

# Understanding Politics, Laws, & Economics

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## Chapter 2



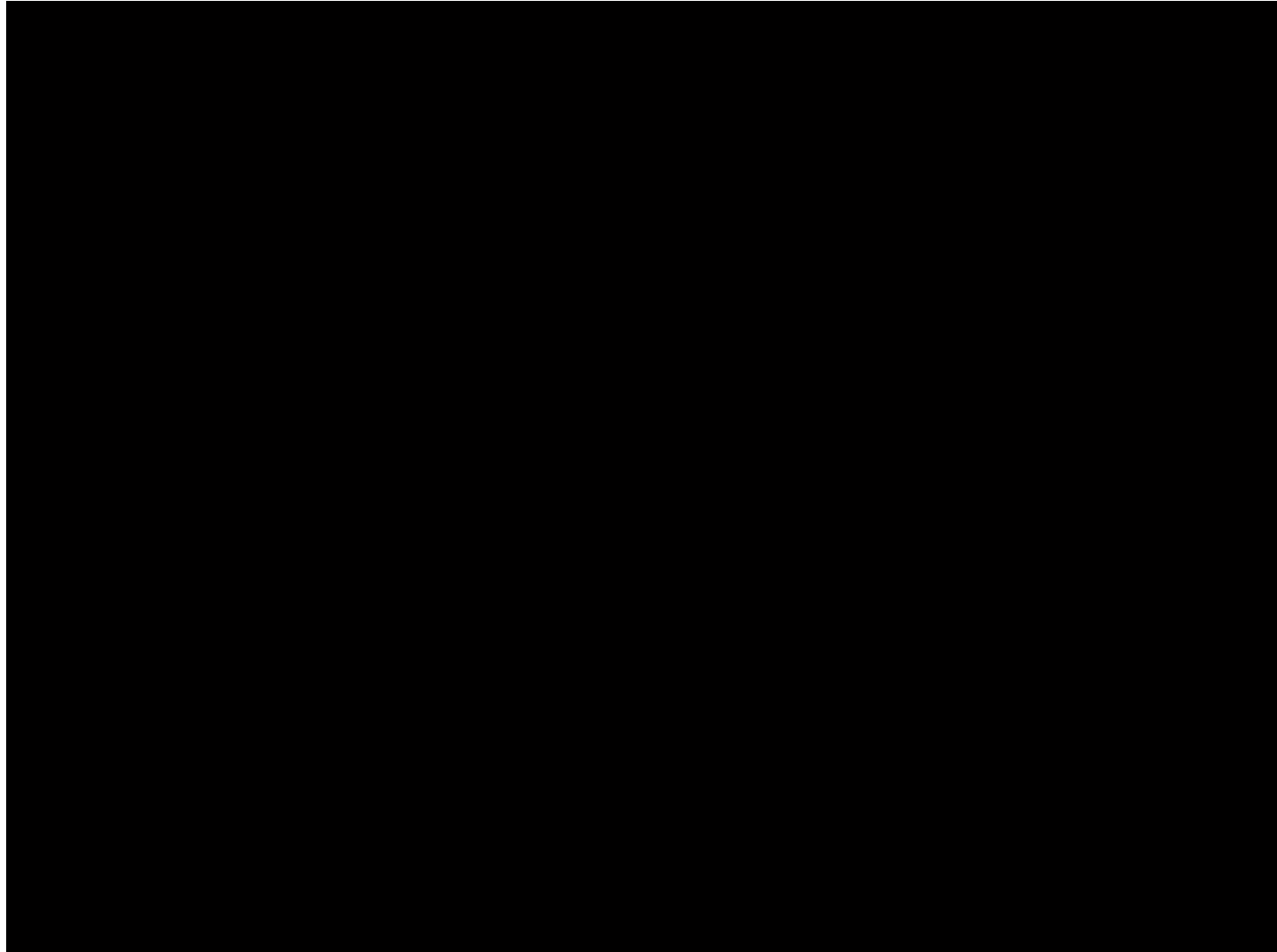
# Opening Case - Cuba

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# Time for a Laugh

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# Objectives for Chapter 2

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## Institutions important?

- Reduce uncertainty

## Institutions effect on business

- Businesses maximize profits subject to constraints
- Informal institutions increase in importance when formal institutions are weak

## Different types of law

## Property rights

- Fundamental to market economies and investment

## Market vs. Command economies

- Or somewhere in the middle

# Importance of Institutions

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Start a business in Argentina? No?

- Understanding of the rules of the game

**Institutions** are “the humanly devised constraints that structure human interaction.” Douglass North

**Formal Institutions** – Institutions such as laws, regulations, and rules

**Informal Institutions** – Institutions such as norms, cultures, and ethics

# The Coke Story

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LESSONS

Degree of Formality	Examples	Supportive Pillars
Formal Institutions	Laws Regulations Rules	Regulatory (coercive power of government)
Informal Institutions	Culture Ethics Norms	Normative Cognitive

Enforced by Government

Values, beliefs, and actions of others affect individuals' and firms' behavior

Internalized (taken for granted) values and beliefs that guide individual and firm behavior

Can oppose each other!

Three pillars combine to guide actions of both individuals and firms

# Why Are Institutions Important?

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Institutions help to reduce uncertainty

- Signals what conduct is legitimate
- Constrain acceptable behavior

Reduces **transaction costs** – costs associated with economic transactions or, more broadly, the costs of doing business

- Imagine if there were no laws or informal inst.
  - Investigate all partners
  - Long contracts
  - Enforce contracts yourself
  - ...
  - Cash business, short term, low value added



# Institution Based View

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## Two core propositions

1. Firms and managers rationally pursue their interest and make choices within institutional constraints
  
2. Formal and informal institutions govern behavior, informal play a larger role when formal institutions are unclear or fail versus when formal institutions are effective

# Why Are Institutions Important?

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Institutions help to reduce uncertainty

- When formal institutions are weak
- Informal institutions take on more importance

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# Institution Based View

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A skillful use of institutional frameworks to acquire advantage is the basis for the institutional view

