regulations based on their political and legal philosophies. The Internet has started to change this, as sellers and buyers have easier access to each other. Nevertheless, countries still have the ability to regulate or strong-arm companies into abiding by their rules and regulations. As a result, global businesses monitor and evaluate the political and legal climate in countries in which they currently operate or hope to operate in the future.

Before we can evaluate the impact on business, let's first look at the different political and legal systems.

What Are the Different Political Systems?

The study of political systems is extensive and complex. A **political system** is basically the system of politics and government in a country. It governs a complete set of rules, regulations, institutions, and attitudes. A main differentiator of political systems is each system's philosophy on the rights of the individual and the group as well as the role of government. Each political system's philosophy impacts the policies that govern the local economy and business environment.

There are more than thirteen major types of government, each of which consists of multiple variations. Let's focus on the overarching modern political philosophies. At one end of the extremes of political philosophies, or ideologies, is **anarchism**, which contends that individuals should control political activities and public government is both unnecessary and unwanted. At the other extreme is **totalitarianism**, which contends that every aspect of an individual's life should be controlled and dictated by a strong central government. In reality, neither extreme exists in its purest form. Instead, most countries have a combination of both, the balance of which is often a reflection of the country's history, culture, and religion. This combination is called **pluralism**, which asserts that both public and private groups are important in a well-functioning political system. Although most countries are pluralistic politically, they may lean more to one extreme than the other.

In some countries, the government controls more aspects of daily life than in others. While the common usage treats totalitarian and authoritarian as synonyms, there is a distinct difference. For the purpose of this discussion, the main relevant difference is in ideology. Authoritarian governments centralize all control in the hands of one strong leader or a small group of leaders, who have full authority. These leaders are not democratically elected and are not politically, economically, or socially accountable to the people in the country. Totalitarianism, a more extreme form of authoritarianism, occurs when an authoritarian leadership is motivated by a distinct ideology, such as communism. In totalitarianism, the ideology influences or controls the people, not just a person or party. Authoritarian leaders tend not to have a guiding philosophy and use more fear and corruption to maintain control.

Democracy is the most common form of government around the world today. Democratic governments derive their power from the people of the country, either by direct referendum (called a direct democracy) or by means of elected representatives of the people (a representative democracy). Democracy has a number of variations, both in theory and practice, some of which provide better representation and more freedoms for their citizens than others.

Did You Know?

It may seem evident that businesses would prefer to operate in open, democratic countries; however, it can be difficult to determine which countries fit the democratic criteria. As a result, there are a variety of institutions, including the *Economist*, which analyze and rate countries based on their openness and adherence to democratic principles.

There is no consensus on how to measure democracy, definitions of democracy are contested and there is an ongoing lively debate on the subject. Although the terms "freedom" and "democracy" are often used interchangeably, the two are not synonymous.

Democracy can be seen as a set of practices and principles that institutionalise and thus ultimately protect freedom. Even if a consensus on precise definitions has proved elusive, most observers today would agree that, at a minimum, the fundamental features of a democracy include government based on majority rule and the consent of the governed, the existence of free and fair elections, the protection of minorities and respect for basic human rights. Democracy presupposes equality before the law, due process and political pluralism. “Liberty and Justice for Some,” *Economist*, August 22, 2007, accessed December 21, 2010, <http://www.economist.com/node/8908438>.

To further illustrate the complexity of the definition of a democracy, the *Economist* Intelligence Unit’s annual “Index of Democracy” uses a detailed questionnaire and analysis process to provide “a snapshot of the current state of democracy worldwide for 165 independent states and two territories (this covers almost the entire population of the world and the vast majority of the world’s independent states (27 micro states are excluded) [as of 2008]).” *Economist* Intelligence Unit, “The Economist Intelligence Unit’s Index of Democracy 2008,” *Economist*, October 29, 2008, accessed December 21, 2010, <http://graphics.eiu.com/PDF/Democracy%20Index%202008.pdf>. Several things stand out in the 2008 index.

