Block

1

AN OVERVIEW OF INTERNATIONAL BUSINESS

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COURSE INTRODUCTION

International business refers to business activities that involve the transfer of resources, goods, services, knowledge, skills, or information across national boundaries. Companies operating in international markets function in a highly competitive environment and require strategies that differentiate their products and enhance their perceived value, while reducing production costs. Traditionally, many such companies have confined much of their value adding activities to their home countries. Alternatively, they may duplicate some value chain activities such as production and sales and service in individual countries. Companies operating internationally face conflicting pressures. They need to offer their product at competitive prices, and at the same time, tailor it to suit local needs. To bring down prices, they may be forced to standardize the product and operate from a single location.

International businesses face several challenges when setting up facilities internationally. The barriers to international trade pose a major threat while entering foreign markets. In addition, the cultural differences and Multinational Enterprise (MNE’s) relationship with the governments of the home country and the host country also play a major role while conducting international business.

As an MNE grows internationally the tools of international financial analysis is apparent. This helps the MNE in taking key financial decisions. Pressures from local competition for customization and price competition from international competitors with low-cost production bases pose a challenge to international companies. These companies have to choose between standardizing products, manufacturing at a low- cost location and passing the cost advantage to customers, and setting up plants in different countries for customizing products, regardless of the high costs that may be involved.

International Business addresses these challenges when a company attempts to go beyond its home markets and compete globally.

This edition has added a large number of contemporary examples and deleted old examples and exhibits. It has simplified the language and text layout to make it more readable.

BLOCK 1: AN OVERVIEW OF INTERNATIONAL BUSINESS

The first block to the course on International business gives an overview of international business. The block contains three units. The first unit gives an introduction of international business and globalization. The second unit deals with trade theories and their application in international business and the trade barriers that hinder international business. The third unit discusses the country differences in the cultural, political, and legal environmental contexts.

The first unit, *International Business and Globalization* introduces the concept of globalization and its importance. The unit discusses the benefits and threats of globalization. It then goes into explaining the link between globalization and international business. It finally discusses the motives for carrying out international business.

The second unit, *International Trade Theories and Application* discusses the major theories of international trade. It finally discusses different types of trade barriers i.e. tariffs and quantitative restrictions (including non-tariff barriers, quotas, and export controls). The barriers to trade in service are also discussed.

The third unit, *Country Differences* defines culture and its significance in international business. It then explains how language and religion create opportunities and difficulties for Multinational enterprises (MNEs). It then goes on to explain the key classifications of national cultures. It then defines corporate culture and explains other layers of culture. It also discusses key cultural issues. The unit then explains the political environment in which the MNE operates. It then explains MNE's relationship with the governments of the home country and the host country. The unit finally discusses the legal environment in which the MNE carries out its operations.

Unit 1

International Business and Globalization

Structure

"We must create a kind of globalization that works for everyone... and not just for a few."

- Nestor Kirchner; Former President of Argentina

1.1 Introduction

In modern times, globalization has become a key buzzword. While globalization may have a different meaning to every individual, its manifestations are found around everyone.

Globalization of business is largely seen as creation of wealth that would benefit nations and individuals worldwide. International business by forging a network of global links around the world engages in international trade and investment.

This unit will discuss the concept of globalization and its importance. The unit then discusses the benefits and threats of globalization. It then goes into explaining the link between globalization and international business. It finally discusses the motives for carrying out international business.

1.2 Objectives

By the end of this unit, you should be able to:

- Outline the concept of globalization and its importance.
- Discuss the benefits and threats of globalization.
- Describe the link between globalization and international business.
- Identify the different motives for carrying out international business.

1.3 Concept of Globalization

For consumers, globalization may mean more choices, reduced prices, and an indistinct national identity for products and services. For instance, a consumer buying a General Motors or Ford car would find that the car is made either in Canada or Mexico or contains several foreign components. In the service sector, similar trends could be observed. For instance, the mortgage on a resident's US property might be underwritten by Dutch bank ABN Amro; a person's retirement benefits might be managed by Germany-based Deutsche Bank or invested in Switzerland-based Nestle.

Globalization also has an impact on the career choices and progression of people. For instance, a student upon graduation may work for many of the foreign companies in the US or may work in another country for a US, local, or a foreign firm.

1.4 The Face of Globalization

1.4.1 Benefits from Globalization

Globalization has its winners and losers, and it allegedly comes at the cost of poorer nations. Globalization is higher among the G-7 nations (G-7 nations are industrialized nations including France, Canada, the UK, the US, Italy, Japan, and Germany) than in the developing and emerging economies. However, some developed nations such as Japan are low on globalization while some developing nations such as Botswana and emerging economies such as the Czech Republic are quite high on globalization.

In 2000, the share of developing countries in world merchandise trade reached the highest level in 50 years. The trade growth of the 49 least developed countries (LDCs) surpassed the global average. Moreover, the signs of globalization in wealthy nations end up in helping poorer economies. For instance, when a Singaporean tourist is visiting Laos, he/she is increasing the export sales of the country by buying services such as hotel stays and tours. Finally, around 95 percent of the 78 million new births every year take place in developing nations. This indicates that sooner or later developing nations will provide the bulk of consumption and production, profiting more than international trade and investment. Employees of foreign companies in developing countries enjoy wages in excess of those paid by domestic firms.

Globalization may not be synonymous with a lack of social safety net or with low levels of public expenditure as is sometimes argued by opponents of globalization. Countries such as Denmark and Sweden offer good examples.

Example: Coca-Cola's Glob al Success

The Coca-Cola Company (Coca-Cola) is often hailed as a model for a global company. It sold several beverage brands worldwide and its flagship brand, Coke had become the symbol of a global product. Studies suggest that the Coca-Cola brand has the highest brand recognition in the world.

Coca-Cola produced Coke in the same way across the world. The concentrate was sold to local bottler. The bottlers then made the drink and distributed it in their markets. But while maintaining a coherent global theme, the company also adapted taste as well as operations in global markets. According to the company's annual report, "We have to maintain our special place in local cultures, recognizing the differences between countries and regions." Coca-Cola's slogan, "think globally and act locally" embodied the central dilemma in international business: the need to maintain control and global strategic focus while allowing for adaptation to suit to the local circumstances from management to distribution. The company also took care of advertising while serving global markets so that controversial themes could be avoided in local markets.

Despite being successful in major global markets, Coca-Cola also had to face some problems. The European Commission has rejected its bid to acquire a beverage maker in France, pointing out that the company already had majority stakes in the European Union markets. The company's efforts to promote itself as a global brand had not prevented it from being identified as an American icon by anti-US and anti-globalization activists.

Compiled from various sources.

1.4.2 Globalization and the Monopoly Power of Corporations

A common complaint against globalization is that it deprives nations of their sovereignty. This may occur because of the growing stature of international organizations such as the World Trade Organization (WTO) whose officials are not elected by popular vote, and because to some people, globalization only means Americanization and therefore a threat to their values and identity. Related to this argument is the criticism that globalization enhances the monopoly power of multinational corporations.

Example

Monsanto holds patent for several genetically modified agricultural seeds globally. One of its patented seed is Bt Cotton seed which it supplies to seed companies and farmers worldwide including India. In 2017 National Seed Association of India offered to mediate between Monsanto and its sub licensees of Bt Cotton seeds in India in the dispute over the matter of trait value.

Contd….

Such practices resulted in high Bt cottonseed prices for farmers, besides eliminating several small- and medium-seed companies from cottonseed business in the past decade. Monsanto spurned the mediation offer and preferred to take the matter to court. Few of the sub licensees agreed to Monsanto's terms as they feared high litigation cost. Although Monsanto had the patent, its act to extract higher price by exercising its power is exploitation. Spurning the offer of mediation too is another example of high handedness.

Source: ICFAI Research Center

These arguments are only partially accurate. The WTO may have assumed the role of a conflict resolution that was earlier the domain of bilateral negotiations but international trade is very much a government-to-government domain.

1.4.3 Globalization and the Environment

Another significant concern against globalization is that it comes at the expense of the environment. Environmentalists often complain that firms relocate their operations mainly to escape the tough rules of pollution in their home country, an argument titled as "lowest common denominator" or "the race to the bottom". This argument is too partially true. Though some firms focus on lowering costs regardless of their environmental responsibilities, others adhere strictly to the codes of environmental protection. For instance, Dow Chemical, have been credited with environmental cleanup in Eastern Europe and former East Germany. Further, the truth is that for most of the organizations, environmental standards are just one the many criteria used in determining their location and investment decision.

Example

In early 2018, Unilever found itself in immense pressure over its use of plastics. It was also named as the most responsible firm for plastic pollution in India, Philippines and Indonesia. Unilever took three strategic targets to address the issues. First, it resolved to ensure that all of its agricultural materials come from sustainable sources by 2020. Secondly, it will eliminate single use plastic packaging material to the extent possible by 2025. Lastly, it will become carbon positive by 2030.

Unilever using plastic materials for packaging is polluting the environment. The resolve undertaken by the company signifies its commitment towards environment.

Source: ICFAI Research Center

Striking a Social Balance with Globalization

Globalization is thus a complex phenomenon whose repercussions are often not clear. Globalization has its set of advantages and challenges for firms at the regional, national, individual, and organizational level. For instance, it is felt that trade benefits all participants and globalization is correlated with higher economic growth, this however, may not console an employee who loses his/her job as a result of foreign competition. Globalization is not the only factor that influences wage levels and job loss, research indicates that technology puts downward pressure on the wages of unskilled labor. The globalization challenge is to maintain a balance between public interest to those suffering its consequences in the short range.

Globalization is linked with other potential negative repercussions. Global capital flow makes less regulated emerging economies such as Argentina, Thailand, and Mexico vulnerable to volatilities of foreign exchange markets or international capital.

Globalization also exposes national economies to the global economy uncertainties; ironically the open economies are vulnerable to a global slowdown. However, the global economies also have the most even income distribution. Therefore, the benefits and hardships are shared by all segments of the society.

A balanced view of globalization acknowledging both its bright and dark sides are called for, in order to derive constructive solutions to the debate of foreign trade and investment. If the globalization infrastructure is developed in a better way, globalization can offer advantages to participating economies, rich or poor. Globalization infrastructure concerns market efficiency and institutional frameworks that support fair transactions of product or services and streamline flows of capital labor, commodities, knowledge, and information. The WTO, World Bank, and the International Monetary Fund (IMF) play a major role in facilitating the globalization infrastructure.

Finally, a balanced view of globalization needs recognition that it is just one of the factors that affect the well-being of a population.

Example

After seven years of negotiations to create the world’s largest free trade region, India in November 2019 closed the door for the time being on the Regional Comprehensive Economic Partnership (RCEP). India runs a large trade deficit with RCEP countries and was looking for specific protection for its industry and farmers from a surge in imports, especially from China. India opted out of RCEP stating that joining the deal in its current form would have adversely affected its national interest.

This is one example of a balanced approach to globalization. The globalization challenge is to maintain a balance between public interest to those suffering its consequences in the short range. Being a member of RCEP would allow other members unrestricted access to Indian market adversely affecting the farm and small industrial sector.

Source: ICFAI Research Center

Activity 1.1

The US auto industry opened its market for foreign players to enter the market. The market saw emergence of Japanese and German car makers. The innovative designs of Japanese and German automakers encouraged consumers to buy their cars. This resulted in the US auto industry incurring losses. Moreover, many Americans had lost their jobs since the auto industry was not selling cars and hence the production had to be cut down. Identify the reasons due to which the US auto industry incurred losses and resulted in loss of American jobs.

Answer:

1.5 Globalization and International Business

1.5.1 International Business

International business refers to "business activities that involve the transfer of resources, goods, services, knowledge, skills, or information across national boundaries." The resources making up the flow include raw materials, people, and capital. Goods may be semi-finished or finished products or assemblies. Services include banking, legal, accounting, insurance, management consulting, education, trade service, tourism, healthcare, etc. knowledge and skills include organizational and managerial skills, technology and innovation, intellectual property rights such as brand names, trademarks, and copyrights. Information flows include information networks and databases. The parties involved may include individuals, company clusters, international institutions, and government bodies. Of these, the dominant players are the companies. They are the prime economic agent which facilitate and gain or suffer from globalization. Their activities which cross national boundaries are called as international transactions. Their international transactions are evident largely in international trade and international investment. International trade takes place "when a company exports goods or services to buyers (importers) in another country." International investment occurs "when the company invests resources in business activities outside its home country."

1.5.2 International versus Domestic Business

International business is the outgrowth of domestic business. In fact, most of the major organizations active in the international arena had started their operations in the domestic market. Leading Japanese automakers such as Mitsubishi, Toyota, and Honda started their operations in the domestic market before they began to export to other countries. As their operations grew in magnitude they decided to set up their facilities in other countries mostly in the US. "Companies or individuals that actively invest and operate in another country without a home base are called international entrepreneurs." They may set up new international ventures abroad and operate them using their experience, expertise, flexibility, and networks. For instance, many investors in Hong Kong do not have any home base in Hong Kong but are active in mainland China where they have their trade and investment activities.

Though international business is often considered as an extension of domestic business, it significantly differs from the latter due to differences in operational nature and environmental dynamics. Environmentally, the diversity existing between countries regarding their interest rates, currency, inflation, cultures, customs, accounting practices, business practices, political stability, laws, and government regulations are among the many reasons for the complexity of international business. Hence international business is perceived to be riskier than domestic business. For instance, variations in currency, interest rates, taxation, and inflation among different nations have an impact on the profitability of an international firm. For a firm that borrows and invests in a foreign country, higher tax rates, interest rates, and inflation rates mean high operation costs and low profitability. On the other hand, for a firm that deposits money in a foreign bank, high rates of interest mean a high return. The clash in cultures is not rare in international business. For instance, when a general manager of US-based Tropical Food Ltd. visited Madagascar to seek opportunities to import spices to the US, he had a culture shock while understanding the workings of the society.

Example

IKEA of Sweden opened its first store in India in August 2018 at Hyderabad. The 400,000 sft outlet of Ikea is a Rs. 1000 crore bet by the company for its India operations. The store was opened after 12 years of study conducted by the company. Ikea also partnered with local start up Urban Clap and hired 150 staff to offer paid delivery and assembly options for its products.

Ikea was concerned that the absence of a strong do-it-yourself culture in India could impede acceptance of Ikea's traditional model of self-assembling furniture. Hence in order to address this they tied up with Urban Clap to offer this service in addition to recruiting additional staff for this purpose.

Source: ICFAI Research Center

International firms also have to face different industrial environments compared to domestic firms. For instance, Coca-Cola receives money in different currencies and has to convert and protect its values; it has to decide upon effective tax strategies in environments with different accounting methods; select the most appropriate human resources for each market, etc. These issues are indicative of other international companies as well as their employees, consumers, regulators, and competitors. Conditions related to market demand and supply in a foreign country differ inevitably from those of the home country. These differences and complexities create more opportunities with risks and uncertainties for international firms than domestic firms. However if a firm is concerned about diversification of the product portfolio or financial portfolio, presence abroad may help mitigate risks for firms or investors. Risk refers to "unpredictability of operational and financial outcomes." Uncertainty refers to "the unpredictability of environmental or organizational conditions that affect firm performance." Uncertainty about organizational or environmental conditions increases the unpredictability of corporate performance and hence increases risk.