- Formal rules make up only a small part of institutional setting
- Informal rules and relationships are still very important
  - Russia after collapse
  - Large firms in US with access to law makers
  - Ex: Iowa corn farmers



*Biofuels have direct, fuel-cycle GHG emissions that are typically 30–90% lower than those for gasoline or diesel fuels. However, since for some biofuels indirect emissions—including from land use change—can lead to greater total emissions than when using petroleum products, policy support needs to be considered on a case by case basis*

# Formal Institutions

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# Risks in Democracy and Totalitarianism



Source: CBS News



Youtube.com  
St. Louis Dispatch



Source: wsj.com



Source: businessinsider.com

# Institutional Transition and Risk

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## **Totalitarianism:**

single person or party in control

Stability risk of government maintaining power and policy

- Coup
- Leader(s) change preferences

Risks change as position in spectrum changes

## **Democracy:**

citizens elect government

Stability risk of changing policies

- Election changes leaders
- Public mood swings policy

**A “stable” government must be able to maintain itself in power and maintain consistency of policies**

# Totalitarianism

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**Communist Totalitarianism** – Totalitarian regime with objective to achieve communist ideals

**Right-wing Totalitarianism** – Totalitarian regime that restricts political freedom but generally permits individual economic freedom (fear that political freedom will lead to communism)

**Theocratic Totalitarianism** – monopolization of political power by one religious party

**Tribal Totalitarianism** – one tribe or ethnic group monopolizes political power and oppresses others  
(Rwanda 1990s, Iraq prior to 2002)

# Political Risk

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**Political Risk** – risk associated with political changes that may negatively impact domestic and foreign firms

- Generally, totalitarianism is more risky
- Extreme risk may lead to nationalization
- Happens in totalitarian countries (mostly 50'-70's)
  - Venezuela more recently
- Political risk still present in democracies but significantly lower



# Political Risk

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## Institutional Transition

- Fundamental and comprehensive changes to the formal and informal rules of the game

Always a possibility, usually doesn't happen overnight

- But can happen relatively quickly

Healthcare in the US...

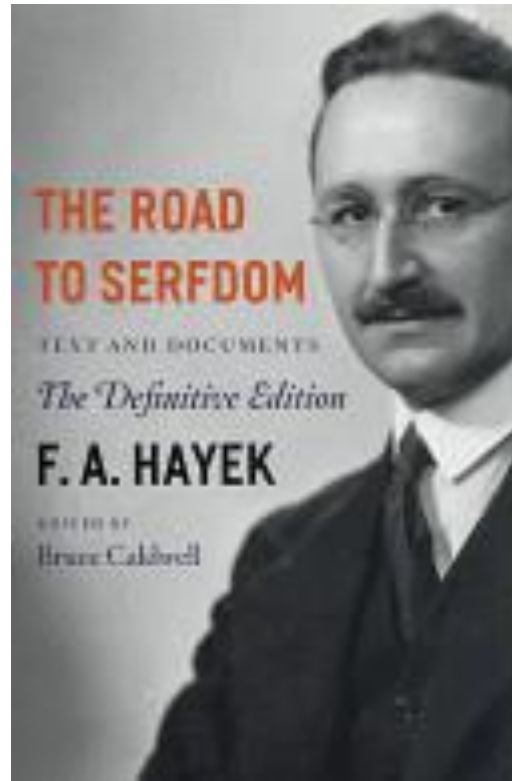
- Change in formal institutions

Also informal institutions

- Change in normative pillar
- Gay marriage in US

# Hayek's The Road to Serfdom

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In cartoons

Source: Reader's Digest

# Road to Serfdom

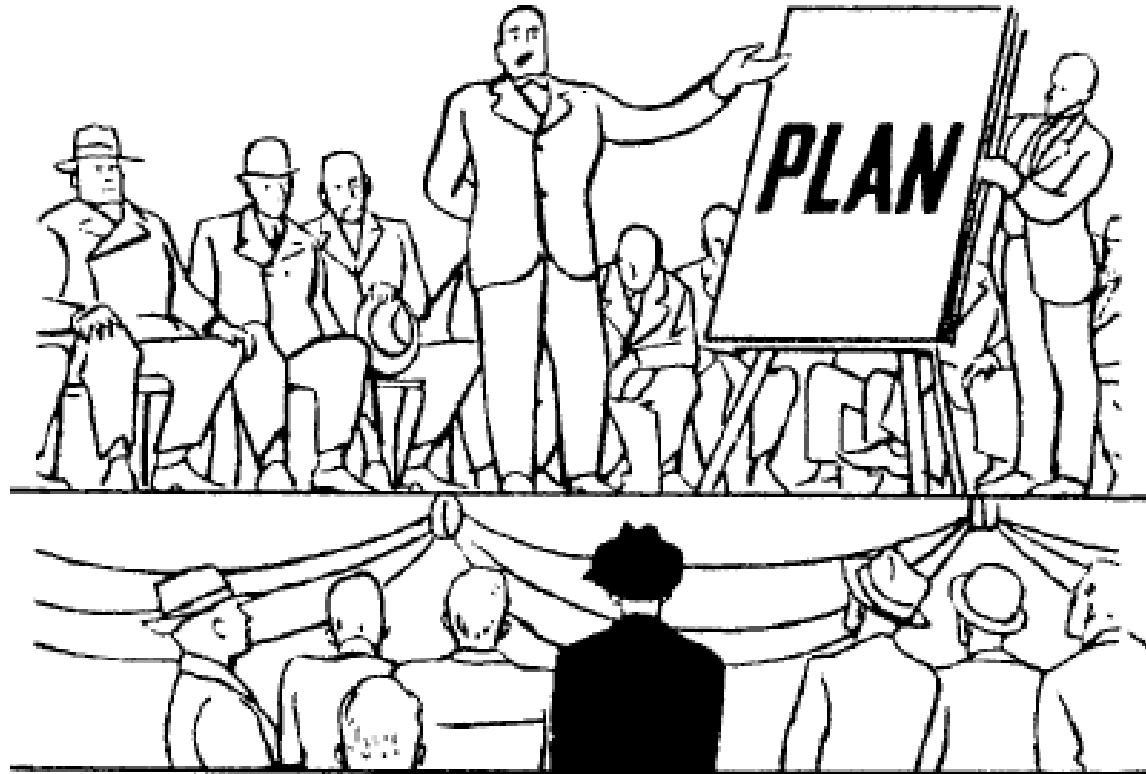
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What's good in war is good in peace. Keep the wartime propaganda and central planning



- Must win the peace, planning has been successful, keep planning



- Planners promise organization and utopia



- But can't agree on a single plan, war time unity is gone, fighting begins



- People can't agree on the plan either What's good for farmer may not be good for consumer...

