



# Contextual analysis of legal systems and their impact on trade and foreign direct investment



Michael R. Czinkota\*, Charles J. Skuba

McDonough School of Business, Georgetown University, Washington, DC 20057, United States

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## ABSTRACT

Differences among nations in legal tradition play a role in foreign direct investment decisions by multinational firms. How large a role and to what degree these factors impact the success of foreign direct investment are important issues for examination. A principal question is whether macro-differences in legal systems are causal for international investment on a stand-alone basis or subordinate to multiple other legal variations and societal considerations. This article examines the historical roots and nature of varying legal systems, traditions, and cultures that continue to affect international business. The study analyzes other major conditions which surround the legal environment in investment target countries such as system transparency, degree of corruption, adequate enforcement, and issues of bias related to foreign-owned firms. In addition, firms may have varying strategic objectives for foreign direct investment which may not be driven by short term profitability.

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## 1. Introduction

The literature is replete with writings on international legal systems. However, often the repercussions of such systems on trade and foreign direct investment are not specifically elucidated or compared. To gain an in-depth understanding of legal issues it is crucial to consider and understand the overall context as shaped by humans and history. In this article we build further on the work of Barbopoulos, Paudyal, and Pescetto (2012) in our attempt to analyze the historical and present day existence of varying legal systems. We also examine system embeddedness and causality flows in a local and international environment. We first provide a broad historical perspective on legal systems in relation to foreign direct investment. We then identify specific key legal variables and concerns which the international manager needs to consider and academic researchers need to integrate into their analytical approaches of legal systems.

In spite of economists postulating their (in)famous constraint of “*ceteris paribus*” (everything else being equal), even straightforwardly similar laws will be different depending on locale, timing, presence of corruption, and legal enthusiasm, which all dictate how these laws are perceived, enforced, or valued in comparison to other priorities. We

expect to give special meaning and depth to considerations of legal systems and their relationship to gains from cross-border acquisitions but we do so with the basic conviction that multiple causalities exist. Our principal question is whether macro-differences in legal systems are causal for international investment on a stand-alone basis or subordinate to multiple other legal variations and societal considerations.

The need for such embeddedness and causality in reality is also importantly reflected by a recent call for papers from Harvard University which suggests “that a large number of scholars believe that the marketing field has moved away from addressing substantive problems and has focused instead on methodological issues. While rigorous methods are essential to scientific progress, a lack of substantive focus can quickly make our field irrelevant. There are already strong indications that our journals have no major impact on the decision making of line managers or senior marketing professionals” (Harvard Business School Call for Conference Papers, 2012), “If business researchers are to have a place at the table of planners, negotiators and policy makers, the relevance of their work needs to increase markedly” (Czinkota, 2000).

### 1.1. Ancient roots

“Non exemplis sed legibus iudicandum est,” declared the Emperor Justinian in his sixth century AD *Corpus Juris Civilis*, “Decisions should be rendered in accordance, not with examples, but with the law” (Walton, 1905). Justinian’s words clearly set the stage for differentiating

\* Corresponding author.

E-mail addresses: czinkotm@georgetown.edu (M.R. Czinkota), cjs29@georgetown.edu (C.J. Skuba).

between systems of code law (civil law or Roman law) which generally holds that laws should be specific and codified, and common law (or case law) which adheres to a body of precedent of past judicial decisions.

Over the millennia of civilization, different laws and legal systems have emerged, many of which still influence legal practice today. Culminating in Justinian's Code, Roman law evolved from the ancient Law of the Twelve Tables in the fifth century BC, which set out to define certain rights, prohibitions, penalties, and procedures (Morey, 1901). This law was apparently influenced by earlier Greek laws, primarily the Solonian Constitution which changed the basis for holding office in Athens from heritage of birth to one's stake in society measured by wealth. Solon's body of laws established a standard that an annual income of 750 bushels of corn was required to allow an Athenian access to the top class of citizenry (Smith, 1897). Since there must have been some variation in the income due to weather and harvest conditions, the actual number of bushels must have been higher to guarantee continuous membership in the top class. A wealth standard, in contrast to a birth standard, also broadened the extension and applicability of domestic power for outsiders. Therefore, this conditionality provided for an important stepping stone to the eventual concept of foreign investors and traders having legal rights.

The earliest known historical evidence of codified law which also reflected the international business dimension comes from the Levant and Mesopotamia. The Hebrew Ten Commandments of Moses were laws recorded in stone. One sees business issues in their prohibition of stealing, false evidence, and coveting possessions. While the stone tablets of Moses are no longer available to us, the stone tablet on which the Code of King Hammurabi of Babylon is still extant. Hammurabi condensed a series of judges' decisions into a body of law that even included regulations for caravan trade with provisions for traveling agents, carriers, warehousemen, and ship captains (Johns, 1910–1911). Hammurabi's Code is an ancient example of a clear focus on international trade in societal development and the need for its regulation.