Operationally, international business is more difficult and costly to manage than economic activities in a single country. If an international firm does not succeed in leading a complex business effectively, benefits may not be realized. Local employees and expatriates may face difficulties in getting along with each other due to cultural and language differences. The cultural diversity encountered while carrying out operations in different countries may create problems of coordination, communication, and motivation. The managerial philosophies and organizational principles often differ among nations thus increasing the complexity of operation and management of international business.

1.6 International Expansion

In general, the motivations for carrying out international business include market motives, economic motives, and strategic motives. The motives vary from one business activity to another, producing several motivations for the international firm with a wide scope of activities in different parts of the world.

1.6.1 Market Motives

Market motives can be offensive or defensive. An offensive motive seizes market opportunities in foreign countries through investment or trade. For example, Mary Kall, Amway, and Avon entered China in search of opportunities in direct marketing business of China. Besides being the fastest growing economies with the largest population in the world, China's strong culture of personal connections and pervasiveness of closely knit families and friends helped the country become the biggest direct selling market.

Example

British fashion clothing brand Superdry is set to nearly double store count in India over the next three years, adding over 30 stores in the market that it entered in 2012, through a franchise partnership with Reliance Brands Ltd, part of Reliance Industries.

Contd….

As of July 2019, Superdry that sells T-shirts, lowers, jackets and accessories for men and women has 35 stores in the country. Superdy's motive can be considered as an example of an offensive motive that involves seizing market opportunities in foreign countries through investment or trade.

Source: ICFAI Research Center

A defensive motive protects and holds the market power or competitive position of a firm from threats such as domestic rivalry or changes in government policies. Dell made investments in Europe, Africa, Asia, and Latin America due to the strong competition in the US.

Example

HBR online in its article dated 29th June 2021 has published an article on five international business examples. The article mentions the most successful mobile manufacturing company Apple. The company opened its first international location in Tokyo, Japan after saturating the American market. The company has adopted a strategy of market expansion to overcome competition and attract creative audiences around the globe through its technology. This is an example for defensive market motive adopted by Apple in its international expansion.

Source: ICFAI Research Center

1.6.2 Economic Motives

Firms go for international expansion to increase their return through lower costs and higher returns. International trade or investment enables companies to benefit from differences in costs of capital, natural resources, and labors as well as differences in the regulatory treatments such as taxation between international and domestic countries. Many companies have expanded into Asia in search of cheap labor or resources. For instance, Fossil, a wrist watch manufacturer choose to locate its headquarters in east Asia rather than its home country, the US.

Example

In an interview on 6th September 2019 to CNBC-TV18's Rituparna Bhuyan, Tara Joseph, president of the Hong Kong unit of American Chamber of Commerce, said that US brands want to see India as a manufacturing hub after the government relaxed foreign direct investment (FDI) policy in single brand retail and contract manufacturing. Around 20 top American high-end apparel companies that own brands like Tommy Hilfiger, Arrow, Ralph Lauren and Calvin Klein want to set their manufacturing units in India.

Indian labour is skilled and available at relatively cheaper cost. With Government doing a policy rejig the International firms want to capitalise on it for economic motives.

Source: ICFAI Research Center

1.6.3 Strategic Motives

Firms participate in international business for strategic reasons. They may aim to capitalize on their distinctive capabilities or resources already developed at home. By deploying these capabilities or resources in foreign markets or by increasing their production through international trade, firms may be able to increase their cash flows. Firms may also go international to have a first mover advantage before any competitor takes that position. This results in strategic benefits for the company such as technological leadership, competitive position, brand image, and customer loyalty. Firms may also benefit from vertical integration involving different countries. For instance, a firm in the oil exploration and drilling business may integrate downstream by building or acquiring an oil refinery in a foreign country that has a market for refined products.

Example

Livemint dated 16th August 2021 has reported that the Middle Eastern energy firm is discussing the purchase of a roughly 20% stake in the Reliance unit for about $20 billion to $25 billion in Aramco’s shares. This would help Reliance lock in a steady supply of crude oil for its giant refineries and make the Indian company a shareholder in Aramco and would give Reliance a stake of around 1% in the world’s biggest energy company. RIL top officials have stated that this is a strategic move by the company in its international expansion. This is a vertical integration involving different countries adopted by RIL for its benefit.

Source: ICFAI Research Center

Another strategic motive is to follow the major customers of a company abroad. For instance, Bridgestone, the Japanese tire maker landed up in the US market when its customers Japanese car makers exported their cars with Bridgestone tires mounted on them. Because product adaptation and responsiveness are becoming critical for business success, proximity to foreign customers is an important driver of foreign investment.

Example

In August 2019 global oil major BP entered into an agreement with Indian conglomerate Reliance Industries by forging a fuel retailing joint venture to capitalize on rising demand in Asia’s third-biggest economy. The new venture will take over Reliance’s 1,400-plus retail fuel stations and its aviation fuel business spread across 30 Indian airports. The plan is to expand its retail fuel network to up to 5,500 sites over five years. BP, which operates gas stations and convenience stores across 18 countries with more than 18,700 sites, had previously obtained permission from the federal oil ministry to enter India’s fuel marketing and aviation business on its own. BP is strategically entering the Indian market to get the benefits of large retail market.

Source: ICFAI Research Center

Check Your Progress - 1

1. ___concerns market efficiency and institutional frameworks that support fair transactions of product or services and streamline flows of capital labor, commodities, knowledge, and information.
   a. Globalization infrastructure
   b. Globalization network
   c. International business
   d. Domestic business
2. ___refers to business activities that involve the transfer of resources, goods, services, knowledge, skills, or information across national boundaries.
   a. International trade
   b. Globalization
   c. Domestic business
   d. International business
3. ___takes place when a company exports goods or services to buyers (importers) in another country.
   a. Globalization
   b. International trade
   c. International expansion
   d. Global business
4. ___occurs when the company invests resources in business activities outside its home country.
   a. International business
   b. International investment
   c. International trade
   d. International expansion
5. Companies or individuals that actively invest and operate in another country without a home base are called_____.
   a. Domestic entrepreneur
   b. Domestic intrapreneur
   c. International entrepreneur
   d. International intrapreneur
6. ___refers to unpredictability of operational and financial outcomes.
   a. Threat
   b. Risk
   c. Uncertainty
   d. Certainty

7. ___refers to the unpredictability of environmental or organizational conditions that affect firm performance.
   a. Uncertainty
   b. Risk
   c. Threat
   d. Risk and Uncertainty
8. In general, the motivations for carrying out international business include market motives, economic motives, and____.
   a. Tactical motives
   b. Operational motives
   c. Strategic motives
   d. None of the above
9. By participating in international business, firms gain_benefits such as technological leadership, competitive position, brand image, and customer loyalty.
   a. Strategic
   b. Operational
   c. Economic
   d. None of the above
10. Market motives can be offensive or ________
    a. Strategic
    b. Aggressive
    c. Regressive
    d. Defensive

1.7 Summary

- For consumers, globalization may mean more choices, reduced prices, and an indistinct national identity for products and services. Globalization has its winners and losers, and it allegedly comes at the cost of poorer nations.
- A common complaint against globalization is that it deprives nations of their sovereignty. The globalization challenge is to maintain a balance between public interest to those suffering its consequences in the short range.
- International business refers to business activities that involve the transfer of resources, goods, services, knowledge, skills, or information across national boundaries.
- In general, the motivations for carrying out international business include market motives, economic motives, and strategic motives.

1.8 Glossary

International business: International business refers to business activities that involve the transfer of resources, goods, services, knowledge, skills, or information across national boundaries.

International entrepreneurs: Companies or individuals that actively invest and operate in another country without a home base are called international entrepreneurs.

International investment: International investment occurs when the company invests resources in business activities outside its home country.

International trade: International trade takes place when a company exports goods or services to buyers (importers) in another country.

Risk: Risk refers to unpredictability of operational and financial outcomes.

Uncertainty: Uncertainty refers to the unpredictability of environmental or organizational conditions that affect firm performance.

1.9 Self-Assessment Test

1. Discuss the concept of globalization.
2. Describe the benefits and threats of globalization.
3. Define international business. Explain the differences between domestic and international business.
4. In general, the motivations for carrying out international business include market motives, economic motives, and strategic motives. Explain these motives in detail.

1.10 Suggested Readings/Reference Material

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1.11 Answers to Check Your Progress Questions

1. (a) Globalization infrastructure

Globalization infrastructure concerns market efficiency and institutional frameworks that support fair transactions of product or services and streamline flows of capital labor, commodities, knowledge, and information.

2. (d) International business

International business refers to business activities that involve the transfer of resources, goods, services, knowledge, skills, or information across national boundaries.

3. (b) International trade

International trade takes place when a company exports goods or services to buyers (importers) in another country.

4. (b) International investment

International investment occurs when the company invests resources in business activities outside its home country.

5. (c) International entrepreneurs

Companies or individuals that actively invest and operate in another country without a home base are called international entrepreneurs.

6. (b) **Risk**

Risk refers to unpredictability of operational and financial outcomes.

7. (a) **Uncertainty**

Uncertainty refers to the unpredictability of environmental or organizational conditions that affect firm performance.

8. (c) **Strategic motives**

In general, the motivations for carrying out international business include market motives, economic motives, and strategic motives.

9. (a) **Strategic**

By participating in **i**nternational business, firms gain strategic benefits such as technological leadership, competitive position, loyalty.

10. (d) **Defensive**

Market motives can be offensive or defensive.

Unit 2

International Trade Theories and Application

Structure

"You cannot have free global trade with highly restrictive, regulated domestic markets".

- Alan Greenspan; American Economist

2.1 Introduction

The previous unit discussed the concept of globalization and its importance. The unit then discussed the benefits and threats of globalization. It then explained the link between globalization and international business. It finally discussed the motives for carrying out international business.

There are two schools of thought on international trade. One school favors free trade while the other advocates protectionism. Advocates of protectionism argue that it is necessary to protect the home industry from foreign competition. Under protection, it would be easy to establish an industry in a country. If the industry is at an infant stage, it needs to be protected from well-established competitors who are already producing on a large scale. But, according to free trade advocates, free trade allows the growth of exports in a country.

This unit will discuss the major theories of international trade. It finally discusses different types of trade barriers.

2.2 Objectives

By the end of this unit, you should be able to:

- Discuss the major theories of international trade.
- Explain the tariff barriers and non-tariff barriers.

2.3 International Trade Theories

International trade is "the exchange of goods and services across borders." Why do nations trade? International trade theories attempt to answer this question and predict the direction, composition, and volume of goods traded across borders.

2.3.1 The Mercantilist Doctrine

Mercantilism emerged in the mid-sixteenth century in England as the first theory of international trade. The doctrine set immense faith in government's ability to improve the residents" well-being using a system of centralized controls. Under mercantilism, the government set two goals in foreign economic policy. The primary goal focused on acquiring gold to increase the nation's wealth. Mercantalists identified the national wealth with the size of the reserves of precious metals in the nation. The second policy goal was to extract trade gains from foreigners through controls and regulations in order to achieve a surplus in balance of trade by minimizing imports (e.g., tariffs and quotas) and maximizing exports (e.g., subsidies).

Example

Nikkei Asia dated 28th July 2021 has reported that due to the deepening foreign exchange crisis, Sri Lankan Government has imposed an indefinite import ban to save hard currency. The government has banned imports ranging from motor vehicles and air conditioners to beer, clothing items, cosmetics and even spices such as turmeric. The country's foreign reserves stood at $4 billion at the end of June. Assume that the policy goal of the government was to achieve a surplus in the balance of trade by minimizing imports through controls and regulations and maximize exports. This is mercantilist type of doctrine as per the international trade theories adopted by the Sri Lankan Government.

Source: ICFAI Research Center

However, in modern economy, gold reserves are simply prospective claims against goods on foreigners. Moreover, as demonstrated by David Hume in 1752, influx of gold would boost the price of exports and increase the domestic price level. Therefore, the country with which the gold is held would lose competitive edge in price which enabled it to acquire gold earlier by exporting more than it had imported. In contrast, the gold lost in the foreign nation would reduce prices and reinforce its exports. Gold reserves signify a minor portion of the foreign exchange reserves. These reserves are often used by the government to intervene in foreign exchange markets in order to influence foreign exchange rates.

Mercantilism overlooks other sources of wealth accumulation of a country such as workforce skills, quantity of its capital, and the strength of other production inputs such as natural resources and land.

2.3.2 Absolute Advantage Theory

The doctrine of laissez-faire to international trade was introduced by Adam Smith in his 1776 landmark treatise, *An Inquiry into the Nature and Causes of Wealth*

of Nations. The literal meaning of laissez-faire means „freedom of enterprise and freedom of commerce‟ or “let make freely”. The keystone of the 19th century liberalism was elimination of the ubiquitous regulation. According to Smith, all nations would benefit from free and unregulated trade that would allow individual countries to specialize in goods that they could best produce due to their natural and acquired advantages. Smith’s trade theory came to be known as the theory of absolute advantage. The theory states that imports in a nation should consist of goods made more efficiently abroad while exports should include goods that are made efficiently at home. For instance, Caribbean countries should export bananas since they have absolute advantage at home and import apples from Washington which has absolute advantage in the US.
According to the absolute advantage theory, the market reaches an efficient end by itself. The intervention of government in the nation’s economic life and trade relations among nations is counterproductive. Free trade would benefit a nation as imports would cost less than domestic products it would otherwise produce. In absolute advantage theory, both the countries would gain from global allocation of national resources unlike the mercantilist doctrine where the nation could gain from trade only when the trading partner lost.

Assume that a world of two countries and two products has perfect competition and have no costs related to transportation. Suppose that in the US and China (a) one unit of input (combination of capital, labor, and land) can produce the quantities of soybeans and clothes listed in the Table I below, (b) each nation has two units of input which can be used to produce either soybean or cloth, and (c) each nation uses one unit of input to produce each product. In case, neither of the nation’s export or import, the quantities shown in the table below will be available for local consumption. The total output of both nations is 4 tons of soybeans and 6 bolts of cloth.

Table I

Commodity	US	China	Total
Tons of soybeans	3	1	4
Bolts of cloth	2	4	6

In the US 3 tons of soybeans or 2 bolts of cloth can be produced with one unit of input. Hence 3 tons of soybeans have the same price as 2 bolts of cloth. However, since China can produce 1 ton of soybean with one unit of input that can produce 4 bolts of cloth, I ton of soybean should cost as much as 4 bolts of cloth. The US has an absolute advantage is soybean production (3 to 1). China has absolute advantage in cloth making (4 to 2).

2.3.3 Comparative Advantage Theory

The absolute advantage theory could not explain some situations where, for instance, one country has an edge over another in producing all goods efficiently.

In this situation would it pay for both the countries? This question was answered by a 19th century English economist, David Ricardo in his 1817 book *On the Principles of Political Economy and Taxation*. According to him, both the countries would benefit from trade even if one was more efficient in production of all goods. Thus, this is “the comparative advantage of a nation in producing a good relative to other nation that determined international trade flows.”

To understand the concept of comparative advantage can be understood by modifying the earlier example. For instance, China has an absolute advantage in producing both soybeans and cloth (Refer to Table II). Compared to China, the US is less efficient in soybean production than in cloth manufacturing. Therefore, US has relative advantage or comparative advantage in producing soybeans, according to Ricardo.