Although almost half of the world’s countries can be considered to be democracies, the number of “full democracies” is relatively low (only 30); 50 are rated as “flawed democracies.” Of the remaining 87 states, 51 are authoritarian and 36 are considered to be “hybrid regimes.” As could be expected, the developed OECD countries dominate among full democracies, although there are two Latin American, two central European and one African country, which suggest that the level of development is not a binding constraint. Only two Asian countries are represented: Japan and South Korea.

Half of the world’s population lives in a democracy of some sort, although only some 14 percent reside in full democracies. Despite the advances in democracy in recent decades, more than one third the world’s population still lives under authoritarian rule. *Economist* Intelligence Unit, “The Economist Intelligence Unit’s Index of Democracy 2008,” *Economist*, October 29, 2008, accessed December 21, 2010, <http://graphics.eiu.com/PDF/Democracy%20Index%202008.pdf>.

What businesses must focus on is how a country’s political system impacts the economy as well as the particular firm and industry. Firms need to assess the balance to determine how local policies, rules, and regulations will affect their business. Depending on how long a company expects to operate in a country and how easy it is for it to enter and exit, a firm may also assess the country’s political risk and stability. A company may ask several questions regarding a prospective country’s government to assess possible risks:

1. How stable is the government?
2. Is it a democracy or a dictatorship?
3. If a new party comes into power, will the rules of business change dramatically?
4. Is power concentrated in the hands of a few, or is it clearly outlined in a constitution or similar national legal document?
5. How involved is the government in the private sector?
6. Is there a well-established legal environment both to enforce policies and rules as well as to challenge them?
7. How transparent is the government’s political, legal, and economic decision-making process?

While any country can, in theory, pose a risk in all of these factors, some countries offer a more stable business environment than others. In fact, political stability is a key part of government efforts to attract foreign investment to their country. Businesses need to assess if a country believes in free markets, government control, or heavy intervention (often to the benefit of a few) in industry. The country’s view on capitalism is also a factor for business consideration. In the broadest sense, **capitalism** is an economic system in which the means of production are owned and controlled privately. In contrast, a **planned economy** is one in which the government or state directs and controls the economy, including the means and decision making for production. Historically, democratic governments have supported capitalism and authoritarian regimes have tended to utilize a state-controlled approach to managing the economy.

As you might expect, established democracies, such as those found in the United States, Canada, Western Europe, Japan, and Australia, offer a high level of political stability. While many countries in Asia and Latin America also are functioning democracies, their stage of development impacts the stability of their economic and trade policy, which can fluctuate with government changes. Chapter 4 provides more details about developed and developing countries and emerging markets.

Within reason, in democracies, businesses understand that most rules survive changes in government. Any changes are usually a reflection of a changing economic environment, like the world economic crisis of 2008, and not a change in the government players.

This contrasts with more authoritarian governments, where democracy is either not in effect or simply a token process. China is one of the more visible examples, with its strong government and limited individual rights. However, in the past two decades, China has pursued a new balance of how much the state plans and manages the national economy. While the government still remains the dominant force by controlling more than a third of the economy, more private businesses have emerged. China has successfully combined state intervention with private investment to develop a robust, market-driven economy—all within a communist form of government. This system is commonly referred to as “a socialist market economy with Chinese characteristics.” The Chinese are eager to portray their version of combining an authoritarian form of government with a market-oriented economy as a better alternative model for fledgling economies, such as those in Africa. This new combination has also posed more questions for businesses that are encountering new issues—such as privacy, individual rights, and intellectual rights protections—as they try to do business with China, now the second-largest economy in the world behind the United States. The Chinese model of an authoritarian government and a market-oriented economy has, at times, tilted favor toward companies, usually Chinese, who understand how to navigate the nuances of this new system. Chinese government control on the Internet, for example, has helped propel homegrown, Baidu, a Chinese search engine, which earns more than 73 percent of the Chinese search-engine revenues. Baidu self-censors and, as a result, has seen its revenues soar after Google limited its operations in the country. Rolfe Winkler, “Internet Plus China Equals Screaming Baidu,” *Wall Street Journal*, November 9, 2010, accessed December 21, 2010, <http://online.wsj.com/article/SB10001424052748703514904575602781130437538.html>.