History does not record earlier rudimentary efforts to establish legal systems which undoubtedly occurred in multiple societies and certainly in Mesopotamia. Tribal customs in various geographies were passed along through oral tradition and sometimes recorded in writing. Codified law and law based upon tradition or precedent would evolve into the two major legal systems that countries practice today. In general, countries with the code law system have much more rigid, but predictable, laws than those with the common law system. In the latter, courts adopt precedents and customs to fit the cases. Therefore, in the codified system jurisprudence goes from the general to the specific, while in common law one uses the specific to augment the general perspective of the law.

Throughout history, enlightened rulers understood the importance of having clear, relevant and non-contradictory legislation. For example, Catherine the Great of Russia invested substantial effort in designing her "Instructions" to guide her subjects into a new legislative system (Massie, 2011). The Napoleonic Code was influential in shaping the legal systems of much of continental Europe in the 19th century. Although wide in theory, the differences between code law and common law and their impact on the international marketer are not always as broad in practice. For example, many common law countries, including the United States, have adopted extensive commercial codes to govern the conduct of business (Czinkota & Ronkainen, 2013).

Civil law and code law are not the only systems in the world. As Barbopoulos et al. (2012) state, residual socialist law is an important reality in many countries. Another key legal perspective that survives today is that of theocracy, which has faith and belief as its key focus and is a mix of societal, legal, and spiritual guidelines. Examples are Hebrew law and Islamic law (Shari'ah), which are the result of scripture, prophetic utterances and practices, and scholarly interpretations (Sinha, 1989). International businesses must adapt to the substantial effect of these laws in theocratic societies. A classic example of how

theocratic approaches affect the international manager is Shari'ah's prohibition of interest (riba). One of the international marketing questions resulting from the Arab Spring of 2011 will be whether and to what extent the current integration of Egypt's French civil law code with Shari'ah will be altered. Article 2 of the Egyptian Constitutional Declaration of 2011 states that Islam is the religion of the state and the Arabic language is its official language. The principles of Islamic law are the chief source of legislation (Government, 2012). If Islamist parties dominate Egyptian elections in 2012, will Shari'ah play a greater role than it currently does?

There is also substantial "customary law" that must be considered by the international manager, particularly in regard to property rights. This law, often un-codified, is guided by tradition and practiced in everyday society. It is particularly weighty in cultures driven by tradition and often functions alongside human rights law, land rights, and IP (intellectual property) law. They have developed and continue to evolve in indigenous communities and in larger societies around the world (WIPO, 2010). Hindu custom, for example, places great importance on the internal concept of duty (*dharma*) and doing what is morally right (Nanda & Sinha, 1996).

An inscription on a pillar in India by Aśoka (ca. 304–232 B.C.), the third emperor of the Mauryan Empire reads, "[T]hese are my rules [to my officials]: to govern according to Dharma, to administer justice according to Dharma, to advance the people's happiness according to Dharma, and to protect them according to Dharma (Harris & Greenwell, 2012)". In Chinese culture, the Confucian Liji elaborated upon the concept of propriety (*li*), "an internalized code of civility that defined proper human conduct" (Encyclopedia, 2012). Such 'customary law' also extends into popular perceptions where international business deeds are easily observed and communicated. Often, the belief is that just because something can be done does not mean that it should be done. Plutarch writes about the need for "Caesar's wife to not even be suspected", a cardinal rule which still packs lots of power as the chairman of the Swiss Central bank discovered, when public perception made him resign in light of potential conflicts of interest when his wife made profitable currency trades during a period of high Swiss franc/dollar volatility (Plutarch, 1980).

Understanding law in international markets is not just a matter of examining codes or judicial precedent but also seeing how it is understood and practiced by people. The Peruvian economist Hernando de Soto has done extensive research on property ownership in developing nations. He emphasizes the importance of "extralegal" property and capital formation arrangements in the absence of formal property deeds and contracts in the slums and favelas of these countries. In the *Mystery of Capital*, he explained to Indonesian ministers "that Indonesian dogs had the basic information needed to set up a formal property system. By traveling their city streets and countryside and listening to the barking dogs", they could understand how the people divided land and property (De Soto, 2000). This may be inefficient, as viewed through the eyes of international managers, but it is nonetheless a reality in much of the world which may offer a second best solution.

## 2. Impact on the international marketer

Domestic laws are not isolated in their repercussions. The international effect of domestic legal decisions can lead to corollary challenges. For example, the cost of domestic safety regulations may significantly affect the pricing policies of firms in their international trade and investment efforts. U.S. legislation that created the Environmental Superfund requires payment by chemical firms based on their production volume, regardless of whether the production is sold domestically or exported. As a result, domestic firms paying into the fund are at a disadvantage internationally when exporting their commodity-type products because they must compete against foreign firms that are not required to make such a payment in their home countries and therefore have a cost advantage.

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