Table II

Commodity	US	China	Total
Tons of soybeans	4	5	9
Bolts of cloth	2	5	7

If each country specializes in what it does best, its output will be as listed in Table III.

Table III

Commodity	US	China	Total
Tons of soybeans	8	0	8
Bolts of cloth	0	10	10

In this case, the terms of trade will be somewhere between 1 ton of soybeans for 1 bolt of cloth that Chinese soybean growers should pay in China and the ½ bolt of cloth that US cloth makers should pay for 1 ton of American soybeans. If we assume that the traders agree on an exchange rate of ¾ bolt of cloth for 1 ton of soybeans. Both the nations will gain from this specialization and exchange as shown in Table IV below.

Table IV

Commodity	US	China	Total
Tons of soybeans	4	4	8
Bolts of cloth	3	7	10

This trade left China with 2 surplus bolts of cloth and 1 ton of soybeans less than it has previously. The US has the same quantity of soybeans with 1 more bolt of cloth.

The concept of opportunity cost can be introduced in the theory of comparative advantage. If the opportunity cost of producing a good is lower in the home country than in the other country, the country has a comparative advantage in producing a good.

It is also vital to understand the sources of comparative advantage. The immediate source of trade is the price difference of the same commodity between different countries; hence the difference in opportunity costs. The difference in price is determined by the interaction of supply and demand. Therefore, the price differential is derived from differences in demand conditions, supply conditions, or both. On the demand side, differences in demand patterns are caused by differences in tastes and incomes, and thus differences in prices. When two countries share similar consumer tastes and income levels, income is unlikely to be a major source of differences in demand. Similarly, differences in tastes may not result in significant demand differences and thus for trade between countries belonging to the same socio-cultural matrix. On the supply side, differences in supply patterns are a result of differences in the patterns of production costs.

Hence, in today's world economy, comparative advantage should be explained by reference to comparative production cost differences, which further depends on the production process of the commodity and on the prices of production factors such as land, capital, labor, and natural resources. In turn, the factor prices are related to the factors available in the national economy. The inputs to the production process are referred to as production factors by economists. The conditions (availability and cost) of production factors are referred to as the country's factor endowment. In today's global economy, quality levels of production factors become more crucial for improving the exports of a country or attract foreign investment. Thus factor endowment should also include quality level of production factors in today's international business environment. However, in the 19^{th} century, because inter-country differences in technology were minor, international variations in comparative advantage were attributed to different national endowment in terms of cost and availability. This forms the theoretical root for Heckscher-Ohlin theorem.

Example

In FY19, exports of agricultural and processed food products from India totalled US$ 38.49 billion. During the period, the top five exported commodities were marine products (US$ 6.80 billion), basmati rice (US$ 4.71 billion), buffalo meat (US$ 3.59 billion), spices (US$ 3.31 billion) and non-basmati rice (US$ 3.00 billion). Indian agricultural/horticultural and processed foods are exported to more than 100 countries/regions; chief among them are the Middle East, Southeast Asia, SAARC countries, the EU and the US. The factors of production required for the stated commodities are relatively abundant in India hence the export.

Source: ICFAI Research Center

Activity 2.1
In England, a gallon of wine and a yard of cloth costs (labor cost) 120 and 100 hours of work respectively while in Portugal, the cost of wine and cloth amounts to 80 and 90 hours of work respectively. As the labor costs in wine production as well as production of cloth is less in Portugal, identify the benefit Portugal has over England in the context of international trade. Also discuss the concept in brief. **Answer:**

2.3.4 Heckscher-Ohlin Theorem

The Heckscher-Ohlin theorem was propounded by Swedish economists, Eli Heckscher and Bertil Ohlin. The theorem explains the link between comparative advantage of nations and national factor endowments. The theorem states that "a country has a comparative advantage in commodities whose production is intensive in its relatively abundant factor, and will hence export those commodities." Meanwhile, a country would import commodities whose production is intensive in the country's relatively scarce factor of production. Therefore the differences in comparative advantage can be attributed to the differences in the structure of the economy. A country is considered to be more relatively efficient in activities suiting its economic structure.

Example

Business Standard dated 18th July 2021 has reported that India's services exports are expected to grow 10 percent in 2021-22 due to healthy growth of sectors such as consulting, audio-visual, freight transport, telecommunications, according to SEPC (Services Export Promotion Council). According to a report of the Ministry of Electronics and IT, Indian technology exports are set to reach $150 billion. The production is intensive in India's relatively abundant factor, which is knowledge and low-priced workers and is hence, exporting of electronic goods as it has a comparative advantage over other nations. This is Heckscher-Ohlin Theory that suggest the intensive production and export of the electronic goods by India.

Source: ICFAI Research Center

There are several assumptions underlying the Heckscher-Ohlin theorem. First, it assumes that countries differ in availability of different factors of production. Second, while each commodity has its own specific production function, the production function is assumed to be identical anywhere in the world. Production function shows "the amount of output that can be produced by using a given quantity of capital and labor." In other words, the theorem assumes that the same amount of input will produce the same amount of output in any country. Third, the theorem holds that the technology is constant in all trading countries and that same technology is used in all countries. Finally, it assumes that the conditions of demand for factors of production are same in all countries. With identical demand conditions, differences in the relative supply of production factors will lead to differences in the relative price of that factor between the two countries.

The Heckscher-Ohlin theorem also implies international equalization of prices of factors of production under free trade – the so-called Heckscher-Ohlin law of factor price equalization. It argues that "the exchange of goods between agricultural and industrial countries would result in an increase in the previously relatively low levels of land rents and a drop of the high level of industrial wages in the agricultural country. However, in the industrial country, the opposite change in factor prices occurs – an increase in industrial wages and a decrease in land rents." In addition to similar factors of production across different countries, the theorem assumes other conditions under which free commodity trade equalizes factor prices:

(1) free competition in every market; (2) absence of costs of transportation; and (3) after the beginning of free trade, all commodities continue to be produced in both countries.

The implications of the Heckscher-Ohlin theorem are described below:

1. Trade in addiction to trade gains should be highest among countries with highest economic structure differences.
2. Trade should enable countries to specialize more in the production and export of goods that are distinct from imports.
3. Trade policy rather than taking the form of trade simulation should take the form of trade restrictions.
4. Countries should be exporting goods making use of their relatively abundant factors.
5. Free trade should equalize factor prices not between countries with markedly different factor endowments but between countries with fairly similar relative factor endowments.
6. Factor prices should be almost equal between countries with liberal mutual trade.
7. The differences in factor endowments stimulate international investment and international investment should be negatively correlated to international trade.

2.3.5 The Leontief Paradox

The central notion of the Heckscher-Ohlin theorem is that a country exports goods making use of the abundant factor in the country and imports goods making use of the scarce factor in the country. This proposition was tested in 1953 in the US by Wassily Leontief, the winner of 1973 Nobel Prize in Economics. Using the trade figures of 1947 and input-output tables covering 200 industries, he found that US imports were capital-intensive and exports were labor-intensive. Because these results contradicted the Heckscher-Ohlin theorem predictions, it has come to known as the Leontief Paradox. The study by Leontief motivated further empirical research. The empirical evidence collected since then shows several paradoxical results and contains serious challenges to the general applicability of factor endowment explanations in other countries such as Japan, Canada, India, and Germany.

Example

ET dated 1st November 2021 has reported that India's capital goods exports have been increasing steadily and in October 2021, the engineering goods exports crossed $ 9 billion. The country's Capital goods, engineering goods and machinery exports have been showing robust growth while it continues to import cheaper labor-intensive goods from China in spite of possessing excess manpower.

Leontief Paradox theory contradicts Heckscher-Ohlin Theorem based on statistics. Developed countries normally export capital-intensive and import labor-intensive goods as they have a comparative advantage on these goods and developing and underdeveloped countries import capital goods and export labor-intensive products. In the case of India being a developing country, the trade results contradicted the Heckscher-Ohlin theorem predictions and hence, it is the Leontief paradox.

Source: ICFAI Research Center

The Leontief paradox stimulated a search for explanations:

- **Demand bias for capital-intensive goods:** The US demand for capital-intensive goods is extremely strong that it could reverse the US comparative cost advantage in such goods.
- **Existence of trade barriers:** The labor-intensive imports were reduced by trade barriers that were imposed to protect and save jobs in America.
- **Importance of natural resources:** Leontief took into consideration only labor and capital inputs leaving out natural resource inputs. As natural resources and capital are often used together in production, a country importing capital-intensive goods may actually be importing natural resource-intensive goods. For instance, the US imports crude oil, which is capital-intensive.

- **Prevalence of factor-intensity reversals:** A factor-intensity reversal occurs when the relative prices of capital and labor change over time, which results in changing the relative mix of capital and labor in commodity production process from being labor-intensive to capital-intensive (or vice versa).

2.3.6 Human Skills and Technology-based Views

Several scholars have challenged the conventional trade theory which assumed that there was equivalence in technology and human skills among different nations. The technology-based and human skills view is regarded as a refinement of the conventional trade theory. To explain the sources of comparative advantage, the theory has added two new production factors such as human skills and technology gaps.

The human skills theorists explain the source of comparative advantage in terms of comparative abundance of high-level human skills and professional skills. According to Donald B Keesing, these include (1) scientists and engineers; (2) draftsmen and technicians; (3) skilled manual workers; (4) managers; and (5) other professionals.

Technology theorists argue that certain some countries have special advantage as new product innovators. According to them, there was an imitation lag that prevents other countries from instantly duplicating the new products of the innovating country. These conditions had led to technology gaps in those products that afford an export monopoly for the innovating country during the period of imitation lag. Similarly, when a firm finds out a different and an advanced production technique, it will enjoy cost advantage and lead the world market for some time.

2.3.7 The Product Life-Cycle Model

The product life-cycle model was proposed by Raymond Vernon in the mid-1960s. The imitation-gap approach was further developed by Vernon where he suggests that changes take place in the input requirements of a new product as soon as it becomes established in a market and becomes standardized in production. As there is a development in the product cycle, the cost advantage changes accordingly and a comparative advantage in innovative capacity could be offset by a cost disadvantage. Vernon developed a four-stage model to explain the behavior of US exports of manufactures, assuming that the export effects of product innovation are undermined by lower costs and technological diffusion abroad. This life-cycle model includes four stages. They are:

1. The US has an export monopoly in a new product;
2. Beginning of foreign production of this product;
3. The foreign production of the new product becomes competitive in export markets;
4. The US becomes an importer of this product which is no longer a new product.

According to Vernon, the US producers may be first to exploit market opportunities for a new product that is technology-intensive. The producers will be first to produce this new product in the US regardless of the cost of production inputs in other countries due to their close proximity to suppliers and customers. In this first stage, the US producers have a monopoly in export markets and focus on building up sales with no concern for foreign competition. In the second stage, the producers of other industrialized countries begin manufacturing the product whose production and design is now standardized. As a consequence of this the overall growth rates of exports in the US decline. In the third stage, foreign producers displace US exports in other export markets. Finally, foreign producers succeed in achieving sufficient competitive strength arising from lower labor costs and economies of scale to export to the US market.

Vernon's theory also states that the product life-cycle model of international trade associates itself with life-cycle stage of the product itself. As the product moves through its life-cycle, the international trade life cycle also changes. The theory explains changes in trade and production in new product lines.

Example

As of 2019 more than 95% of the Apple's iPhones are assembled in Taiwan. The two companies which assembles it are Foxconn and Pegatron both based at Taiwan. Technically, Foxconn is the company's trade name; the firm's official name is Hon Hai Precision Industry Co. Ltd. Foxconn is Apple's longest running partner in building these devices. It currently assembles the majority of Apple's iPhones in its Shenzen, China, location, although Foxconn maintains factories in countries across the world, including Thailand, Malaysia, the Czech Republic, South Korea, Singapore, and the Philippines. Pegatron is a relatively recent addition to the iPhone assembly process. As such the input requirements of iPhone products are established in the market and became standardized. It is estimated that it built about 30% of the iPhone6 orders in its Chinese plants. Even if one buys an iPhone in the US one will get the device assembled by one of these companies. The devices come with an inscription as 'designed in California'. Thus, in Apple's case the headquarters in US is dedicated to develop design and prototypes and the actual manufacturing and assembling is outsourced to derive cost advantage.

Source: ICFAI Research Center

2.3.8 Linder's Income-Preference Similarity Theory

The Hecksher-Ohlin theorem states that the trade incentive is greatest among nations which have radically different factor endowments. This means that trade chiefly takes between developed manufacturing countries and developing countries that produce labor-intensive goods and primary products such as natural resource commodities like oil and petroleum.

Staffan B Linder, a Swedish economist divided international trade into two different categories such as primary products and manufactures. Linder states that the factor endowment differences explain trade in natural resource-intensive products but not in manufactures. According to him, the range of manufactured exports of a country can be determined by internal demand. International trade in manufactures takes place primarily among developed nations as nations export only those goods that are manufactured at home and will manufacture at home only those goods for which there is a strong domestic demand.

Linder also asserts that the more similar preferences in demand for manufactured goods in two countries, more intensive will be the potential trade in manufactures between them. If two countries have same or similar demand structures, then the investors and consumers will have same demand for goods with similar degrees of sophistication and quality, a phenomenon known as preference similarity. The similarity results in boosting trade between two industrialized countries. Linder argues that the determinants of the demand structure can be explained by average per capita income. Countries that have high per capita income demand for high-quality "luxury" consumer goods and sophisticated capital goods while countries with low per capita income demand for low quality "necessity" consumer goods. Consequently, a rich country that has a comparative advantage while producing high-quality advanced manufactures will discover their big export markets in other affluent countries where there is a demand for such products. Similarly, manufactured exports of poor countries will find their best markets in other poor countries having similar demand structures. Linder also acknowledges that the effect of per capita income levels on trade in manufactures may be distorted or constrained by cultural and political differences, entrepreneurial ignorance, transportation costs, and legislative obstructions such as tariffs.

Example

According to Export Promotion Bureau (EPB) data, Bangladesh's exports to India stood at $1.25 billion in 2018-19, up by 42.91%, which was $873.27 million in the previous fiscal. Of the total amount, apparel sector earned $499.09 million in 2018-19 fiscal, which is 79.09% higher compared to $278.67 million in the previous year while knitwear products accounted for $369.43 million and woven items $129.66 million. Balance was accounted for by various other products like jute and leather goods etc. Bangladesh offers apparel goods at reasonable prices, while global retailers are opening more outlets in India, who buy products from here. Besides, transportation cost from Bangladesh was low, which encouraged importers to buy goods for both local brands as well as foreign brands. India being culturally similar have similar consumption patterns.

Contd….

Intra-regional trade accounts for a high proportion of the world trade due to similarities in demand structures and income levels, in addition to efficiencies arising from reduced transaction costs and uncertainty. Bangladesh and India have similarity in consumption patterns in addition to lower transportation cost hence the rise in exports.

Source: ICFAI Research Center

2.3.9 The New Trade Theory

The new trade theory was expounded by Dixit and Norman, Lancaster, Krugman, Helpman, and Ethier. According to these theorists, countries not only specialize and trade solely to take advantage of their differences; they also trade due to the increasing returns, which make specialization beneficial per se. The new trade theory makes several contributions in understanding international trade.