It might seem straightforward to assume that businesses prefer to operate only in democratic, capitalist countries where there is little or no government involvement or intervention. However, history demonstrates that, for some industries, global firms have chosen to do business with countries whose governments control that industry. Businesses in industries, such as commodities and oil, have found more authoritarian governments to be predictable partners for long-term access and investment for these commodities. The complexity of trade in these situations increases, as throughout history, governments have come to the aid and protection of their nation’s largest business interests in markets around the world. The history of the oil industry shows how various governments have, on occasion, protected their national companies’ access to oil through political force. In current times, the Chinese government has been using a combination of government loans and investment in Africa to obtain access for Chinese companies to utilize local resources and commodities. Many business analysts mention these issues in discussions of global business ethics and the role and responsibility of companies in different political environments.

What Are the Different Legal Systems?

Let’s focus briefly on how the political and economic ideologies that define countries impact their legal systems. In essence, there are three main kinds of legal systems—common law, civil law, and religious or theocratic law. Most countries actually have a combination of these systems, creating hybrid legal systems.

Civil law is based on a detailed set of laws that constitute a code and focus on how the law is applied to the facts. It’s the most widespread legal system in the world.

Common law is based on traditions and precedence. In common law systems, judges interpret the law and judicial rulings can set precedent.

Religious law is also known as theocratic law and is based on religious guidelines. The most commonly known example of religious law is Islamic law, also known as **Sharia**. Islamic law governs a number of Islamic nations and communities around the world and is the most widely accepted religious law system. Two additional religious law systems are the Jewish Halacha and the Christian Canon system, neither of which is practiced at the national level in a country. The Christian Canon system is observed in the Vatican City.

The most direct impact on business can be observed in Islamic law—which is a moral, rather than a commercial, legal system. Sharia has clear guidelines for aspects of life. For example, in Islamic law, business is directly impacted by the concept of interest. According to Islamic law, banks cannot charge or benefit from interest. This provision has generated an entire set of financial products and strategies to simulate interest—or a gain—for an Islamic bank, while not technically being classified as interest. Some banks will charge a large up-front fee. Many are permitted to engage in sale-buyback or leaseback of an asset. For example, if a company wants to borrow money from an Islamic bank, it would sell its assets or product to the bank for a fixed price. At the same time, an agreement would be signed for the bank to sell back the assets to the company at a later date and at a higher price. The difference between the sale and buyback price functions as the interest. In the Persian Gulf region alone, there are twenty-two Sharia-compliant, Islamic banks, which in 2008 had approximately \$300 billion in assets. Tala Malik, “Gulf Islamic Bank Assets to Hit \$300bn,” *Arabian Business*, February 20, 2008, accessed December 21, 2010, www.arabianbusiness.com/511804-gulf-islamic.

banks-assets-to-hit-300bn. Clearly, many global businesses and investment banks are finding creative ways to do business with these Islamic banks so that they can comply with Islamic law while earning a profit.

Government—Business Trade Relations: The Impact of Political and Legal Factors on International Trade

How do political and legal realities impact international trade, and what do businesses need to think about as they develop their global strategy? Governments have long intervened in international trade through a variety of mechanisms. First, let's briefly discuss some of the reasons behind these interventions.

Why Do Governments Intervene in Trade?

Governments intervene in trade for a combination of political, economic, social, and cultural reasons.

Politically, a country's government may seek to protect jobs or specific industries. Some industries may be considered essential for national security purposes, such as defense, telecommunications, and infrastructure—for example, a government may be concerned about who owns the ports within its country. National security issues can impact both the import and exports of a country, as some governments may not want advanced technological information to be sold to unfriendly foreign interests. Some governments use trade as a retaliatory measure if another country is politically or economically unfair. On the other hand, governments may influence trade to reward a country for political support on global matters.

Did You Know?

State Capitalism: Governments Seeking to Control Key Industries

Despite the movement toward privatizing industry and free trade, government interests in their most valuable commodity, oil, remains constant. The thirteen largest oil companies (as measured by the reserves they control) in the world are all state-run and all are bigger than ExxonMobil, which is the world's largest private oil company. State-owned companies control more than 75 percent of all crude oil production, in contrast with only 10 percent for private multinational oil firms. Ian Bremmer, "The Long Shadow of the Visible Hand," *Wall Street Journal*, May 22, 2010, accessed December 21, 2010, <http://online.wsj.com/article/SB10001424052748704852004575258541875590852.html>; "Really Big Oil," *Economist*, August 10, 2006, accessed December 21, 2010, <http://www.economist.com/node/7276986>.