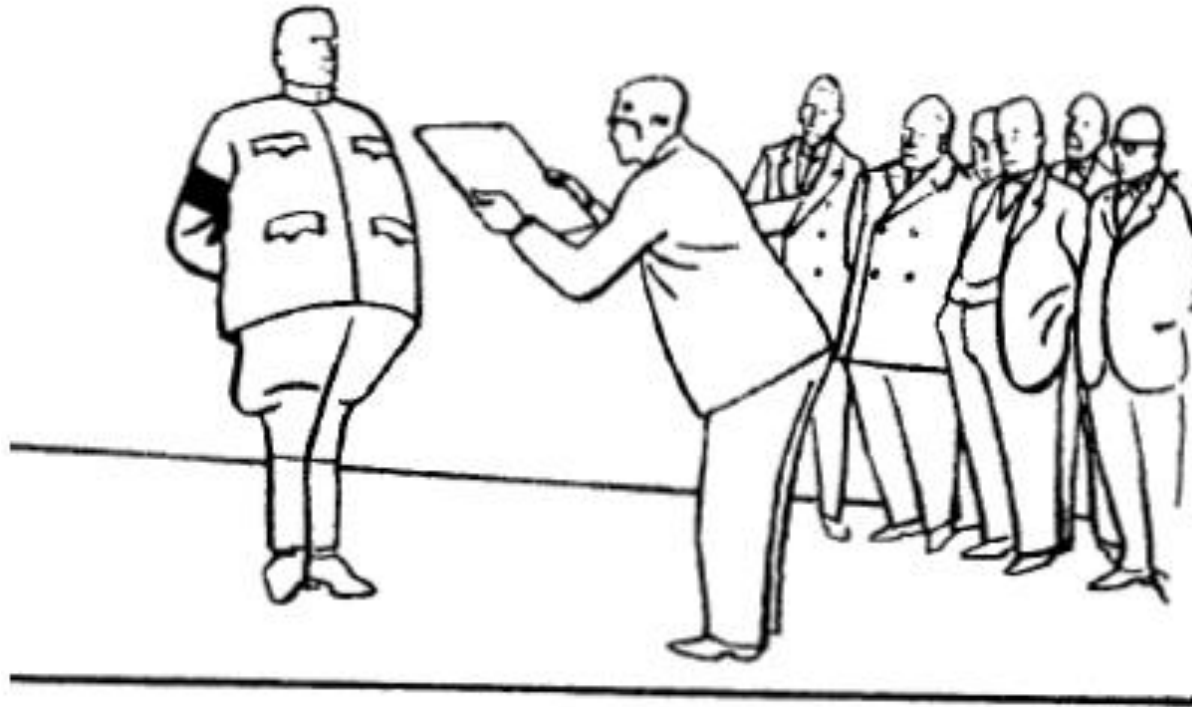


- Propaganda to sell planning





Calls for a leader to unite the people



Strong man given/wins power to help enforce and execute the plan

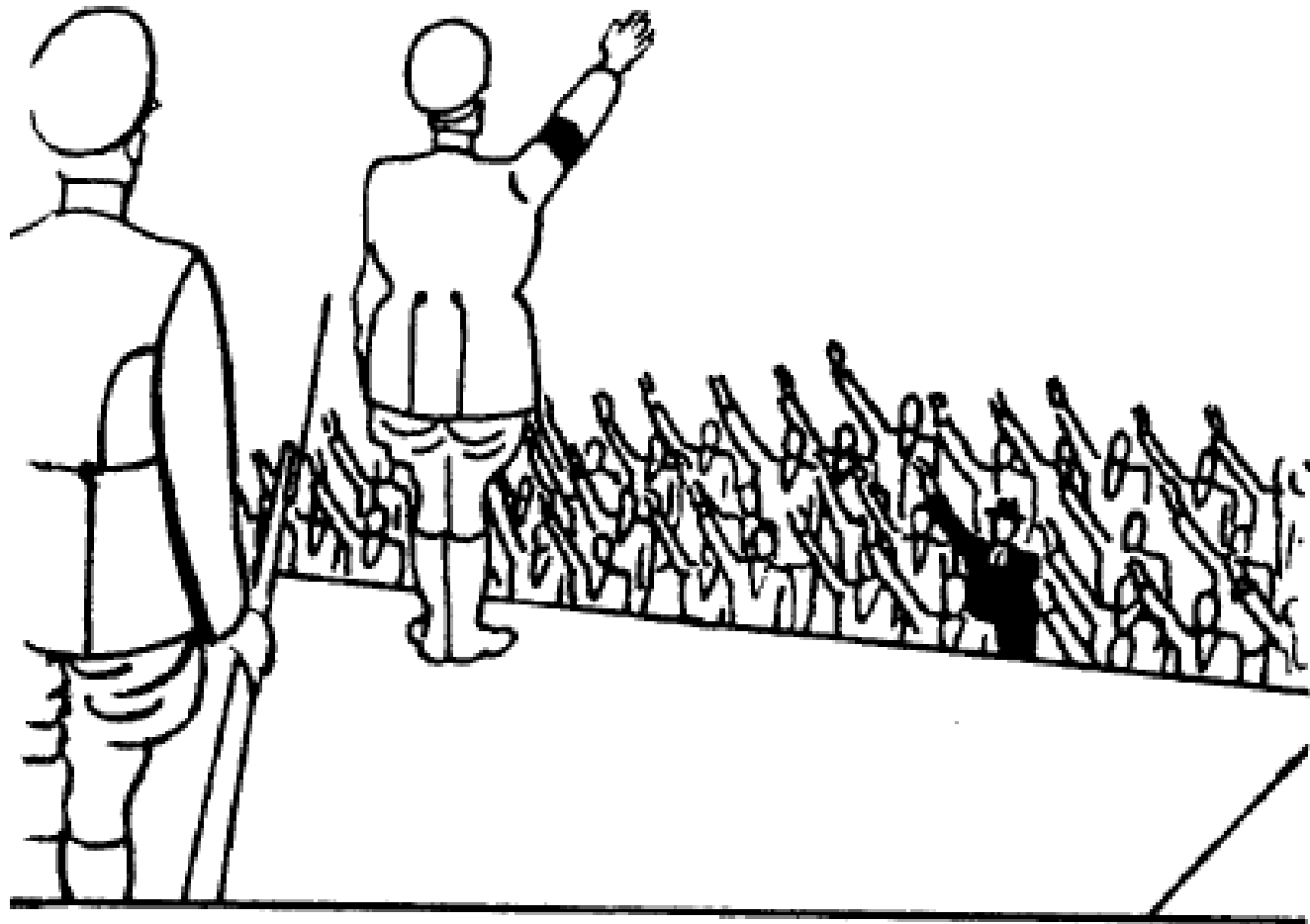


Loyalty to the leader and group identity is required to regain order and unity of purpose