First, the theorists of the new trade theory introduce the view of an industrial organization in the trade theory, and include real-life imperfect competition in international trade. They argue that increasing returns to specialization in many industries are a result of economies of scale. Economy of scale is "reduction of manufacturing cost per unit as a result of increased production quantity during a given time period."

Second, the theory suggests that inter-industry trade continues to be determined by Heckscher-Ohlin theory. In contrast, intra-industry trade is mainly driven by increasing returns that result from specialization within the industry. This suggests that comparative advantage from increasing returns that result from industry specialization and factor endowment differences can coexist since they vary in the application of inter-industry versus intra-industry trade.

Finally, the new trade theory comprehends the significance of externality in international trade and specialization. Externality takes place when action of one agent has a direct affect on the environment of another agent. In international trade, externalities include political relations between two countries; government policies; history of the importing and exporting country; consumption differences between different cultures, etc. The theorists of new trade theory contend that these externalities could be the alternatives to comparative advantage as factors that influence actual patterns of international trade.

The new trade theory has several implications. First, it helps in explaining the Leontief paradox by bringing in the concept of economies of scale. According to the theory, a firm engages in trade as they expect increasing returns from larger economies of scale. These economies may not essentially associate with factor endowment differences between exporting and importing countries. Scale economies were likely to lead countries to specialize and trade with a country which is similar in terms of consumption preferences and income levels.

Second, the new trade theory helps in explaining the intra-industry trade, which is a two-way trade that is carried out with goods belonging to the same industry. Trade is carried out with intend to realize economies of scale, and may not be correlated with factor endowment differences. Finally, this theory goes into explaining intra-firm trade, which takes place when import and export activities are carried out between the subsidiaries of the same multinational enterprise (MNE). MNEs consider intra-firm trade as a facilitator that globally integrates upstream and downstream activities.

Example

As of 2019 despite being a competitor to Apple in the mobile phones segment, Samsung uses its supplier status and supplies various components to Apple. With three different subsidiaries – Samsung Electro-Mechanics Co. Ltd., Samsung Electronics Co. Ltd., and Samsung SDI. Co. Ltd. – which are located in four different countries (South Korea, China, the U.S., and the Philippines), Samsung is one of Apple's major suppliers. It supplies multiple components, including flash memory, which is used for storing data content; the mobile DRAM, used for multi-tasking various applications in devices and the application processors which are responsible for controlling and keeping the whole device running. Samsung does this to reduce its own manufacturing cost through bulk production. Samsung is adopting the principles of new trade theory as it retains and continues with its supplier status with respect to Apple despite being a competitor to achieve higher economies of scale.

Source: ICFAI Research Center

2.3.10 Theory Assessment

No though single theory has the capability to explain the entire range of motives of international trade, they collectively offer invaluable insights into why international trade takes place. The differences in factor endowments are the most general explanation of the pattern of old trade. Despite its diminishing power in explaining today’s international trade, the comparative advantage theory still has the capability of explaining international trade in natural resource products. When the factor endowments are extended to include skilled labors and technologies, the Heckscher-Ohlin theorem can be applied to current import and export activities between developed and developing nations.

The product life cycle theories and the technological gap (e.g. technology-based views and human skills) emerge as powerful explanations of trade in new products, i.e. products made by skilled workforce using technologies. These technologies and skills can be used to improve the terms of trade of a country, which is a major concern of both developed and developing countries. The terms of trade is “the relative price of exports, that is, the unit price of exports divided by the unit price of imports.” The terms of trade will be improved if the country exports more goods associated with technologies and human skills. In this case, the foreign trade contribution to the economic growth of the nation will be stronger. Though the product life-cycle model is not as applicable today than at the time it was conceptualized, it still explains key patterns in the international trade evolution. The import and export structures of a nation change over time. Similarly, every new product has life stages in the global marketplace.

The theories which provide insights on the triggers of international trade on trade between regions with similar levels of income and consumption patterns and sophisticated manufacturing products is the Leontief Paradox and Linder's income-preference similarity theory. According to these theories, market demands are viewed as an important parameter for international trade. In reality, international trade today is driven not only by national differences in factor endowments but also by national differences in market demand. Intra-regional trade accounts for a high proportion of the world trade due to similarities in demand structures and income levels, in addition to efficiencies arising from reduced transaction costs and uncertainty. The limitation of these theories is that they could not enlighten how trade activities would take place between nations having similar levels of income with different consumption preferences. Due to this drawback, the increasing trade between developed countries and industrialized countries (e.g. Hong Kong, Singapore, South Korea, and Taiwan) or emerging markets (e.g. India, China, Brazil, Mexico, and Russia). The key driver of this trade phenomenon seems to be the elevated purchasing power and rising income levels.

Finally, the new trade theory helps in understanding the intra-industry and intra-firm trade. For explaining international trade, it links national factor endowments with firm behavior and firm incentives. This link was crucial since firms rather than countries conduct international trade and investment. The international trade efficiency can be maximized if economies-of-scale advantages firms and national factor endowment differences can be combined and simultaneously realized. The limitation of this theory is that it overlooks other incentives and focuses only increasing returns from economy of scale.

2.4 Types of Trade Barriers

Trade barriers are divided into two types – tariff barriers and quantitative restrictions (non-tariff barriers, quotas, and export controls). Tariff barriers are "official constraints on the importance of certain goods and services in the form of a total or a partial limitation or in the form of a special levy." Non-tariff barriers are "indirect measures that discriminate against foreign manufacturers in the domestic market or otherwise distort and constraint trade." While tariff barriers were reduced during the General Agreement on Tariffs & Trade (GATT) regime, some of the non-tariff barriers such as subsidies have been reduced. The trade barriers pose obstacles to international trade.

2.4.1 Tariff Barriers

Tariff trade barriers mainly include tariffs and antidumping laws.

Tariffs

A tariff is a "tax levied on goods by the country of importation." The most common device for import regulation is the tariff or import duty. When imposed on goods being brought into the country, it is referred to as an import duty. Import duty is levied to increase the effective cost of imported goods in order to increase the demand for domestically produced goods. Another type of tariff, less frequently imposed, is the export duty which is levied on goods being taken out of the country, to discourage the export of those goods. This may be done if the country is facing a shortage of that particular commodity or if the government wants to promote the export of that good in some other form, for example, a processed form rather than in raw material form. It may also be done to discourage exporting of natural resources. When imposed on goods passing through the country, the tariff is called transit duty.

Tariff can be imposed on three different bases – specific duty, ad valorem, and compound duty. A specific duty is a flat duty based on the number of units regardless of the value of the goods. For example, there may be a duty of Rs. 5,000 per computer imported into India. In this case, a person importing, say, 20 computers would have to pay a duty of (5,000 x 20 = Rs.1,00,000). Tariffs are considered to be transparent and *ad valorem* i.e. based on the product or service value. An ad valorem duty is expressed as a percentage of the value of the good. So a person importing a walkman worth Rs. 2,000 carrying an import duty of 10% would have to pay Rs. 200 towards duty charges. A compound duty is a combination of a specific and an ad valorem duty. For example, a book worth Rs. 500 carrying a specific duty of Rs. 25 and an ad valorem duty of 2% would in effect be carrying a compound duty of Rs. 35. Tariffs are considered to be one of the least restrictive type of trade barriers.

In the 19^{th} century, tariffs were widely used but were reduced over time. This trend was reversed by the Smooth-Hawley Act of 1930 which pushed tariffs to 60 percent level of the import value.

In the following decades, tariffs in the US and other nations substantially declined. However, tariffs on some products in the US for instance, sugar remained high.

Over the years, remarkable progress has been made toward tariff reduction or elimination. Some companies make efforts to circumvent tariffs. For example, Heartland By-Products, a Michigan-based firm, circumvents the tariff on sugar by buying sugar molasses from its sister company in Canada which makes it from sugar bought at world prices. The process is then reversed and the molasses is turned into sugar syrup which is sold to makers of candy, ice cream, and cereals in the US.

Due to low tariffs, governments make attempt to shift products in the high tariff category while firms develop strategies to benefit from the lower tariff category.

Example

In September 2018, India raised import duty on a range of items including air-conditioners, refrigerators, washing machines, footwear, jewellery, furniture fittings and tableware besides imposing it on aviation turbine fuel (ATF) as the government sought to rein in the current account deficit and shore up the rupee.

Source: ICFAI Research Center

Optimal Tariff and Infant Industries

OptimalTariff

The optimal tariff theory assumes that by imposing tariffs, governments can capture a significant portion of the profit margin of manufacturers. In other words, assuming that the exporter willingly cannot raise prices, domestic customers will not have to pay higher price, the government manages to obtain the proceeds that would have been otherwise obtained by the exporter. The optimal theory also assumes that the exporter will not absorb the lower prices and will not shift its efforts to other markets. The theory does not take into consideration that higher tariffs would trigger smuggling that would eventually end in reduction of

Infant Industries

The infant industry for tariffs argues that an industry new to a developing country needs protection from tariff walls or risks being squeezed by global players beforethey begin to grow and develop. This argument was raised vigorously by the USthroughout the 19th century, by Japan after World War II, and by Korea in the 1960s. These countries aimed to encourage domestic industry development whilegenerating revenues for the state at the expense of foreign manufacturers. The consumer interests were not taken into consideration as demonstrated byinternational trade theories. For instance, when US motor vehicles were kept out of Korea and Japan by imposing high tariffs and other barriers, this resulted in higherlocal prices.

2.4.2 Dumping and Anti-dumping

Dumping is defined by the WTO as "selling a product at an unfairly low price, with the "fair price" defined as the domestic price, the price charged by an exporter in another market, or a calculation of production costs." Dumping interferes with free flow of trade as distorts pricing. It also undermines the principle of comparative advantage as it may cause the exporting country to specialize in any product or service in which it will not have any advantage over the importing country.

Due to the adverse impact of dumping on trade, the WTO allows remedies against it but only "material injury" has been demonstrated to the domestic industry. In theory, the extra duties that could be added up to 40 percent of the price of the product can be brought down to realistic level, permitting the efficient producers to sell their goods. The problem arises when retaliation is often used in the form of anti-dumping duties for the protection of inefficient domestic producers.

Activity 2.2 The World Trade Organization had imposed a cap of 1.8 million units on Japanese imports. This encouraged the Japanese car manufacturers to move beyond exporting entry level cars to more expensive models to increase their dollar volumes without violating the trade barrier. Identify the trade barrier. Also discuss other trade barriers. **Answer:**

2.4.3 Quantitative Restrictions

Quantitative restrictions include non-tariff barriers, quotas, and export controls.

Non-Tariff Barriers

"Non-tariff barriers are obstacles to trade, not anchored in laws and official regulations and therefore are not transparent." It is difficult to deal with a non-tariff barrier as the offending party will not admit that there is a barrier and will refuse to enter into negotiations for its removal. Some barriers are difficult to detect and monitor. There are many non-tariff barriers whose combined effect can be substantial.

Administrative barriers

Administrative barriers are often used by governments to block the entry of products while arguing that the barrier does not exist. An example of an administrative barrier is labeling. Most of the countries require product labels in local languages, which is considered to be a reasonable requirement but one that puts an additional burden on the small exporter who may not find it economically feasible to do.

Example

In May 2018, Food Safety and Standards Authority of India (FSSAI) proposed that the country of origin of the food shall be declared on the label of food imported into India. It further added, "When a food undergoes processing in a second country, which changes its nature, the country in which the processing is performed shall be considered to be the country of origin for the purposes of labelling," FSSAI clarified that the labelling should be in English language but if a particular State wants it may insist on labelling to be printed in local language.

Source: ICFAI Research Center

Production subsidies

Subsidies are “payments provided by a government or its agencies to domestic companies in order to make them more competitive vis-à-vis foreign competitors at home and/or abroad.”

Subsidies bring in an artificial incentive into the production equation of domestic manufacturers by funneling resources away from their optimal deployment. However, subsidies, in contrast to tariffs, do not distort decisions of consumers because they do not increase prices beyond the global level. According to the WTO, subsidies can be prohibited, actionable, and non-actionable. Prohibited subsidies require the recipient to make use of domestic goods rather than using foreign goods or to meet export targets. Actionable subsidies are disallowed when damage is demonstrated to the national interests of the company which is complaining. Non-actionable subsidies include offering support to disenfranchised regions to enable companies to comply with stringent employment laws and R&D assistance not exceeding one quarter or one half of total R&D cost. Countervailing duties cannot be imposed on non-actionable subsidies. These duties are set to counter the impact of subsidies.

Emergency import protection

The WTO recognizes remedies against a surge in imports, defined as “a sudden and dramatic increase in imports or in market share that can cause material damage to the domestic industry.” Though the remedies cannot be targeted at a particular country, they can set a quota formula for allocating supply among different exporting countries. A variation of emergency restrictions could be seen while setting “voluntary quotas” for instance, the quotas imposed by the US government to stem the rising tide of Japanese auto imports are voluntary as the importing country threatens other measures if no heed is paid to the quotas.

Although emergency import protection are seen to disrupt free trade flow, it can be justified in that it can safeguard competition by preventing existing players from making exit from the market.

Embargoes and boycotts

Embargoes and boycotts halt the trade by interfering with the free flow of trade. Both make attempt to damage a country by withdrawing international trade benefits. An embargo is "the prohibition on exportation to a designated country." A boycott is the "blank prohibition on importation of all or some goods and services from a designated country." Boycotts are considered to be non-tariff barriers as firms deny their existence. They are initiated by national governments. For instance, the US embargo on Cuba. They are also sometimes initiated by non-government organizations (NGOs) such as consumer groups and business associations.

Finally, buy local campaigns make efforts to curtail all imports, regardless of the origin of the country.

Technical standards

Technical standards refer to "provisions made by government agencies in various countries that pertain to a large array of areas, for example, safety, pollution, technical performance, and the like." Companies wishing to sell their products in a country need to show that that their products meet the standards of the country where they plan to sell their products. A group appointed by the US National Research Council and headed by Gary Hufbauer, concluded:

"(1) Standards that differ from international norms are employed as a means to protect domestic producers; (2) restrictive standards are written to match the design features of domestic products, rather than essential performance criteria; there remains unequal access to testing and certification systems between domestic producers and exporters in most nations; (3) there continues to be a failure to accept test results and certifications performed between domestic producers and exporters in most nations; (4) there continues to be a failure to accept test results and certifications performed by competent foreign organizations in multiple markets; and (5) there is significant lack of transparency in the system for developing technical regulations and assessing conformity in most countries."

Example

As per a report published by Powerline in July 2019 the industrial sector accounts for 30 – 34 per cent of the total energy consumption in India, of which about 70% is electrical energy consumption. Electric motors are known as the workhorses of industry. Historically India has been following BIS standard IE1 motors. Under the National Motor Replacement Program the government is trying to switch to high efficiency IE3 standard motors. It is estimated that this replacement when completed will bring a saving of Rs. 35 billion for the country per annum.

Source: ICFAI Research Center

Corruption

Corruption in another trade barrier. For instance, the US which has anti-bribing legislation may refrain from doing business in countries where bribes are expected. Some exporters also refrain from selling in markets where intellectual property (IP) is not respected. Trebilcock and Howse argue that IP protection is of interest to innovating countries such as the US but not of economies such as Taiwan and Korea which imitate knowledge developed elsewhere.