Table 2.1 The Major Global State-Owned Oil Companies

Aramco	Saudi Arabia
Gazprom	Russia
China National Petroleum Corp.	China
National Iranian Oil Co.	Iran
Petróleos de Venezuela	Venezuela
Petrobras	Brazil
Petronas	Malaysia

Source: Energy Intelligence Group, "Petroleum Intelligence Weekly Ranks World's Top 50 Oil Companies (2009)," news release, December 1, 2008, accessed December 21, 2010, www.energyintel.com/documentdetail.asp?document_id=245527.

In the past thirty years, governments have increasingly privatized a number of industries. However, "in defense, power generation, telecoms, metals, minerals, aviation, and other sectors, a growing number of emerging-market governments, not content with simply regulating markets, are moving to dominate them." Ian Bremmer, "The Long Shadow of the Visible Hand," *Wall Street Journal*, May 22, 2010, accessed December 21, 2010, <http://online.wsj.com/article/SB10001424052748704852004575258541875590852.html>.

State companies, like their private sector counterparts, get to keep the profits from oil production, creating a significant incentive for governments to either maintain or regain control of this very lucrative industry. Whether the motive is economic (i.e., profit) or political (i.e., state control), "foreign firms and investors find that national and local rules and regulations are increasingly designed to favor domestic firms at their expense. Multinationals now find themselves competing as never before with state-owned

companies armed with substantial financial and political support from their governments.” Ian Bremmer, “The Long Shadow of the Visible Hand,” *Wall Street Journal*, May 22, 2010, accessed December 21, 2010, <http://online.wsj.com/article/SB10001424052748704852004575258541875590852.html>.

Governments are also motivated by economic factors to intervene in trade. They may want to protect young industries or to preserve access to local consumer markets for domestic firms.

Cultural and social factors might also impact a government’s intervention in trade. For example, some countries’ governments have tried to limit the influence of American culture on local markets by limiting or denying the entry of American companies operating in the media, food, and music industries.

How Do Governments Intervene in Trade?

While the past century has seen a major shift toward free trade, many governments continue to intervene in trade. Governments have several key policy areas that can be used to create rules and regulations to control and manage trade.

- **Tariffs.** Tariffs are taxes imposed on imports. Two kinds of tariffs exist—**specific tariffs**, which are levied as a fixed charge, and **ad valorem tariffs**, which are calculated as a percentage of the value. Many governments still charge ad valorem tariffs as a way to regulate imports and raise revenues for their coffers.
- **Subsidies.** A subsidy is a form of government payment to a producer. Types of subsidies include tax breaks or low-interest loans; both of which are common. Subsidies can also be cash grants and government-equity participation, which are less common because they require a direct use of government resources.
- **Import quotas and VER.** Import quotas and voluntary export restraints (VER) are two strategies to limit the amount of imports into a country. The importing government directs import quotas, while VER are imposed at the discretion of the exporting nation in conjunction with the importing one.
- **Currency controls.** Governments may limit the convertibility of one currency (usually its own) into others, usually in an effort to limit imports. Additionally, some governments will manage the exchange rate at a high level to create an import disincentive.
- **Local content requirements.** Many countries continue to require that a certain percentage of a product or an item be manufactured or “assembled” locally. Some countries specify that a local firm must be used as the domestic partner to conduct business.
- **Antidumping rules.** Dumping occurs when a company sells product below market price often in order to win market share and weaken a competitor.
- **Export financing.** Governments provide financing to domestic companies to promote exports.
- **Free-trade zone.** Many countries designate certain geographic areas as free-trade zones. These areas enjoy reduced tariffs, taxes, customs, procedures, or restrictions in an effort to promote trade with other countries.
- **Administrative policies.** These are the bureaucratic policies and procedures governments may use to deter imports by making entry or operations more difficult and time consuming.

Did You Know?