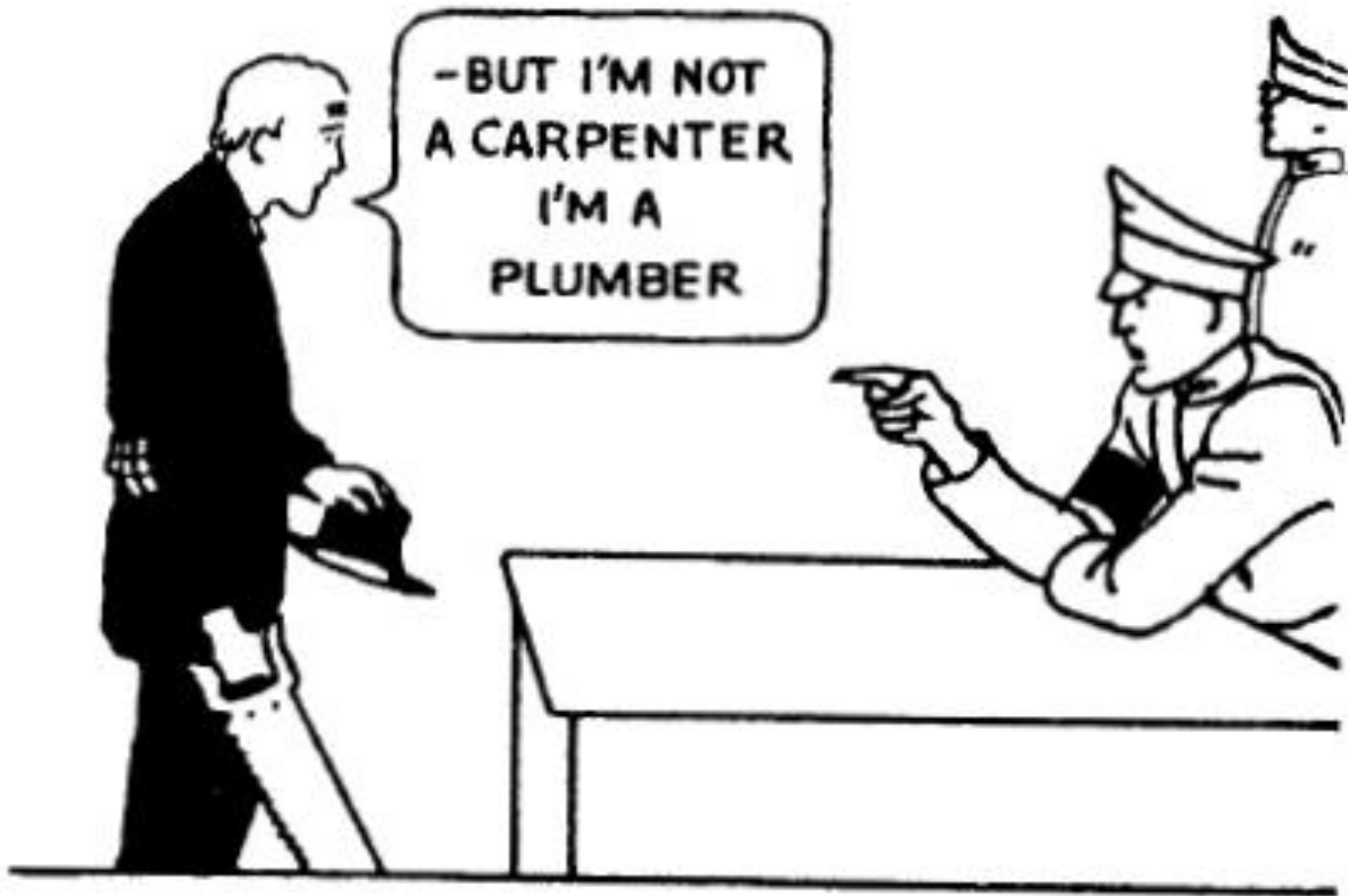
Opposition is shouted down and ostracized



Political leader(s) find a scapegoat, straw-man, minority enemy, blame problems on them. This unites the majority against that minority. (WWII it was the Jews)