Ironically, the efforts to fight corruption may also serve as barriers to trade. For instance, pre-shipment inspection is carried out in many countries to prevent tax evasion, fraud, and capital flight by subjecting incoming imports to continuous inspection by private companies which are contracted. In many cases, such inspections delay or block imports for protecting domestic producers that may be associated with the inspectors.

Quotas

Quotas are "quantitative limitations on the importation of goods typically spelled in terms of units." Some quotas allow for an increase that is preset. For instance, an annual increase of 4 percent while some quotas allow for a decrease that is preset as contained in the North America Free Trade Agreement (NAFTA). Quotas can also be established in terms of market share beyond which cessation of imports or tariffs are triggered.

Quotas hold the quantifiable, definitive protection of domestic producers unlike tariffs. However, they may yield unintended consequences. In contrast to tariffs, quotas do not have the needed potential that could trigger efficiencies arising from the need to remain competitive with the domestic producers.

Rule of origin

Tariffs and quotas are administered on the basis of the country of origin, the default for which is the importing country. The terms for rule of origin differ between types of tariffs and supports.

Rule of origin is usually an issue of contention, however, because the value added to the product in the country which is transient could be debatable. For instance, the French government once returned the shipment of cars of US-based Honda saying that the cars were Japanese and hence fell under the Japanese car imports quota, which had already exceeded.

As a remedy to the problems accruing from rule of origin, the World Trade Organization (WTO) issued a first ever agreement on rules of origin. It requires that the rules to be applied in a consistent way, they need to be transparent, they should be based on positive standard, and they will not distort, restrict, or disrupt trade.

Export controls

Most of the countries impose a limit on the number of products that could be exported to other countries especially those nations that are considered to be enemy or where the security of the exporting nation is at risk. Export controls are "activated against products with a national security potential, but also to so-called dual-use products such as computers and trucks that can have both security and civilian uses."

During emergencies, export controls are used for preventing the export of goods that are vital to armed forces and domestic industry, for example, oil. Export controls differ from other trade barriers in the sense that they are placed by the exporting country rather than the importing country. Companies which export goods often pressurize their government to ease export controls by arguing that the importing country will receive products from competitors where export controls are not strict. Finally, export controls affect manufacturers in the home country and in the third country. This has relevance especially in countries such as the US which has substantial surplus in technology balance of payments. For instance, the US warns Israel to ensure that it does not use sensitive technologies of the US in its sales to China.

Example

India exported fresh and chilled onions worth $496.82 million in 2018-19. Exports were worth $154.5 million in the first four months of 2019-20. "Export of all varieties of onions, as described above, is prohibited with immediate effect," the Directorate General of Foreign Trade (DGFT) said in a notification in September 2019. The commerce and industry ministry amended the export policy making it 'prohibited' from 'free' earlier.

Source: ICFAI Research Center

Barriers to Service Trade

Barriers to service trade differ from those affecting merchandise trade. As knowledge plays a major role in a service economy, any limitations on free information flow, including constraints related to individual mobility e.g. immigration controls signify barriers to trade in services. Some of the barriers to trade in services are identical to tariff barriers in nature.

According to Trebilcock and Howse, in the absence of global regulations and standards free trade in services may result in reduction in global welfare. For instance, lax regulation in the banking industry of a country may damage depositors in another country, resulting in net reduction in global welfare.

Example

In June 2019 the US government said that it is planning to curb the distribution of the H-1B visa to Indians. Both the US and Indian governments withdrew trade benefits for each other. However, the US government went a step ahead and curbed the distribution of its H-1B visa for Indians to 15 per cent. India has been the only country that takes 70 per cent of the 85,000 H-1B visas applied annually.

Source: ICFAI Research Center

Check Your Progress - 1

1. Which theory emerged in the mid-sixteenth century in England as the first theory of international trade?
   a. Absolute advantage theory
   b. Comparative advantage theory
   c. Mercantilism
   d. Heckscher-Ohlin theorem
2. Who introduced the doctrine of laissez-faire to international trade?
   a. Adam Smith
   b. David Hume
   c. Bertil Ohlin
   d. Donald B Keesing
3. The concept of opportunity cost was introduced in which theory?
   a. Linder"s Income-Preference Similarity theory
   b. Heckscher-Ohlin Theorem
   c. Comparative advantage theory
   d. Leontief Paradox
4. Which theorem explains the link between comparative advantage of nations and national factor endowments?
   a. Product life-cycle theory
   b. Mercantilist doctrine
   c. Heckscher-Ohlin Theorem
   d. The New Trade theory
5. Who found that US imports were capital-intensive and exports were labor-intensive?
   a. Staffan B Linder
   b. Wassily Leontief
   c. Eli Heckscher
   d. Raymond Vernon

6. Which view is regarded as a refinement of the conventional trade theory?
   a. Leontief Paradox
   b. Linder‟s Income-Preference Similarity
   c. Product Life-cycle Model
   d. Human Skills and Technology-based View
7. Who proposed the product life-cycle model of international trade?
   a. Vernon
   b. Linder
   c. Krugman
   d. Norman
8. Which economist divided international trade into two different categories such as primary products and manufactures?
   a. Staffan B Linder
   b. Bertil Ohline
   c. Adam Smith
   d. David Ricardo
9. ___is reduction of manufacturing cost per unit as a result of increased production quantity during a given time period.
   a. Product life cycle
   b. Economy of scale
   c. Imperfect competition
   d. Factor endowment
10. A______is a tax levied on goods by the country of importation.
   a. Tariff
   b. Quota
   c. Non-tariff
   d. Export Quotas
11. ___are quantitative limitations on the importation of goods typically spelled in terms of units.
   a. Quotas
   b. Optimal tariff
   c. Tariffs
   d. Non- tariffs
12. ___are activated against products with a national security potential, but also to so-called dual-use products such as computers and trucks that can have both security and civilian uses.
   a. Dumping
   b. Tariffs

c. Rule of origin
d. Export controls

13. ___ is defined as selling a product at an unfairly low price, with the „fair price‟ defined as the domestic price, the price charged by an exporter in another market, or a calculation of production costs.
    a. Rule of origin
    b. Tariffs
    c. Dumping
    d. Anti-dumping
14. ___are obstacles to trade, not anchored in laws and official regulations and therefore are not transparent.
    a. Tariff barriers
    b. Non-tariff barriers
    c. Export controls
    d. Administrative barriers
15. Labeling is an example of which barrier?
    a. Tariff barriers
    b. Administrative barriers
    c. Corruption
    d. Boycott
16. ___are payments provided by a government or its agencies to domestic companies in order to make them more competitive vis-à-vis foreign competitors at home and/or abroad.
    a. Technical standards
    b. Emergency import protection
    b. Subsidies
    c. Foreign sales corporation
17. A/An_____is the prohibition on exportation to a designated country.
    a. Embargo
    b. Boycott
    c. Production subsidies
    d. Emergency import protection
18. A/An_____is the blank prohibition on importation of all or some goods and services from a designated country.
    a. Boycott
    b. Embargo
    c. Subsidy
    d. Corruption

19. Corruption_refer to provisions made by government agencies in various countries that pertain to a large array of areas, for example, safety, pollution, technical performance, and the like.
    a. Technical standards
    b. Production subsidies
    c. Administrative barriers
    d. Embargo

2.5 Summary

- Mercantilism emerged in the mid-sixteenth century in England as the first theory of international trade. The doctrine set immense faith in government's ability to improve the residents‟ well-being using a system of centralized controls.
- The theory of absolute advantage states that imports in a nation should consist of goods made more efficiently abroad while exports should include goods that are made efficiently at home.
- The concept of opportunity cost can be introduced in the theory of comparative advantage. If the opportunity cost of producing a good is lower in the home country than in the other country, the country has a comparative advantage in producing a good.
- The Hecksher-Ohlin theorem states that a country has a comparative advantage in commodities whose production is intensive in its relatively abundant factor, and will hence export those commodities.
- Wassily Leontief found that US imports were capital-intensive and exports were labor-intensive.
- The technology-based and human skills view is regarded as a refinement of the conventional trade theory. To explain the sources of comparative advantage, the theory has added two new production factors such as human skills and technology gaps.
- The product life-cycle model was proposed by Raymond Vernon in the mid-1960s. The imitation-gap approach was further developed by Vernon where he suggests that changes take place in the input requirements of a new product as soon as it becomes established in a market and becomes standardized in production.
- Staffan B Linder, a Swedish economist divided international trade into two different categories such as primary products and manufactures. Linder states that the factor endowment differences explain trade in natural resource-intensive products but not in manufactures.

- The new trade theory was expounded by Dixit and Norman, Lancaster, Krugman, Helpman, and Ethier. According to these theorists, countries not only specialize and trade solely to take advantage of their differences; they also trade due to the increasing returns, which make specialization beneficial per se.
- Tariff barriers chiefly include tariffs and anti-dumping laws.
- The optimal tariff theory assumes that by imposing tariffs, governments can capture a significant portion of the profit margin of manufacturers.
- Non-tariff barriers include administrative barriers, production subsidies, emergency import protection, foreign sales corporation, embargoes and boycotts, technical standards, and corruption.

2.6 Glossary

Boycott: A boycott is the blank prohibition on importation of all or some goods and services from a designated country

Dumping: Dumping is defined by the WTO as selling a product at an unfairly low price, with the „fair price" defined as the domestic price, the price charged by an exporter in another market, or a calculation of production costs.

Economy of scale: Economy of scale is reduction of manufacturing cost per unit as a result of increased production quantity during a given time period.

Embargo: An embargo is the prohibition on exportation to a designated country.

Export controls: Export controls are activated against products with a national security potential, but also to so-called dual-use products such as computers and trucks that can have both security and civilian uses.

International trade: International trade is the exchange of goods and services across borders.

Non-tariff barriers: Non-tariff barriers are indirect measures that discriminate against foreign manufacturers in the domestic market or otherwise distort and constraint trade.

Quotas: Quotas are quantitative limitations on the importation of goods typically spelled in terms of units.

Subsidies: Subsidies are payments provided by a government or its agencies to domestic companies in order to make them more competitive vis-à-vis foreign competitors at home and/or abroad.

Tariffs: Tariffs are surcharges that an importer must pay above and beyond taxes levied on domestic goods and services.

Tariff barriers: Tariff barriers are official constraints on the importance of certain goods and services in the form of a total or a partial limitation or in the form of a special levy.

Technical standards: Technical standards refer to provisions made by government agencies in various countries that pertain to a large array of areas, for example, safety, pollution, technical performance, and the like.

2.7 Self-Assessment Test

1. Briefly discuss the different theories of international trade.
2. Define tariff barriers. Explain different types of tariff barriers.
3. Define non-tariff barriers. Explain different types of non-tariff barriers.
4. Explain how quotas and export controls pose barriers to international trade.

2.8 Suggested Readings/Reference Material

1. Charles W L Hill and G Thomas M Hult (2021). International Business – Competing in the Global Marketplace. 12th edition, McGraw Hill India.
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Additional References:

1. Serenity Gibbons. How to expand your business internationally without compromising your core model. Forbes (2020). https://www.forbes.com/sites/serenitygibbons/2020/03/24/how-to-expand-a-business-internationally-without-compromising-your-core-model/?sh=66335a6f741d
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3. Brett Steenbarger. Why diversity matters in the world of Finance. 2020. https://www.forbes.com/sites/brettsteenbarger/2020/06/15/why-diversity-matters-in-the-world-of-finance/?sh=36dba0637913

4. IFC. Social and Green Bonds. https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/investor+relations/ir-products/socialbonds
5. Business Insider. Global ecommerce market report: ecommerce sales trends and growth statistics for 2021. https://www.businessinsider.com/global-ecommerce-2020-report?IR=T

2.9 Answers to Check Your Progress Questions

1. (c) Mercantilism

Mercantilism emerged in the mid-sixteenth century in England as the first theory of international trade.

2. (a) Adam Smith

The doctrine of laissez-faire to international trade was introduced by Adam Smith.

3. (c) Comparative advantage theory

The concept of opportunity cost was introduced in comparative advantage theory.

4. (c) Heckscher-Ohlin theorem

Heckscher-Ohlin theorem explains the link between comparative advantage of nations and national factor endowments.

5. (c) Wassily Leontief

Wassily Leontief found that US imports were capital-intensive and exports were labor-intensive.

6. (d) Human skills and technology-based view

Human skills and technology-based view is regarded as a refinement of the conventional trade theory.

7. (a) Raymond Vernon

Raymond Vernon proposed the product life-cycle model of international trade.

8. (a) Staffan B Linder

Staffan B Linder divided international trade into two different categories such as primary products and manufactures.

9. (b) Economy of scale

Economy of scale is reduction of manufacturing cost per unit as a result of increased production quantity during a given time period.

10. (a) Tariff

A tariff is a tax levied on goods by the country of importation.

11. (a) Quotas

Quotas are quantitative limitations on the importation of goods typically spelled in terms of units.

12. (d) Export controls

Export controls are activated against products with a national security potential, but also to so-called dual-use products such as computers and trucks that can have both security and civilian uses.

13. (c) Dumping

Dumping is defined as selling a product at an unfairly low price, with the „fair price" defined as the domestic price, the price charged by an exporter in another market, or a calculation of production costs.

14. (b) Non-tariff barriers

Non-tariff barriers are obstacles to trade, not anchored in laws and official regulations and therefore are not transparent.

15. (b) Administrative barriers

Labeling is an example of administrative barrier.

16. (c) Subsidies

Subsidies are payments provided by a government or its agencies to domestic companies in order to make them more competitive vis-à-vis foreign competitors at home and/or abroad.

17. (a) Embargo

An embargo is the prohibition on exportation to a designated country.

18. (a) Boycott

A boycott is the blank prohibition on importation of all or some goods and services from a designated country.

19. (a) Technical standards

Technical standards refer to provisions made by government agencies in various countries that pertain to a large array of areas, for example, safety, pollution, technical performance, and the like.

Unit 3
Country Differences

Structure

"Strength lies in differences, not in similarities."

- Stephen R Covey, Author

3.1 Introduction

The previous unit discussed the major theories of international trade and different types of trade barriers.

Culture plays an important role in international business. It not only affects employee interaction but the overall strategy adopted by a business. The different layers of culture affect the strategy and operations of an MNE in the home and the host country.

The political-legal environment is crucial for an MNE at home as well as abroad. The political environment identifies key constituencies and the legal environment sets the rules of the game as well as the range in which a legitimate business can be conducted.

This unit will define culture and its significance in international business. It then explains correlates of culture. It then goes into explaining the key classifications of national cultures. It then defines corporate culture and explains other layers of culture. It also discusses key cultural issues. The unit then explains the political environment in which the MNE operates. It then explains MNE's relationship with the governments of the home country and the host country. The unit finally discusses the legal environment in which the MNE carries out its operations.

3.2 Objectives

By the end of this unit, you should be able to:

- Define culture and its significance in international business.
- Discuss how language and religion create opportunities and difficulties for MNEs.
- Discuss different key national culture classifications.
- Define corporate culture and discuss the various layers of culture affecting MNE strategy and operations.
- Discuss key cultural issues.
- Discuss the political environment in which an MNE operates.
- Discuss the relationship of an MNE with the host and the home governments.
- Discuss the various legal systems and various jurisdictions.

3.3 Culture and International Business

The Oxford Encyclopedia English Dictionary defines culture as "the art and other manifestations of human intellectual achievement regarded collectively; The customs, civilization, and achievement of a particular time or people; The way of life of a particular society or group."