Government Intervention in China

As shown in the opening case study, China is using its economic might to invest in Africa. China’s ability to focus on dominating key industries inspires both fear and awe throughout the world. A closer look at the solar industry in China illustrates the government’s ability to create new industries and companies based on its objectives. With its huge population, China is in constant need of energy to meet the needs of its people and businesses.

As a result, the government has placed a priority on energy related technologies, including solar energy. China’s expanding solar-energy industry is dependent on polycrystalline silicon, the main raw material for solar panels. Facing a shortage in 2007, growing domestic demand, and high prices from foreign companies that dominated production, China declared the development of domestic polysilicon supplies a priority. Domestic Chinese manufacturers received quick loans with favorable terms as well as speedy approvals. One entrepreneur, Zhu Gongshan, received \$1 billion in funding, including a sizeable investment from China’s sovereign wealth fund, in record time, enabling his firm GCL-Poly Energy Holding to become one of the world’s biggest in less than three years. The company now has a 25 percent market share of polysilicon and almost 50 percent of the global market for solar-power equipment. Jason Dean, Andrew Browne, and Shai Oster, “China’s ‘State Capitalism’ Sparks Global Backlash,” *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, <http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html>.

How did this happen so fast? Many observers note that it was the direct result of Chinese government intervention in what was deemed a key industry.

Central to China's approach are policies that champion state-owned firms and other so-called national champions, seek aggressively to obtain advanced technology, and manage its exchange rate to benefit exporters. It leverages state control of the financial system to channel low-cost capital to domestic industries—and to resource-rich foreign nations (such as those we read in the opening case) whose oil and minerals China needs to maintain rapid growth. Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, <http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html>.

Understanding the balance between China's government structure and its ideology is essential to doing business in this complex country. China is both an emerging market and a rising superpower. Its leaders see the economy as a tool to preserving the state's power, which in turn is essential to maintaining stability and growth and ensuring the long-term viability of the Communist Party. Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, <http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html>.

Contrary to the approach of much of the world, which is moving more control to the private sector, China has steadfastly maintained its state control. For example, the Chinese government owns almost all the major banks, the three largest oil companies, the three telecommunications carriers, and almost all of the media.

China's Communist Party outlines its goals in five-year plans. The most recent one emphasizes the government's goal for China to become a technology powerhouse by 2020 and highlights key areas such as green technology, hence the solar industry expansion. Free trade advocates perceive this government-directed intervention as an unfair tilt against the global private sector. Nevertheless, global companies continue to seek the Chinese market, which offers much-needed growth and opportunity. Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks Global Backlash," *Wall Street Journal*, November 16, 2010, accessed December 22, 2010, <http://online.wsj.com/article/SB10001424052748703514904575602731006315198.html>.

KEY TAKEAWAYS

- There are more than thirteen major types of government and each type consists of multiple variations. At one end of the political ideology extremes is anarchism, which contends that individuals should control political activities and public government is both unnecessary and unwanted. The other extreme is totalitarianism, which contends that every aspect of an individual's life should be controlled and dictated by a strong central government. Neither extreme exists in its purest form in the real world. Instead, most countries have a combination of both. This combination is called pluralism, which asserts that both public and private groups are important in a well-functioning political system. Democracy is the most common form of government today. Democratic governments derive their power from the people of the country either by direct referendum, called a direct democracy, or by means of elected representatives of the people, known as a representative democracy.
- Capitalism is an economic system in which the means of production are owned and controlled privately. In contrast a planned economy is one in which the government or state directs and controls the economy.
- There are three main types of legal systems: (1) civil law, (2) common law, and (3) religious law. In practice, countries use a combination of one or more of these systems and often adapt them to suit the local values and culture.
- Government-business trade relations are the relationships between national governments and global businesses. Governments intervene in trade to protect their nation's economy and industry, as well as promote and preserve their social, cultural, political, and economic structures and philosophies. Governments have several key policy areas in which they can create rules and regulations in order to control and manage trade, including tariffs, subsidies; import quotas and VER, currency controls, local content requirements, antidumping rules, export financing, free-trade zones, and administrative policies.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Identify the main political ideologies.
2. What is capitalism? What is a planned economy? Compare and contrast the two forms of economic ideology discussed in this section.
3. What are three policy areas in which governments can create rules and regulations in order to control, manage, and intervene in trade.

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