Chapter 1

Business Across Borders

Think about the day of a typical student in Europe or North America. She[1] puts on a pair of Nikes and spreads some Nutella on her toast. Her Corolla provides economical transportation to school. She downs a Big Mac at lunch with the help of a Diet Coke (or a Coke Light if she's in Europe) while text-messaging on her Nokia cell-phone. Her day is only half over, but multinational corporations have already clothed, transported, fed, and transmitted her.[2]

Firms doing business abroad face extra challenges that do not trouble their counterparts who confine their business within national borders. These firms also have the opportunity to make much higher profits. It is hard to think of any large, successful corportation that is *not* a multinational. This book will analyze the key decisions made by multinational enterprizes: chiefly, where to make what and how to manage far-flung operations. First, however, we need to learn the terminology used to describe international business. In this chapter we define the types of international transactions and entities. We then take up the question about what exactly makes international business truly different. We enumerate the six forms of separation that create challenges and opportunities for business that crosses borders.

1.1 Overview of International Business

International business consists of a number of different types of transactions between entities from different countries. The organization in charge of measuring international transactions in a systematic way is the International Monetary Fund (IMF). It summarizes all international transactions between what it calls "institutional units" (households and firms) in the *Balance of Payments* (BoP).

[1]Females outnumber males in the universities of most English speaking countries.

[2]The companies are, in order the listed above, Nike (USA), Ferrero (Italy), Toyota (Japan), McDonalds (USA), Coca-Cola (USA), and Nokia (Finland).

Although we are only interested in a subset of these transactions, the BoP framework is a useful way of organizing ideas. For the IMF, transactions are "changes in economic relationships." *International business comprises exchange transactions in which at least one of the parties is a firm.* All business transactions form part of the BoP but the BoP also includes non-business transactions such as aid transfers and family remittances. Some exchanges actually occur *within* firms, that is the "buyer" and "seller" are not independent of each other and might even be part of the same legal entity. The BoP considers branches and subsidiaries (defined below) of multinational enterprises to be separate entities.

What makes a business transaction "international"?

Different criteria are used in different contexts (income taxation, tariffs) but BoP determines nationality in a manner that allows us to apply it non-arbitrarily to the full range of economic transactions. *A business transaction is considered to be international if the entities involved reside in different countries.* Putting it in simple terms, when the payer's address lists a different country from the recipient's address, the exchange is deemed international. Of course this just begs the question of what we mean by the "address." For households, the residence is the place where the members live on an indefinite basis.[3] For firms, it is an establishment (factory, office) where it engages in the production of goods and services.

Why should we use residency to determine whether an exchange is international? An obvious alternative would be "nationality." This might seem less ambiguous than residency, since we can just look and see whether two parties have passports from different countries. Leaving aside the fact that some individuals don't have passports and a few have more than one, the standard of nationality would mean that all purchases and earnings of migrants who have not changed citizenship would be viewed as international transactions. The nationality concept would be even more problematic for firms. On the one hand we could define nationality by country in which the firm is incorporated. However, this practice would give different treatment to two factories making the same thing in the same place, depending on whether they were organized legally as subsidiaries (nationals of the country they were incorporated) or branches (nationals of the parent country). Alternatively, we could abandon legal definitions of a firms' nationality and instead focus on the citizenship of the individuals who own and control the firm. This is not practical for modern multinational corporations since these individuals likely come from many different countries. The concept of nationality remains important for taxation in some countries and also

[3]For the BoP, the formal definition of residence is the "center of economic interest" but the rule of thumb is that it takes a year in the foreign country for it to become the new residence. There are many exceptions. For example, students abroad and patients receiving treatment abroad are considered residents of their home country as long as they are part of households there. As discussed in Chapter 12, the rules that income taxation authorities use to determine residency are fairly complicated.

in some negotiations on "trade" in services. However, our default standard for defining transactions as international will be the BoP's residence rule.

For transactions involving goods, that is physical objects that can be moved from one country to another, there is a third criteria that is sometimes applied. It ignores the residences and nationalities of the parties involved in the transaction and instead examines whether the "origin" country differs from the "destination" country. Customs administrators determine the country goods come from through sometimes elaborate "rules of origin," discussed in Chapter 4. The origin test applied to goods works in practice the same as the residence test. This is because the producer of foreign-origin goods is deemed to be a foreign resident as long as it has a permanent establishment in that country.

1.1.1 Types of Transaction

The IMF *Balance of Payments Manual* breaks down transactions according to standard categories. The list below follows the IMF scheme but excludes transactions that are not part of international business.

Trade: international transactions involving products, i.e. exports and imports of goods and services.

- **Merchandise:** transactions involving the transfer of ownership of a tangible and moveable object from a seller to a buyer.
- **Services:** transactions in which a consumer benefits from actions taken by the service provider. Service transactions are extremely diverse and include transportation, communication, construction, accounting, advertising, research, entertainment, and some insurance and financial services. Royalties and licence fees—the payments for authorized use of patents, trademarks, and copyrights—are also considered service transactions. Usual features of services are intangibility and the involvement of the consumer in the "production" of the service (think of haircuts, hotel room stays, and consulting).
- **Goods for processing:** transactions in which raw goods (e.g. crude oil, cotton thread) from country A are first exported to country B, where they undergo processing, and are then imported back into country A (e.g. as refined gas or t-shirts) *without* a transfer of ownership. Although this would appear to be export of processing services from country B to A, the BoP considers the two flows (A to B, B to A) as *trade in goods*.