Anthropologists Herskovits and Harris define culture as "the man-made part of the environment" and "the learned patterns of thought and behavior characteristic of a population or society."

Modern management scholars such as Hofstede define culture as "the collective programming of the human mind," whereas Trompenaars and Hampden-Turner define culture as "the way in which people solve problems and recognize dilemmas."

The significance of culture to international business cannot be overestimated. For instance, culture is considered as a key ingredient in the "liability of foreigness". At the firm level, the impact of culture ranges from strategy formulation to FDI and organization design. Culture has an influence on organizational behavior processes such as perception, leadership, and motivation, as well as human resource management, and negotiations, decision making and management style. Marketing, supply chain management, and accounting and all other functions are virtually influenced by culture. Culture also plays a crucial role in international alliances and mergers.

3.4 Correlates of Culture

Culture is correlated with other variables that vary cross-nationally. Culture, however, cuts across linguistic and religious boundaries and the latter cut across national boundaries. For instance, Belgium, Nigeria, and Switzerland are countries which have multiple official languages. South Korea and Lebanon has a large Christian minority while Northern Ireland has both Catholic and Protestant communities.

3.4.1 Language

Webster's dictionary defines language as "a systematic means of communicating ideas or feelings by the use of conventionalized sigs, gestures, marks, or especially articulate vocal sounds." Language is one of the defining expressions of culture. It determines how norms and values are expressed and communicated.

As there are fundamental differences in language in structure and us of dialects and slangs, language blunders are common. For instance, Coca-Cola is translated into Chinese as bite the wax tadpole which was outdone by PepsiCo. whose jingle "Pepsi comes alive" is translated into "brings your ancestors from the burial place".

Non-verbal language which is considered to be an important means of communication that varies across cultures and languages. It is more important in some cultures than in others. The gestures also vary from one culture to another and their meanings may lead to embarrassing blunders. For instance, in western cultures, the hand gesture is used to implore someone to come over is used in Korea for pets and is not taken as positive expressions if used for a Korean executive.

For international organizations, knowing the language nuances, understanding the different dialects, and recognizing the usage of slang is very important. In order to succeed in international business, organizations need to respect different languages and gain knowledge about culture of the host country.

Example

HSBC (Hong Kong and Shanghai Banking Corporation) has a tagline "The world's private bank," at present. Prior to this it had a tagline 'Assume Nothing'. In 2009, the HSBC spent millions of dollars on its "Assume Nothing" campaign. In many countries, the message was translated as "Do Nothing." In the end, the bank scrapped its original campaign and spent $10 million to change its tagline to "The world's private bank."

Source: ICFAI Research Center

Language blunders are mistakes in using particular phrases due to ignorance or carelessness. Usually the impact of this is very clumsy. Language is one of the defining expressions of culture. It determines how norms and values are expressed and communicated. As there are fundamental differences in language in structure and use of dialects and slangs, language blunders are common. In HSBC's case the translation resulted in a blunder as customers perceived the bank to be doing nothing instead of its intended communication.

3.4.2 Religion

Religion contains norms and key values that reflect in the life of an adherent. Globally, Christianity claims to have the most adherents while Islam is the fastest growing. De Blij and Murphy term Christianity, Islam, and Buddhism as "global religions" whereas religions dominating a single national culture are termed as cultural religions.

International business is influenced by religions in many ways. Business firms and national institutions try to adopt practices that satisfy religious decrees without undermining modern business practices. For instance, as bank interest is prohibited in Islamic law, banks in Moslem countries issue shares to depositors and the borrowers are charged fees and commissions to maintain profitability without charging any interest.

Example

RAKBANK is a UAE based bank which has RakBank Islamic Banking Division (RAKislamic) which operates all the banking accounts as per Sharia laws. Normal fixed/term deposit account under RAKislamic is called Mudaraba Account. Depositors of the Mudaraba accounts will deposit amounts with RAKislamic. RAKislamic will form a common Mudaraba pool and invest the Mudaraba depositors' money in such Common Mudaraba pool investment activities. Profit on the Mudaraba Depositors' investment in the common Mudaraba pool will be distributed among the Mudaraba Depositors and RAKislamic as agreed between Mudaraba Depositors and the Bank from time to time.

Source: ICFAI Research Center

Activity 3.1

MyCare Ltd. (MyCare) is a leading hair care company in the US. The company was known for its unique brand names. The company's hair product names "Mist Stick" was the best selling hair care product in the US. The company expanded itself into Europe starting with Germany. The product launched in Germany had the same US brand name. The product was not well received in the German market as "mist" was used as slang for manure. In this context, identify the cultural variable that created a threat to the operations of MyCare in the

German market. Also discuss other variables and their threats and opportunities to a multinational enterprise. **Answer:**

3.5 National Culture Classifications

Though culture and nation are not similar, the cultural and national boundaries partially overlap each other. The key classifications of national cultures are described below:

3.5.1 Hofstede's Dimensions of Culture

A questionnaire survey conducted by Hofstede on employees of IBM worldwide in 1980 gives a systematic assumption of cultures across countries. According to Hofstede's survey findings, countries can be classified along five basic cultural dimensions – power distance, uncertainty avoidance, individualism versus collectivism, masculinity versus femininity and long-term orientation versus short-term orientation.

Power Distance

Power distance is "the extent to which hierarchical differences are accepted in society and articulated." It can also be defined as "the degree of inequality among people that is viewed as being acceptable." Societies high in power distance tolerate high social inequalities i.e. everybody has his/her rightful place in the society; the ideal boss is a good patriarch or a benevolent director; and status symbol plays a crucial role. Countries belonging to such societies accept wide differences in power and income distribution. High power distance countries include Malaysia, the Philippines, Mexico, Venezuela, Arab countries, India, and West Africa. Lower power distance countries tend to be more egalitarian i.e. the rich and powerful in such societies seem to be less powerful; a resourceful democrat is an ideal boss; and status symbol is frowned upon. Low power distance countries include Australia, Germany, the UK, Norway, Denmark, Sweden, New Zealand, Israel, and Austria. An instance of a high power distance society is one that follows a caste system and where upward mobility is very limited. In contrast, a low power distance society does not emphasize differences in people's status, wealth, and power; equality and upward mobility is common in such cultures.

According to Hofstede, "culture sets the level of power distance at which the tendency".

Example

Prince Garments Pvt. Ltd. (PGPL) promoted by Mr Jeevlal Jain has been handling the affairs of the company for over two decades has decided to hand over the affairs of the company to his two sons. Mr. Jeevlal was highly regarded as a father figure by the over 200 employees of the company and commanded the respect of an ideal boss and good patriarch. Here the power distance is the cultural dimension of Hofstede reflected because the MD of the company has been enjoying the hierarchical status.

Source: ICFAI Research Center

Uncertainty Avoidance

Uncertainty avoidance refers to "the extent to which uncertainty and ambiguity are tolerated." In other words, uncertainty avoidance means how much people in a given culture feel threatened by uncertainty and rely on mechanisms to minimize it. Societies with strong uncertainty avoidance possess a need for formality and rigid rules that structure life. Greece, Portugal, France, and Spain are countries with strong uncertainty avoidance. Consumers in such countries value freshness and naturalness. In countries with weak uncertainty avoidance, people tend to be innovative, easy going, and entrepreneurial. India, Malaysia, Singapore, Hong Kong, and the UK are examples of countries with weak uncertainty avoidance. According to Hofstede, uncertainty avoidance is the most critical dimension for foreign investment due to its implication for risk taking and investment. For instance, MNEs with high uncertainty avoidance are likely to take an incremental approach to internationalization. For instance, Nissan, the Japanese car manufacturer lagged behind its US and European counterparts in establishing production facilities in China.

Example

There isn't a pharmacy in France that doesn't stock Avene Products, all of which are derived from the brand's own thermal spring, where the water is tested every day to ensure its purity. Part of the skincare range tackles problems like atopic dermatitis, psoriasis, eczema, and burns and Avène also offer services like body wrapping, hydro heliotherapy, and underwater massages. Reason for Avene's success in France is due to the preference attached to the naturalness and freshness expected of the products by French consumers.

Source: ICFAI Research Center

Individualism versus Collectivism

Individualism refers to how much people prefer to act as individuals rather than acting as members of a group. In societies that are high on individualism, the focus in on people's own interests and that of their immediate families. In a collectivist society, the interests of a group take a center stage. The members are loyal to the group. Individualist countries include the UK, the US, Australia, and New Zealand. Collectivist countries include Taiwan, Indonesia, South Korea, and Venezuela.

Example

Business insider.in dated 16th November 2022 has published an article on how corporations are using inflation as an excuse to raise prices and make fatter profits. The article specially mentions the world's largest American retailer Walmart. Walmart, which announced third-quarter financial results of 2021-22, was able to post better-than-expected earnings by offering fewer discounts to shoppers and bragging to investors about its ability to hike prices with relative impunity. Here, Individualism is the cultural dimension of Hofstede's definition & concept as in the case of Walmart described in the given situation.

Source: ICFAI Research Center

Masculinity versus Feminity

Masculinity-Feminity takes into consideration the importance of masculine values such as assertiveness, status, success, achievement, and competitive drive within society versus feminine values such as quality of life, solidarity, and people- orientation. Japan is a masculine society while Italy, Austria, Mexico, Chile, Thailand, Sweden, and the Netherlands are examples of countries scoring low on masculinity trait. Societies scoring high on masculinity experience a high degree of gender differentiation. Societies scoring high on feminity experience a lower level of gender differentiation. MNEs from feministic cultures, e.g. carmakers Saab and Volvo (now owned by General Motors and Ford respectively), have the tendency to emphasize social rewards and benefits at the workplace that are viewed as excessive by their parent companies.

Example

ET dated 18th October 2021 has published an article titled "Tata Group driven by values, not valuations". The author mentions that Tatas embody value. They do not work for stock markets but for the people and that is Tata's philosophy. The Group always is oriented towards its people, and it has the tendency to emphasize social rewards and benefits at the workplace and the country at large, and earned the goodwill of the ruler and the ruled. This is femininity of Hofstede's cultural dimension that prevailed in Tata Group of companies.

Source: ICFAI Research Center

Long-term Orientation versus Short–term Orientation

The follow-up research by Hofstede led to the fifth dimension called Long-term orientation (LTO) and Short-term orientation (STO). It was originally termed as "Confucian Dynamism" due to its anchoring in the Confucian value system. LTO represents values such as persistence, thrift, and traditional respect of social obligations. In cultures with high LTO, organizations are likely to adopt a longer planning horizon. Organizations with such deeply rooted cultures may face the difficulty in changing the traditions and practices. LTO emphasizes virtues and obligations whereas in STO values and rights are emphasized. People have strong convictions and are less willing to c4o4mpromise in LTO. While in the short-term orientation, results and achievements are reached within the short time, or within the set time frame, generally for short duration, in the long term orientation, acceptance of business results takes a longer time. Further, employees in shorter time orientation switch jobs often whereas employees in long-term orientation aspire for a long and cordial relationship with the company. While Asian countries such as China and Japan are known for their long-term orientation, U.S. has a short-term orientation, giving importance to short-term gains and quick results.

The LTO is not originally a dimension of Hofstede. Rather, it results of his cooperation with Michael Bond and his associates.

Example

Study.com dated 17.09.21 has published an article on Japanese car manufacturing company Honda. Honda has plants in many countries such as the US, India, Japan, etc. The employees work to build their future and the company's future. The company always work for the future and value persistence. The company has deep routed Japanese culture and seldom deviates from the established norms even on foreign soil as per the author though it is becoming difficult in the US. The long-term orientation is the cultural dimension of Hofstede's definition & concept that reflected in Honda company.

Source: ICFAI Research Center

[1]A sixth dimension was added by Hofstede in 2010 which is discussed below.

Indulgence versus Restraint (IVR)

In 2010, Hofstede added the sixth dimension to his cultural dimension model. This is called Indulgence vs. Restraint dimension which is based on Bulgarian sociologist, Michael Minkov’s survey. This dimension is based on the extent to which people try to control their desires and impulses. If the control is weak, it is called indulgence and if the control is strong it is called as restraint. Hofstede says that culture in each country is either indulgent or restrained. When there is

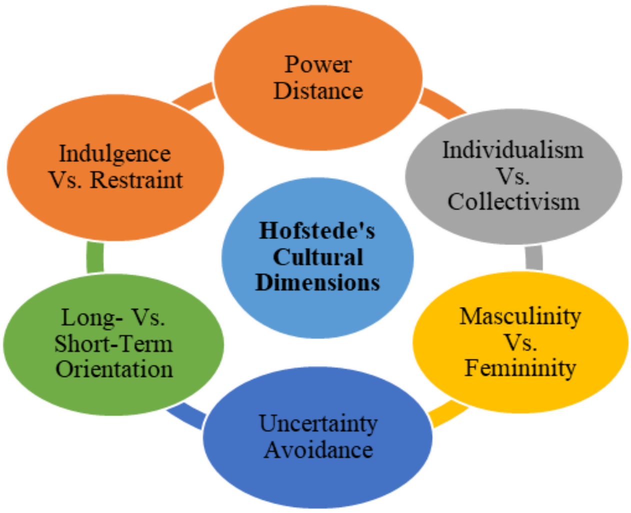
[1] Geert Hofstede Country Comparison Tool: https://www.hofstede-insights.com/product/compare-countries/
Harry B. Santosoa*, Martin Schrepp, Heliyon, www.heliyon.com
Hofstede, G. (2001). Culture’s Consequences: Comparing Values, Behaviors, Institutions, and Organizations Across Nations. Second Edition, Thousand Oaks CA: Sage Publications.
Steers, R.M. et al. (2013). Management Across Cultures: Developing Global Competencies. Cambridge University Press.
https://relivingmbadays.wordpress.com/2012/12/30/geert-hofstedes-five-dimensions-of-national-culture/

indulgent culture, people are optimistic and importance is given to freedom of speech and personal happiness. Such a society allows relatively free gratification of basic and natural human drives and impulses. People enjoy life mixing with fun. On the other hand, when there is restrained culture, people are pessimistic and are controlled much as they exhibit rigid behavior. Such a society suppresses gratification of needs. Society controls people through strict social norms. According to Hofstede, Eastern European countries, including Russia, are characterized by a restrained culture.

Since psychologist Dr. Geert Hofstede published his cultural dimensions model after intensive research, it has become a standard for understanding cultural differences and individual behavior globally. Hofstede researched with the people who worked in IBM across 50 countries. Initially, he explained four dimensions and later, he added two more dimensions - Long-term vs short-term orientation and Indulgence vs. Restraint.

The following Figure 3.1 gives all the six cultural dimensions explained by Hofstede.