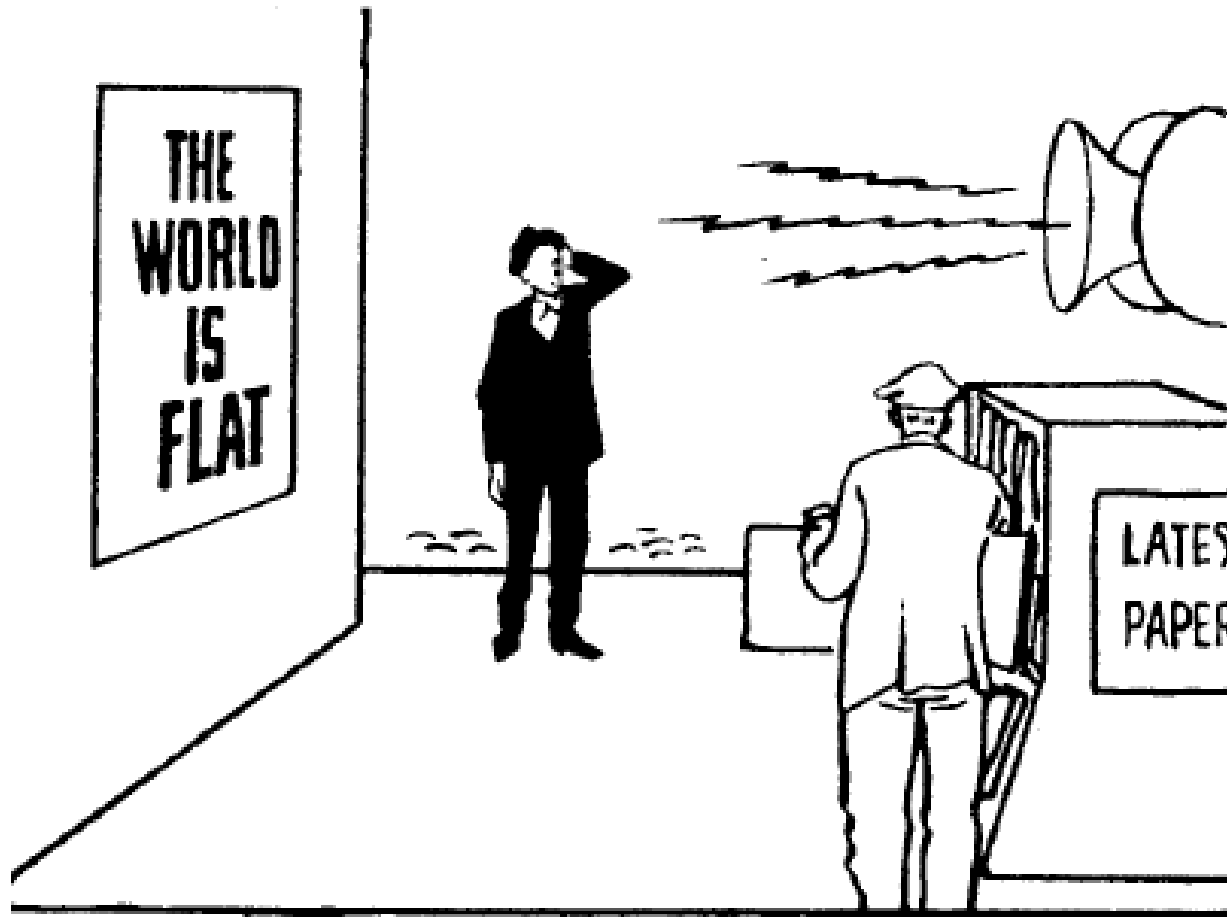
Now nobody wants to be the scapegoat so nobody opposes the plan, all freedom is gone