Figure 3.1: Hofstede's Cultural Dimensions

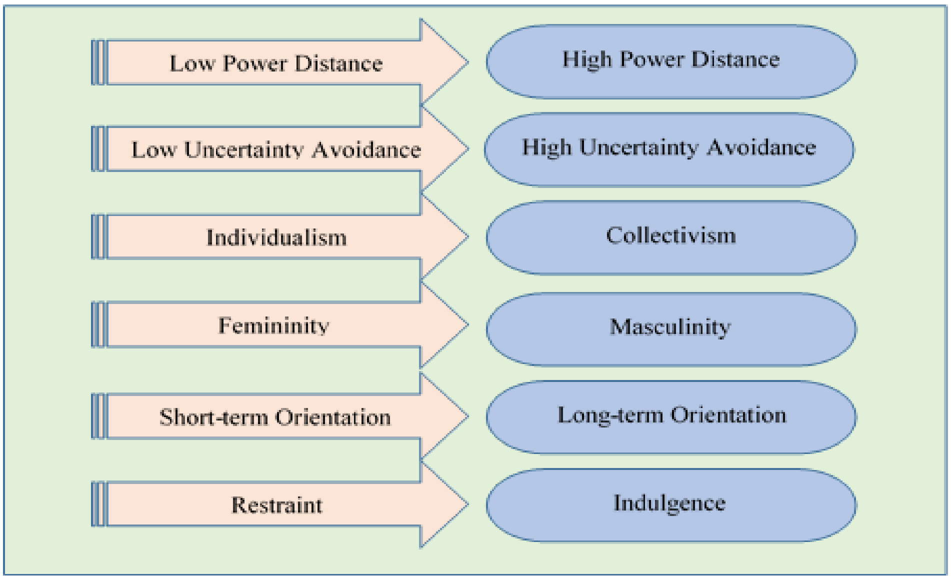


Source: ICFAI Research Center

5.1.1 Analysis of Hofstede's Cultural Dimensions

Culture plays an important role in organizational behavior. Culture is learned behavior. Organizations develop a culture of their own over a period of time. The culture of an organization makes it distinct from other organizations. The organizational culture influences the behavior of employees working for the organization and, to an extent, has an influence on people in society at large. Different organizations have different cultures and influence the behavior of individuals differently. In fact, organizational culture creates a distinct identity for individuals working for an organization. Cultural norms dominate interpersonal relationships at work. Hofstede's model assumes that culture is a set of learned traits, which cause behaviors or reactions to specific situations to be more likely in some cultures than in others. Thus, differences between cultures result from differences in basic values shared by the members of these cultures. Cultural norms play a large part in interpersonal relationships at work. The cultural dimensions researched by Hofstede, describe how people in a specific culture interact with other people. As long as one remains in one's own culture, the problem of adaptation does not arise. But with globalization and internationalization of work, everything seems to be different.

Figure 3.2: Application of Hofstede' Cultural Dimensions



Source: ICFAI Research Center

The framework offered by Hofstede's Cultural Dimensions model, if applied in the direction as shown in the above Figure 3.2, helps people to evaluate themselves and become confident in cross cultural settings without being faced by culture shock.

3.5.2 Schwart's Classification

This framework originated in psychology and has been used in a limited extent in literature. Schwartz and his associates identify three polar dimensions of culture which are described below:

Embeddedness versus Autonomy

Embeddedness implies emphasis on tradition and social relationships. Autonomy implies being encouraged to express one's own attributes and finding meaning in one's own uniqueness.

Example

An article in Springerlink.com dated 17th February 2021 reports that though there is a digital revolution, few old generation private sector banks are still following the traditional method of banking especially those, which are rural-based where customer relationship with the banker plays a major role. Adoption of digital banking channels is yet to pick up in a big way as in the case of new generation banks. Here, embeddedness is reflected in the given situation as it implies an emphasis on tradition and social relationship that is still prevalent in the old generation banks.

Source: ICFAI Research Center

Autonomy is of two kinds – intellectual autonomy (creativity, self-direction) and affective autonomy (the pursuit of self-indulgence and stimulation).

Example

CEO world.com dated 16th August 2021 has published a detailed report on HCL and the culture in the organization titled "Human-Centered Design Includes Empowering Humans and Machines to Work Together". The organization helps executives make sense of the technology and its potential to empower greater efficiency and effectiveness in the workforce. They are encouraged to express their own attributes and free to develop their own thought process that can be beneficial to the organization as per the company's top official. Here, autonomy is one of the Schwart's cultural classification that aptly fits into the HCL culture.

Autonomy implies being encouraged to express one's own attributes and finding meaning in one's own uniqueness in creativity and innovativeness which is reflected in HCL H R culture.

Source: ICFAI Research Center

Hierarchy versus Egalitarianism

Hierarchy means legitimacy of resource allocation and hierarchical role.

Example

Prince Garments Pvt. Ltd. (PGPL) is promoted by Mr. Jeevlal Jain and his two sons. The company has around 20 branches in Maharashtra and Gujarat. Most of the decisions are taken by the promoters that include fixing of pay, increments to employees, garment designs and allocation of resources to branches, etc. Here, hierarchy is the type of culture followed by PGPL based on Schwart's cultural classification.

Hierarchy is the type of cultural classification where legitimacy of resource allocation and hierarchical role were held by few and the management style of PGPL reflects this.

Source: ICFAI Research Center

Egalitarianism means promoting welfare of others and transcendence of self-interests.

Example

Tata Steel has the tag line- We also make tomorrow. The company promotes sustainable livelihood for the underprivileged communities and development of the communities around the area of operation, initiating projects such as Tarang Warli Art, Poultry Farm, Marigold Cultivation, Rice Cultivation, Paper Bag Project, amongst others.

Tata Steel is well known for promoting the welfare of others over self-interests as per an article in tatawiron.org dated 12^{th} June 2021. This is Egalitarianism cultural environment that is adopted by Tata Steel based on Schwart's cultural classification.

Source: ICFAI Research Center

Mastery versus Harmony

Mastery implies mastering the social environment through ambition, success, etc. Harmony implies living in peace with nature and society.

3.5.3 Trompenaars and Hampden-Turner's classification

Trompenaars and Hampden-Turner's classification is drawn largely from the previous literature but are validated by the authors.

Universalism versus particularism: In universal cultures, legal solutions are prominent and rules can be applied in all situations. The US, the UK, Canada, Germany, the Netherlands, and the Scandinavian countries are high on universalism. Countries high on particularism for instance, Arab countries offer more benefits to employees in return for commitment.

Communitarianism versus individualism: In individual cultures, people see themselves chiefly as individuals whereas in communal cultures they see themselves as group members. Countries high on individualism are Nigeria, Romania, Israel, Canada, the US, Denmark, and Czech Republic. Egypt, Mexico, India, Japan, and Nepal are high on communitarianism.

Neutral versus emotional: In neutral cultures, interactions are objective and impersonal; in emotional cultures, interactions are laden with emotions. Countries with high neutral expression are Poland, Ethiopia, Japan, and New Zealand. Countries high on emotional expression include Oman, Kuwait, Egypt, and Spain.

Example

Jacinda Ardern was elected to be the Prime Minister of New Zealand, youngest the country has had since 1856. In 2018 she gave birth to her first child from her partner Clarke Gayford whom she is yet to marry.

Contd….

During her time away for maternity she gave her official responsibilities to her deputy prime minister but was available for discussions on all important matters. While such display from an elected head of a country might not be acceptable in many cultures but for New Zealanders it was acceptable.

Source: ICFAI Research Center

Diffuse versus specific: In diffuse cultures such as in France, Japan, and Mexico, there is no clear separation between different life domains. In specific cultures such as in the US and Germany, interaction is narrowly confined and private life is separated from work.

Achievement versus ascription: In achievement cultures, people are evaluated on their performance and status is based on achievement. In ascriptive cultures, status is bestowed on kinship, birth, and age. Countries high on achievement are the US and Canada. Countries high on ascription include Saudi Arabia and Kuwait.

Attitudes to time: Countries such as the US, Brazil, and Ireland plan for a shorter time horizon whereas Portugal and Pakistan plan for a longer time horizon.

Attitudes toward the environment: Countries such as the US, Spain, and Israel control the environment whereas Russia, Nepal, and Venezuela are not geared toward such control.

3.6 Corporate Culture

Corporate culture is “the culture adopted, developed, and disseminated by a company.” It is crucial for an MNE that adopts a global strategy and adopts corporate culture for integrating its various units. According to Hofstede, corporate culture is more superficial than the national culture because the imprints on the national culture reside in deeply embedded values.

Laurent proposed that corporate culture plays a major role in modifying behavior and artifacts, and beliefs and values but the underlying assumptions can be found deeply in national culture.

3.6.1 Other layers of culture

Ethnicity

In many countries, significant ethnic communities exist. For instance, in the US, various Asian and Hispanic communities have been growing rapidly creating subculture within the culture of the US. These variations are recognized by the MNE as they affect many issues from employee relations to consumption patterns.

Industry

Industry is an important layer of culture. For instance, the high-tech industry is considered to be innovative, informal, and flexible. Common norms and values shared by marketers where MNEs operate helps in facilitating global integration.

Demographics

Hofstede et.al. found that age, education, seniority, and hierarchical level have a strong affect on differences in values. For instance, Ralston et.al. found that the new generation of Chinese managers were more individualistic than the previous generation.

Ideology

Ideology is an important layer of culture. For instance, Maoist ideology provided many of the beliefs and values in China from the mid-1950s to mid-1970s.

3.7 Key Cultural Issues

A culture distinguishes itself from others based on its beliefs, values, and norms. Cultural or business etiquette is "the manners and behavior that are expected in a given situation, be it business negotiations, a supervisor-subordinate discussion of raise, or the behavior expected outside the workplace and after business hours." Violating business culture is considered to be more offensive in some cultures, especially those that emphasize realistic behavior and are high on uncertainty avoidance.

3.7.1 Cultural Stereotypes

Stereotypes are the beliefs about others, their attitudes and behavior. Auto-stereotypes are how people see themselves as more distinguished than others. Hetero-stereotypes are how people are seen by others.

Stereotypes are important because they affect how MNE staff at headquarters and other locations perceive other MNE employees.

Example

Siemens has an online training program called 'Decide Fairly' developed in collaboration with the 'Chefsache' initiative to remedy a unique cultural problem. The genesis to start this program came from one of its employees, who while shopping in the supermarket, came to the snap conclusion that a man buying pink yogurt must be buying it for his wife! But many of its employees have already been victims of such thinking for a variety of reasons: because of their countries of origin, or because the way they speak or look does not match expectations. The snap conclusion by the Siemens employee reflects cultural stereotype.

Source: ICFAI Research Center

3.7.2 Cultural Distance

Cultural distance is "a measure of the extent to which cultures differ from each other." It plays a key role in MNE strategies and foreign investment. It also affects alliance performance and entry mode.

3.7.3 Convergence and Divergence

The convergence hypothesis assumes that the technology and economics combine and make countries more alike and with diffusion of MNC practices and global integration of markets, convergence will accelerate. The divergence hypothesis assumes that countries will maintain their distinctive characteristics, and those differences may even accentuate over time.

3.8 The Political Environment

Political behavior is defined as "the acquisition, development, securing, and use of power in relation to other entities, where power is viewed as the capacity of social actors to overcome the resistance of other actors." The political processes faced by an MNE though not unique to international business, are problematic and complex than it is usually in the case of domestic operations.

Economists view political processes as constraints that impede free flow of production factors, intermediary and final goods that distort demand and supply.

Political constraints and political agenda are influenced by the nature of international business activity. For instance, exporters may seek to reduce limitations on high-technology exportation while importers focus on activities such as tariff reduction, etc.

3.8.1 The Institutional Context

The crucial layer of the political environment is constituted by the historical landscape of political relations and institutions between and within countries. For instance, nearly after 40 years of the French colonial rule, former western Africa colonies continue to import their needs from France.

Affinity or animosity between nations reflects how nations are aligned or estranged based on their history and political reality. Countries with high political affinity and historical bond such as the US and the UK tend to have high levels of mutual trade and investment. In contrast, trade and investment is prohibited among hostile countries.

Political considerations often have an influence over third countries. For instance, the US administration threatened the Israeli government to cancel the sale of airborne aircraft warning systems to China, threatening Israel that it would cancel the aid if it entered into a deal with China.

3.8.2 Political Risk

Political risk is "the probability of disruption to an MNE's operation from political forces and events and their correlates." Political risks narrow down the decision- making span of the foreign investor, in effect transferring decision-making power to the host government. This refrains an MNE to invest or seek a higher premium to compensate for the risk. Political risk can be measured using qualitative approaches, scenario approaches, aggregates of expert opinions, decision-tree methods, and quantitative techniques.

Political risks are of three types – ownership, operational, and transfer. Ownership risk represents a threat to the MNE‟s ability to select or shift to a given governance structure or the current ownership structure. Operational risk includes changes to the rules of the game under which the firm carries out its operations. Transfer risk involves impediments to the transfer of production factors theory.

3.9 The MNE-Government Relationship

An important political challenge faced by MNEs is their relationship with the governments of the host and the home country. The government also affects the legal and economic environment in which the MNE carries out its operations. Governments are also responsible for trade and investment policies, transfer-pricing policies, and capital and exchange controls.

3.9.1 MNE Relationship with the Host Country

Three models that analyze the MNE-government relationship are sovereignty at bay, dependency, and no-mercantilism. The sovereignty at bay models considers an MNE as a threat to the national sovereignty of the host country. The dependency model sees a cooperative relationship only between the MNE and the government of the home country.

The nature of the relationship between the MNE and host governments is termed as coopetition – a combination of cooperation and competition. From the view of the government, increasing pressure of global integration, decelerated economic growth, heightened competition for inbound FDI, and stronger needs for upgrading economic structure encourage coopetition with MNEs. From the view of an MNE, increasingly foreign operations are depending on industrial, educational, technological, and financial structures built by host governments.

Example

Chinese tech giant Oppo is looking to cash in on the "incredible" opportunities thrown by untapped millennial population in the Indian market and charting out strategies to back the government's 'Make in India' mission by extending support to startups and bringing India-centric innovations. Keeping 'Make in India' mission at the core of its growth strategy, Oppo is aiming to manufacture 100 million smartphone units locally by the end of 2020 and bring world-class technological products that meet the needs of the ever-evolving Indian consumers. Given India’s own manufacturing capability for smartphones still allowing a foreign company to come and invest presents a unique scenario.

Oppo and Government of India are cooperating with each other for mutual gains while eventually the Government would like Indian manufacturing to compete with foreign entity for world markets.

Source: ICFAI Research Center

The key political goal of an MNE in a host country is to establish a favorable trade and investment environment. The MNEs aim to face few regulatory hurdles as possible and strives to remove limits on foreign ownership and open access to local markets. Another important goal for an MNE is to obtain legitimacy. Legitimacy is "the acceptance of the MNE as a natural organ in the local environment."

The aim of the host governments is to protect their national interests as the security of the nation is concerned. Local governments are also concerned about protecting their environment from pollution, unsustainable logging, and the like.

The bargaining power of a nation is high when it offers an attractive environment that is unmatched by other locations. The bargaining power of an MNE is high when it offers a differential and technologically advanced product which others cannot provide. Governments compete with each other and are willing to bargain with an MNE over provisions for investment incentives. The incentives can be used for preferential tax treatment, infrastructure development, interest subsidies, and loans and loan guarantees.

3.9.2 MNE and its Home Government

The home government plays a major role in facilitating the political objectives of an MNE. For instance, when Saudi Arabia was deciding to buy a new aircraft from Airbus or Boeing, former US president, Bill Clinton called the king on behalf of Boeing. The intervention of the government only is to preserve jobs and protect interests of the nation. Political pressure is also applied to close home market to foreign competition.