Career is planned, no freedom

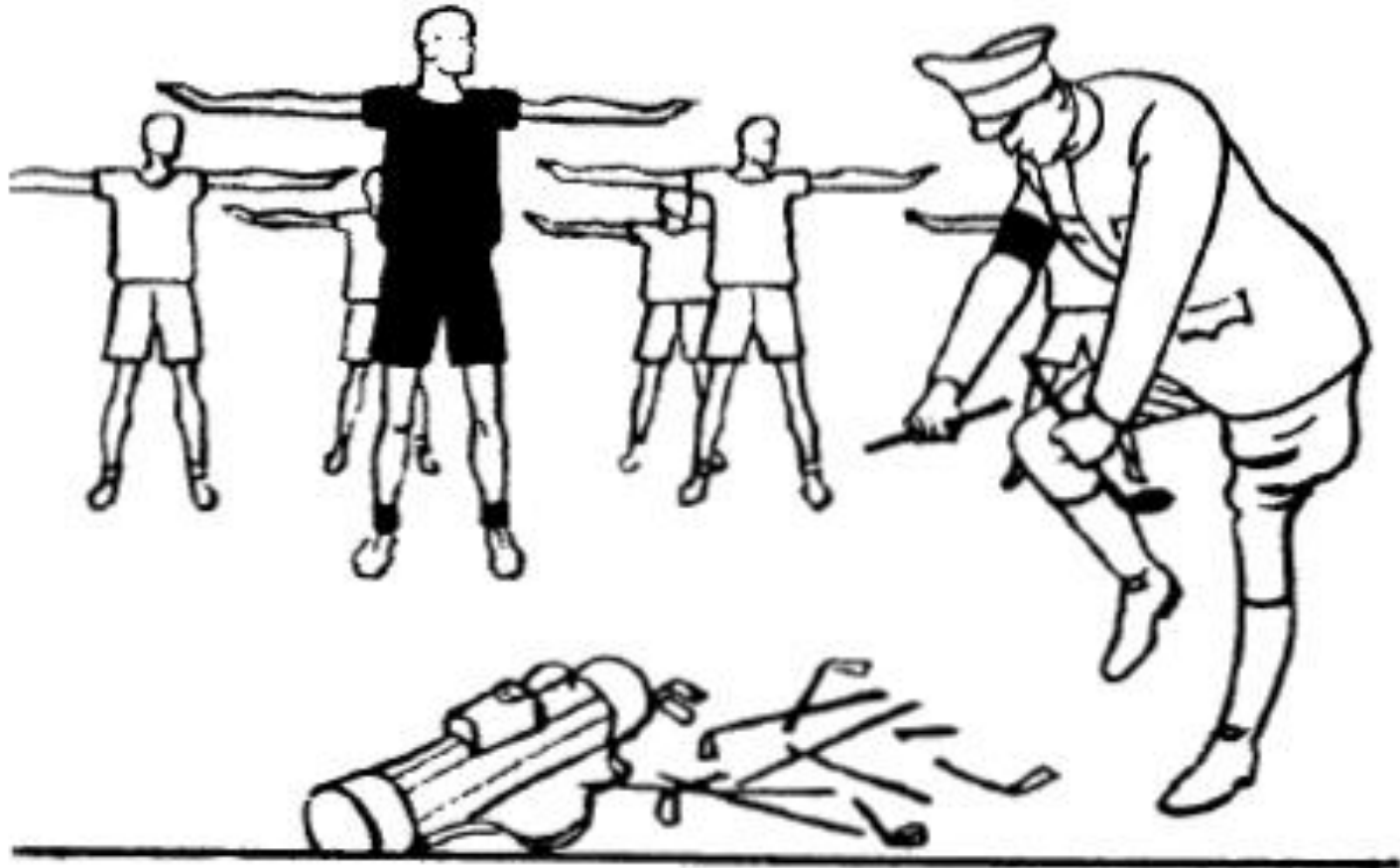


Wages are planned

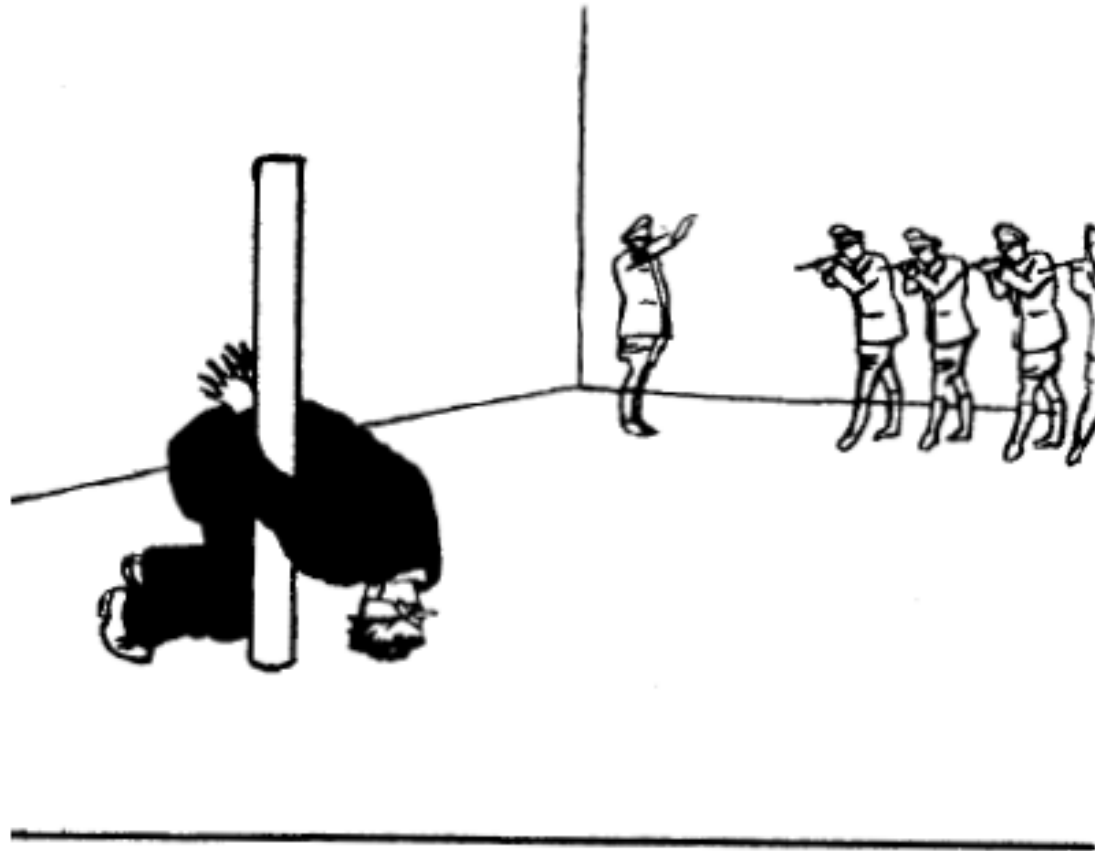


Subjected to massive propaganda  
Thinking is planned





Recreation is planned



Discipline is planned too

Poor performance is now disloyalty to the “cause.” Poor performers and protesters are traitors

# Road to Serfdom

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Hitler returned from WWI in 1918 with no job, no real skills, and no friends.

Had seized power by 1933. Started the concentration camps for real and perceived political opponents to “re-educate” them

Invaded Poland in 1939

15 years till camps open, relatively quick

# Legal Systems

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# Legal Systems

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## Three types of systems used to categorize legal systems

- **Civil Law** – a legal tradition that uses comprehensive statutes and codes as a primary means to form legal judgments
- **Common Law** – a legal tradition that is shaped by precedents from previous judicial decisions
  - Common law developed in England and spread to colonies, civil law was more common on European continent
- **Theocratic Law** – a legal system based on religious teachings

# Civil Law

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Most widely distributed throughout the world

Comprehensive statutes and codes

Judges apply the law, do not interpret

- Less flexible than common law in short run
- But more predictable
- Potentially more flexible in long run though
  - Easier to rewrite law than precedent

English in origin and spread to English speaking countries

- Shaped by precedent (previous decisions)
- Judges resolve disputes on interpretation
- More flexible/less -predictable than civil law in the short run
- Less flexible than civil law in long run
- More confrontational than civil law

Longer, more detailed contracts

# Theocratic Law

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## Legal system based on religious teachings

- Islamic law (Sharia) is only surviving example of theocratic legal system
- Practiced by some governments including Iran and Saudi Arabia (potentially more or less following the Arab spring)



# What kind of Law does the US have?

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# Legal Systems, Property Rights, and Development