3.10 The Legal Environment

3.10.1 The Institutional Context

The origins of the legal systems dates back to past centuries. A common law system had originated in England, which was followed by the US and former British colonies such as New Zealand and Australia. Common law was associated with an independent judiciary. A civil law system that originated in the Roman Empire was used by Latin America and Continental Europe. Civil law is considered to be less flexible than the common law system as the former follows a legal code which is applied universally. Common law has limitations on the range of events that justify non-compliance to natural disasters, etc. Civil law has very high intervention from the government.

Another legal system is theocratic law, which is a system that relies on religious code. For instance, countries such as Saudi Arabia and Iran rely on Islamic law as the basis of their legal system.

There are major differences in legal systems that go beyond the distinction between common law and civil law systems. A basic difference is the independent status of the judiciary. For instance, in civil law systems where the law is administered by public officials, there is a clear separation of powers. Enforcement is another key difference between legal systems. Enforcement is lax and inept in many developing nations. Finally, legal environments also differ on their tendency to rely on court as the key conflict resolution mechanism. For instance, the US is considered to be one of the most litigious societies in the world. In contrast, Japan relies more on third-party mediation to resolve conflicts.

3.10.2 Legal Jurisdiction

Legal jurisdiction is “the legal authority under which a legal case can be adjudicated. It is often difficult to determine legal jurisdiction in international business.” The MNE is mainly subjected to home country and host country laws and less often to third country laws.

A firm is subject to internationalizing regulatory system and international law at the international jurisdiction level. A firm is subject to laws and regulations of a regional entity such as the European Union or trade framework such as the ASEAN, at the regional-global jurisdiction level. The most importation jurisdiction level for an MNE is at the national level, whether at the home, host, or a third country.

Of late, the WTO has been proactive in deciding jurisdiction and contradictory laws matters.

3.10.3 Regional Jurisdiction

Regional bodies are also increasingly taking responsibility for enacting and enforcing laws. At times, uncertainty prevails as to whether regional jurisdiction supersedes national jurisdiction.

3.10.4 National Jurisdiction

The MNE has to comply with domestic jurisdiction at home and foreign jurisdiction abroad. For instance, the Foreign Corrupt Practices Act MNEs in the US responsible for bribery and related activities in their foreign operations.

3.10.5 Legal Issues

Legal issues concerning MNEs include protection of individual and corporate property, restriction on foreign asset ownership, and contract law.

3.10.6 Rule of Origin Laws

Measuring local content or determining duties is important for knowing product origin, which is also a frequent requirement in trade and foreign direct investment (FDI). In developing economies, local content is an important issue. For instance, India requires local content for domestic production of cars by foreign manufacturers.

Example

Apple's plans to open its fully-owned iconic outlets in India were gathering dust with the government for years as India mandates companies applying for more than 51% FDI through single-brand retailing route to locally source 30% of the products they sell in the country.

However, in August 2019 India amended rules for single brand licence holders to include exports and contract manufacturing to be counted in the mandatory 30% local sourcing norm over a period of five years. Consequently Apple has chosen Mumbai's Maker Maxity Mall, co-owned by Reliance Industries, to open its first company-owned iconic outlet in India. This COCO (company-owned, company-operated) store will be at par with Apple stores in Hong Kong that are in the range of 20,000 to 25,000 sq ft. The Mumbai flagship store will be on three levels – one floor dedicated as experience centre, another floor for retailing and the top for service centre. India's insistence on 30% local sourcing was an obstacle which was taken care of by broadening the provision.

Source: ICFAI Research Center

3.10.7 Competition Laws

Antitrust Legislation and Enforcement

US antitrust legislation is the most advanced legislation which is emulated by several countries. In recent years, the European Commission (EU) has been aggressively enforcing antitrust legislation. For instance, the EU was investigating Coca-Cola's sales and distribution practices as PepsiCo alleged that the former paid retail outlets for not stocking Pepsi's products.

Activity 3.2

ABC Ltd. (ABC), a computer chip company is a leading chip manufacturer in the US. The company had a major market share of 80 percent in the US. Its only competitor was another chip manufacturer, XYZ Ltd. (XYZ) which had a 20 percent market share in the US. ABC aimed to capture more market share in the US. Hence it paid retailers for not stocking XYZ"s products. Which law is being violated by ABC? Also discuss other laws that companies should consider while engaging in businesses.

Answer:

Subsidies

EU rules prohibit subsidies from the government that give an edge to a firm from country over another. However, the EC is less concerned with infringements detrimental to non-EU firms.

3.10.8 Marketing and Distribution Laws

National laws determine the practices that are allowed in advertising, distribution, and promotion. For instance, advertising cigarette on TV is prohibited in many countries.

3.10.9 Product Liability Laws

Product liability laws are stringent in the EU, the US, and many other developed countries. The laws are however, lax or not enforceable in many developing economies.

Example

Johnson & Johnson has been a household name for more than 100 years with a reassuringly cozy image as the quintessential family brand of baby powder, baby shampoo and the maker of Band-Aids. In October 2019 A Philadelphia jury hit Johnson & Johnson with an $8 billion verdict over its marketing of the anti-psychotic drug Risperdal, siding with a Maryland man who argued that the health care giant downplayed risks that the drug could lead to breast growth in boys. Compensatory damages of $680,000 were already awarded in the case in March 2016.

Source: ICFAI Research Center

3.10.10 Treaties

"Treaties are agreements signed by two (bilateral) or more (multilateral) nations." "A multilateral treaty that is ratified by many countries with a joint interest in the issue at hand is called a law-making treaty." Treaties of Friendship, Commerce and Navigation (FCN) offer same rights and privileges enjoyed by domestic businesses in the other country to firms from signatory countries. Most of the treaties include a Most Favored Nation (MFN) clause that entitles signatory state to receive the same favorable treatment enjoyed by other countries.

Other important treaties include the ones that involve protection of intellectual property rights.

3.10.11 Patent Laws

Patent registration is based on nationality – a patent issued in the US cannot be protected from infringement in other countries. A first to invent system grants patent protection to an entity or a person inventing the product or the technology.

A first to file principle means that the first to file a patent in any country will be awarded a patent without having to prove that he/she had invented the product or technology.

Two international treaties that govern patent protection is the Paris Convention for Protection of Industrial Property and the Patent Cooperation Treaty.

Check Your Progress - 1

1. ___ is the art and other manifestations of human intellectual achievement regarded collectively; The customs, civilization, and achievement of a particular time or people; The way of life of a particular society or group.
   a. Cultural dimension
   b. Cultural distance
   c. Cultural stereotype
   d. Culture
2. ___as a systematic means of communicating ideas or feelings by the use of conventionalized sigs, gestures, marks, or especially articulate vocal sounds.
   a. Culture
   b. Religion
   c. Language
   d. Non-verbal communication
3. ___ is the extent to which hierarchical differences are accepted in society and articulated.
   a. Power distance
   b. Uncertainty avoidance
   c. Individualism
   d. Long-term orientation
4. ___refers to the extent to which uncertainty and ambiguity are tolerated.
   a. Masculinity
   b. Collectivism
   c. Uncertainty avoidance
   d. None of the above
5. ___refers to how much people prefer to act as individuals rather than acting as members of a group.
   a. Feminity
   b. Power distance
   c. Long-term orientation
   d. Individualism

6. Which of the following are three polar dimensions of culture defined by Schwartz and his associates?
   i. Mastery versus Harmony, Hierarchy versus Egalitarianism
   ii. Embeddedness versus Autonomy, Masculinity versus Feminity
   iii. Individualism versus Collectivism
   iv. Embeddedness versus Autonomy
   v. Power distance
   a. i, ii, and iii
   b. ii, iii, and v
   c. i, iii, and iv
   d. i and iv
7. ___is the culture adopted, developed, and disseminated by a company.
   a. National culture
   b. Individualistic culture
   c. Feminist culture
   d. Corporate culture
8. ___is the manners and behavior that are expected in a given situation, be it business negotiations, a supervisor-subordinate discussion of raise, or the behavior expected outside the workplace and after business hours.
   a. Cultural etiquette
   b. Cultural distance
   c. Corporate culture
   d. Convergence
9. ___ is defined as the acquisition, development, securing, and use of power in relation to other entities, where power is viewed as the capacity of social actors to overcome the resistance of other actors?
   a. Political affinity
   b. Political challenge
   c. Political behavior
   d. Political agenda
10. ___is the probability of disruption to an MNE"s operation from political forces and events and their correlates.
   a. Political goal
   b. Political risk
   c. Legal risk
   d. Political objective

11. ___is the acceptance of the MNE as a natural organ in the local environment.
    a. Coopetition
    b. Legitimacy
    c. Political risk
    d. None of the above
12. ___is the legal authority under which a legal case can be adjudicated. It is often difficult to determine legal jurisdiction in international business.
    a. Domestic jurisdiction
    b. International jurisdiction
    c. Regional jurisdiction
    d. Legal jurisdiction

3.11 Summary

- Culture as the art and other manifestations of human intellectual achievement regarded collectively; The customs, civilization, and achievement of a particular time or people; The way of life of a particular society or group.
- Culture is correlated with other variables that vary cross-nationally. Culture, however, cuts across linguistic and religious boundaries and the latter cut across national boundaries.
- A survey conducted by Hofstede yielded four underlying assumptions – power distance, uncertainty avoidance, individualism/collectivism, and masculinity/femininity.
- Schwartz and his associates identify three polar dimensions of culture: embeddedness versus autonomy, hierarchy versus egalitarianism, and mastery versus harmony.
- Trompenaars and Hampden-Turner's classification includes key dimensions such a universalism versus particularism, communitarianism versus individualism, neutral versus emotional, diffuse versus specific, achievement versus ascription, attitudes to time, and attitudes toward the environment.
- According to Hofstede, corporate culture is more superficial than the national culture because the imprints on the national culture reside in deeply embedded values.
- A culture distinguishes itself from others based on its beliefs, values, and norms. Key cultural issues include cultural etiquette, cultural stereotypes, cultural distance, and convergence and divergence.
- Political behavior is defined as "the acquisition, development, securing, and use of power in relation to other entities, where power is viewed as the capacity of social actors to overcome the resistance of other actors."

- The crucial layer of the political environment is constituted by the historical landscape of political relations and institutions between and within countries.
- An important political challenge faced by MNEs is their relationship with the governments of the host and the home country. The government also affects the legal and economic environment in which the MNE carries out its operations.

3.12 Glossary

Cultural etiquette: Cultural or business etiquette is the manners and behavior that are expected in a given situation, be it business negotiations, a supervisor-subordinate discussion of raise, or the behavior expected outside the workplace and after business hours.

Corporate culture: Corporate culture is the culture adopted, developed, and disseminated by a company.

Individualism/collectivism: Individualism/collectivism refers to "the extent to which the self or the group constitutes the center point of identification for the individual."

Legitimacy: Legitimacy is the acceptance of the MNE as a natural organ in the local environment.

Legal jurisdiction: Legal jurisdiction is the legal authority under which a legal case can be adjudicated. It is often difficult to determine legal jurisdiction in international business.

Political risk: Political risk is the probability of disruption to an MNE"s operation from political forces and events and their correlates.

Power distance: Power distance is the extent to which hierarchical differences are accepted in society and articulated.

Treaties: Treaties are agreements signed by two (bilateral) or more (multilateral) nations.

Uncertainty avoidance: Uncertainty avoidance refers to the extent to which uncertainty and ambiguity are tolerated.

3.13 Self-Assessment Test

1. Define culture and explain its significance in international business.
2. Briefly describe how language and religion create opportunities and difficulties for MNEs.
3. Describe in brief the different key national culture classifications.
4. Define corporate culture and discuss the various layers of culture affecting MNE strategy and operations.
5. Explain the key cultural issues.

6. Discuss the political environment in which an MNE operates.
7. Describe the relationship of an MNE with the host and the home governments.
8. Discuss the various legal systems and various jurisdictions.

3.14 Suggested Readings/Reference Material

1. Charles W L Hill and G Thomas M Hult (2021). International Business – Competing in the Global Marketplace. 12th edition, McGraw Hill India.
2. Oded Shenkar, Yadong Luo, Tailan Chi (2021). International Business, 4th edition, Routledge
3. Alan C Shapiro (2019). Multinational Financial Management, 11th Edition, Wiley
4. Prakash G Apte (2017). International Financial Management, 8th edition, McGraw-Hill India
5. H.G.Mannu (2018). International Economics. Vikas Publishing House
6. Francis Cheunilam (2020). International Business – Text and Cases. 6th edition. Prentice Hall India Learning Private Limited
7. John Wild and Kenneth Wild (2019). International Business – The Challenges of Globalization. Pearson Education

Additional References:

1. Serenity Gibbons. How to expand your business internationally without compromising your core model. Forbes (2020). https://www.forbes.com/sites/serenitygibbons/2020/03/24/how-to-expand-a-business-internationally-without-compromising-your-core-model/?sh=66335a6f741d
2. IFRS Foundation. Use of IFRS standards around the world. 2018. https://cdn.ifrs.org/-/media/feature/around-the-world/adoption/use-of-ifrs-around-the-world-overview-sept-2018.pdf
3. Brett Steenbarger. Why diversity matters in the world of Finance. 2020. https://www.forbes.com/sites/brettsteenbarger/2020/06/15/why-diversity-matters-in-the-world-of-finance/?sh=36dba0637913
4. IFC. Social and Green Bonds. https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/investor+relations/ir-products/socialbonds
5. Business Insider. Global ecommerce market report: ecommerce sales trends and growth statistics for 2021. https://www.businessinsider.com/global-ecommerce-2020-report?IR=T

3.15 Answers to Check Your Progress Questions

1. (d) Culture

Culture is the art and other manifestations of human intellectual achievement regarded collectively; The customs, civilization, and achievement of a particular time or people; The way of life of a particular society or group.

2. (c) Language

Language is a systematic means of communicating ideas or feelings by the use of conventionalized sigs, gestures, marks, or especially articulate vocal sounds.

3. (a) Power distance

Power distance is the extent to which hierarchical differences are accepted in society and articulated.

4. (c) Uncertainty avoidance

Uncertainty avoidance refers to the extent to which uncertainty and ambiguity are tolerated.

5. (d) Individualism

Individualism refers to how much people prefer to act as individuals rather than acting as members of a group.

6. (d) i and iv

The three polar dimensions of culture defined by Schwartz and his associates are embeddedness versus autonomy, hierarchy versus egalitarianism, and mastery versus harmony.

7. (d) Corporate culture

Corporate culture is the culture adopted, developed, and disseminated by a company.

8. (a) Cultural etiquette

Cultural or business etiquette is the manners and behavior that are expected in a given situation, be it business negotiations, a supervisor-subordinate discussion of raise, or the behavior expected outside the workplace and after business hours.

9. (c) Political behavior

Political behavior is defined as the acquisition, development, securing, and use of power in relation to other entities, where power is viewed as the capacity of social actors to overcome the resistance of other actors.

10. (b) Political risk

Political risk is the probability of disruption to an MNE‟s operation from political forces and events and their correlates.

11. (b) Legitimacy

Legitimacy is the acceptance of the MNE as a natural organ in the local environment.

12. (c) Theocratic law

Theocratic law system is based on religious code.

13. (d) Legal jurisdiction

Legal jurisdiction is the legal authority under which a legal case can be adjudicated. It is often difficult to determine legal jurisdiction in international business.

International Business

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