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# Property Rights

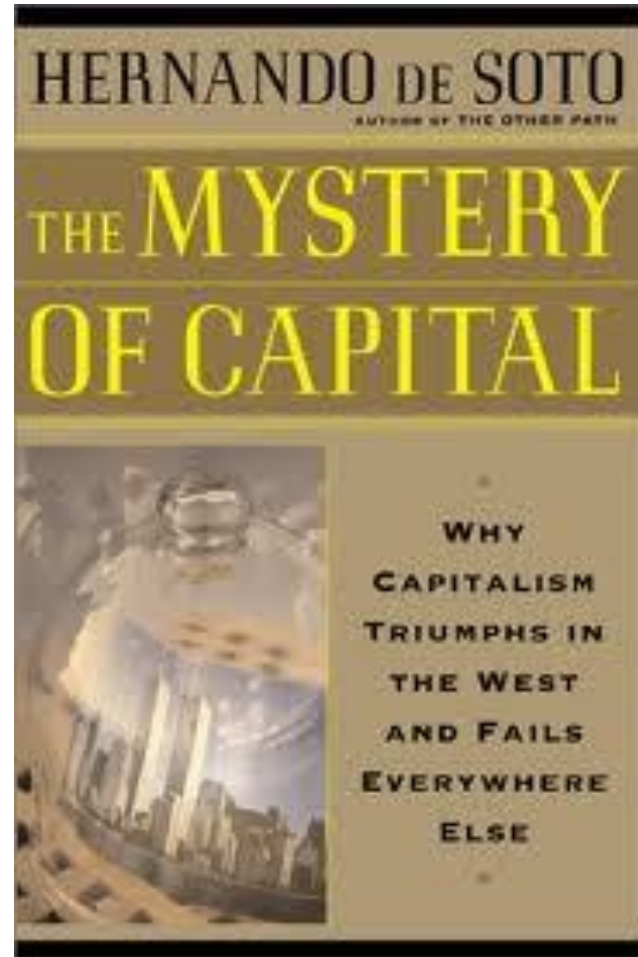
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**Property Rights** – the legal rights to use an economic property (resource) and to derive income benefits from it

- Ex: home, car, land, factory, minerals
- Also includes intellectual property
- Create incentive to save and invest
- PR well defined in advanced economies (enforcement is another issue)
  - Tangible property rights makes other less tangible activity possible, i.e. collateral and credit

# Hernando Desoto

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# Property Rights Matter

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## Squatters Camp



Source: [pisympphony.com](http://pisympphony.com)

## Neighborhood



Source: [cityofhenderson.com](http://cityofhenderson.com)

# Intellectual Property Rights

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Often think of tangible items as “property” but idea also extends to intangible or intellectual property

- **Intellectual property** – intangible property that results from intellectual activity (such as the content of books, videos, music, and websites)
- **Intellectual Property Rights** (IPR) are the rights associated with the ownership of intellectual property

# Intellectual Property

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Many international agreements on recognizing IPR and increasing

## Piracy – unauthorized use of IP

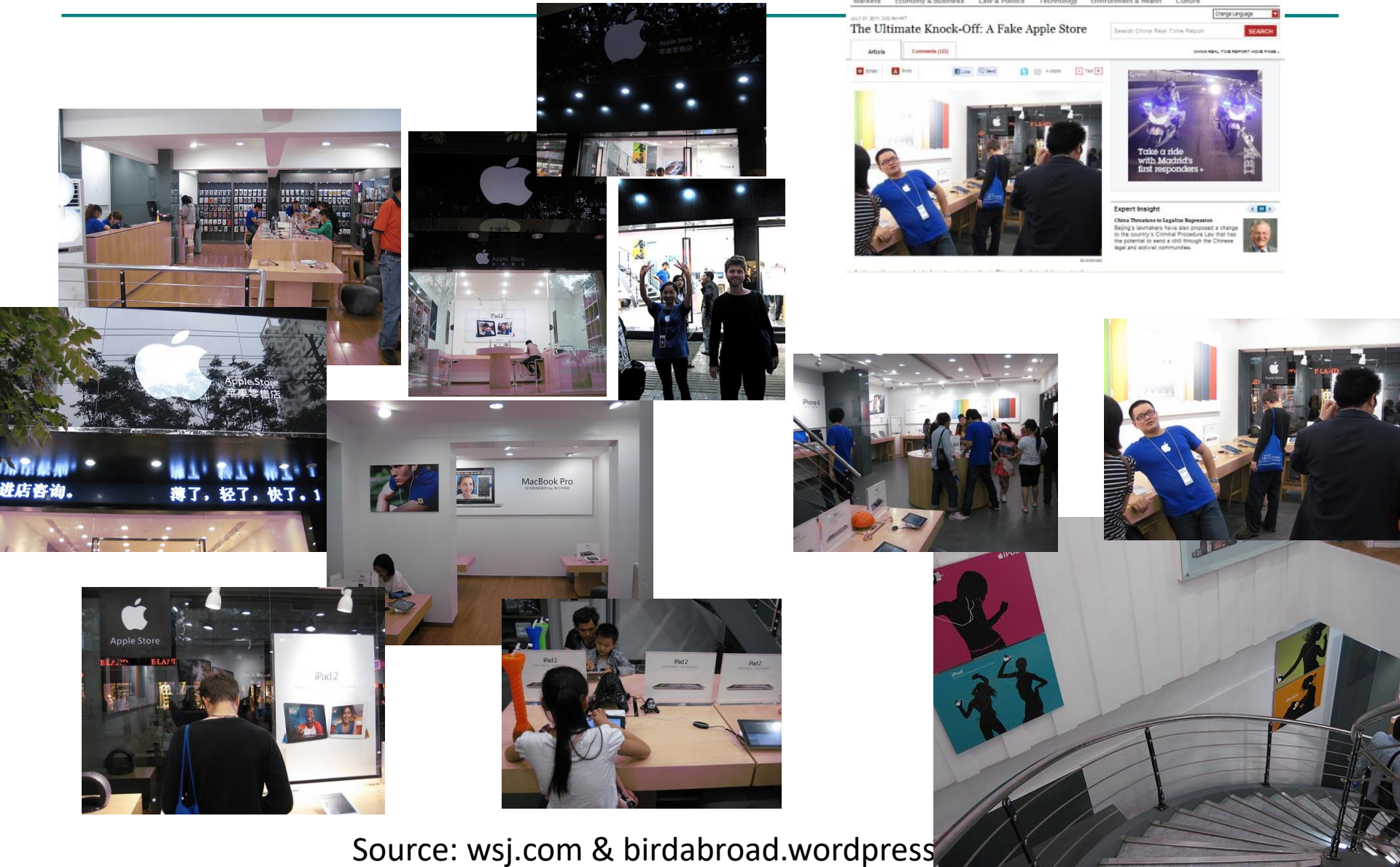
- i.e. downloading or sharing music w/o auth.
- Selling fake movies or counterfeit software

## Why such a problem?

- Counterfeiting is rational behavior!
- Weak enforcement of IPR laws, large benefits
  - Students – chance of prosecution is slim
  - Often small fines
  - China - \$10K of profits before prosecuted
  - Lack of economic alternatives



# Fake Apple Store



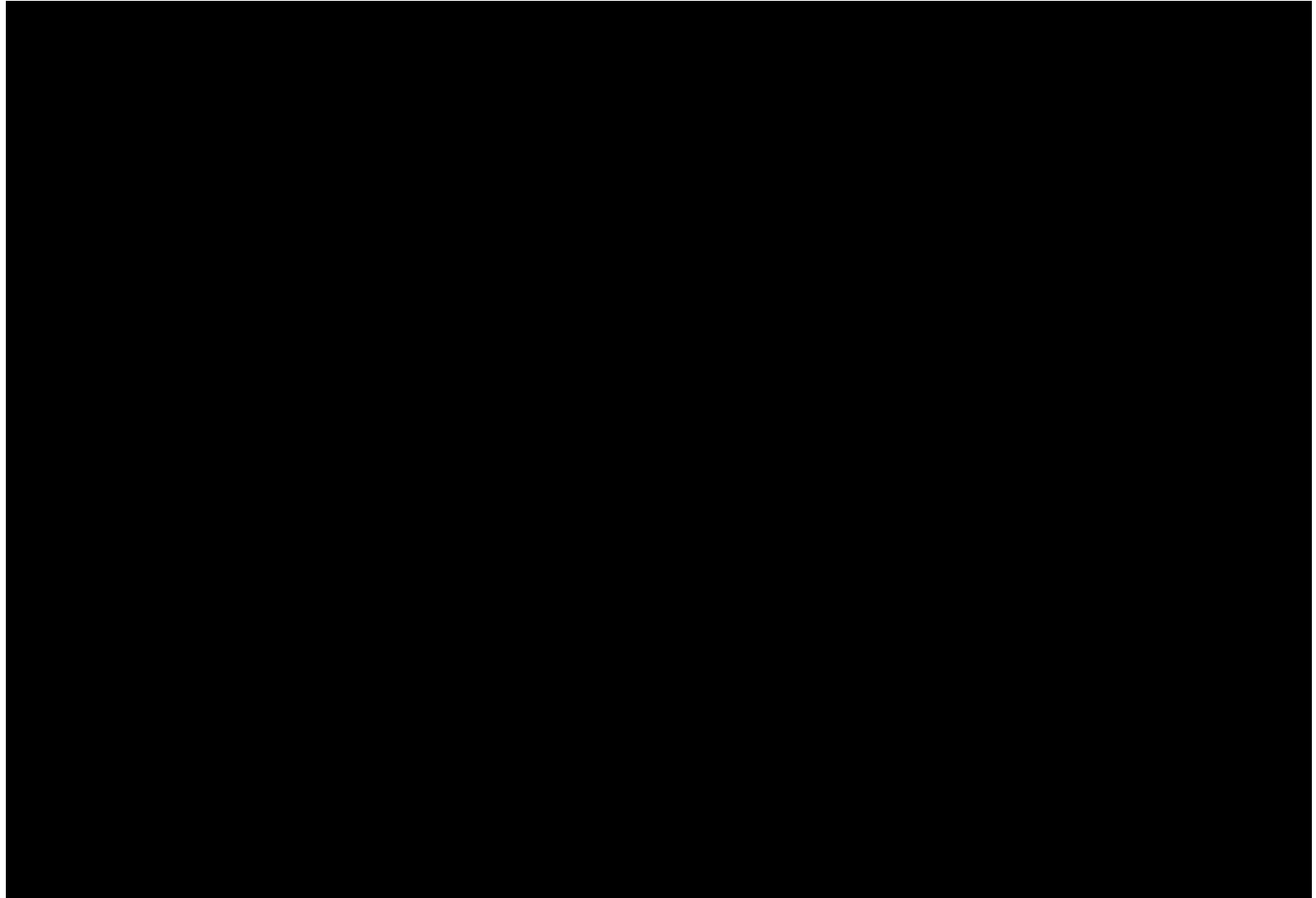
Source: wsj.com & birdabroad.wordpress

# Fake Apple Store



# I Have A Drug Problem

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# Protecting IPR

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## To protect Intellectual Property Rights:

- Defensive:
  - Change the incentives
    - Licensing agreements to share profits
    - Joint ventures
  - Limit exposure
    - Only allow pieces of product to be made in single location and assemble in US
    - Don't outsource the critical parts
- Offensive:
  - Price discrimination – different prices for different consumers. (must limit “arbitrage”)

# Concerns

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Changes in political ruling party can cause a shift in the spectrum

Never observe ends of spectrum:

- US is a mixed economy
- Always some gov't intervention
- Total control impossible to achieve
  - Black markets
  - Second jobs under the table...

Watch for changes in policies to signal movement in spectrum

# Takeaways

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Industrialized economies supported by strong institutions

- Often lacking in developing countries

Rational choices within constraints of framework

- Wish all you want, but decide based on reality...

When entering a new country do your homework to understand formal institutions

If formal institutions are weak and look at informal for guidance