Income: earnings and investment income for firms' employees, shareholders, and creditors.

- **Investment Income:** dividends (income on equity) and interest (income on debt).

Employee Compensation: wages, salaries, and benefits.[4]

Income and Trade receipts, net of payments, are the main determinants of most countries' *current accounts*.[5]

Investment: transactions involving assets. Figure 1.1 shows how to classify investment transactions based on ownership shares.

Portfolio Investment: investments in financial assets including equity securities (if owning less than 10% of the shares), debt securities and other financial instruments.

Direct Investment: the establishment or acquisition of an enterprise in which the investor intends to have a long-term relationship that includes an "effective voice in management," but not necessarily a "controlling interest." Since the actual objectives of investors may be difficult to discern, the IMF recommends that a 10% rule be applied to classify investments. If the investor owns 10% or more an enterprise, then it should be deemed to be direct investment.

Equity Capital: investments in foreign affiliates known as

- *branches* when the unit is not separately incorporated,
- *associates* when the investing firm owns from 10% to 50% of the equity in a separately incorporated entity, and
- *subsidiaries* when the parent firm owns more than 50% (the usual requirement for "controlling interest") of the separately incorporated entity (also known as majority owned affiliates).

Reinvested earnings: The investor's share of enterprise earnings is deemed to be paid out to the investor. If it is in fact not distributed but reinvested, the IMF counts this as additional direct investment, *as if* a dividend had been paid and a new investment made.

Acquisition of intangible assets: transactions involving changes in ownership of patents, franchises, and other transferable contracts.

The magnitudes of the different international transactions are illustrated in Table 1.1 for the case of Canada in 2004.[6] The last column sums inflows and outflows and divides by the total for all listed transactions (small items were left out). It reveals that about two thirds of all Canada's business transactions are trade in goods. In a given category, Canada's payments and receipts are mainly of the same order of magnitude. The exception is direct investment where Canada invests about eight times more abroad than it hosts. During the last five years direct investment into Canada has plummeted to less than a tenth of its 2000 level.

[4]Since most compensation transactions occur between residents of the same country, this is a very small component of net international income payments.

[5]The omitted component is transfers.

[6]Data obtained online at `http://www40.statcan.ca/l01/cst01/econ01a.htm`.

Figure 1.1: IMF classifications for International Investment

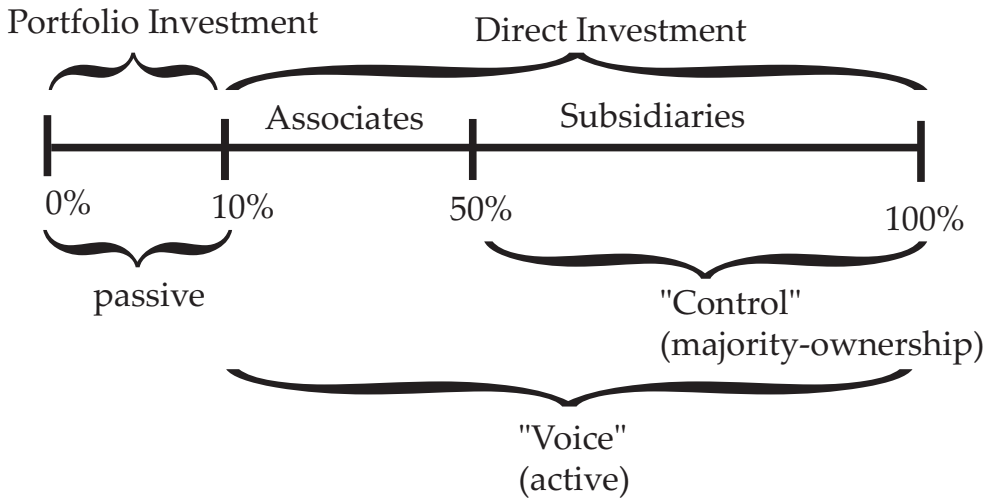

Table 1.1: Canada's international business transactions in 2004

Transaction	Receipts (Bn$) IN	Payments (Bn$) OUT	Balance IN−OUT	Shares (IN+OUT)/Total
Goods	429	363	66	67.5%
Services	62	74	−12	11.6%
Inv. Income	38	63	−25	8.6%
Portfolio Inv.	55	19	36	6.3%
Direct Inv.	8	62	−54	6.0%
Total	592	581	11	100.0%

1.1.2 Types of Entities

Having defined the different types of international business transactions, we should now consider the entities that carry out these activities. The three types of entities that concern us are defined below.

"Uninational" Enterprises: Firms that own permanent establishments and produce in only one country. These firms are also owned by domestic residents or as portfolio investment by foreign investors. Their sole forms of international business are importing and exporting in short-term transactions.

Multinational Contractual Networks: (MNCNs) collections of sellers and buyers from different countries that are linked in long-term relationships but

without significant cross-holdings of equity. Links take the form of contractual obligations. Examples include Nike and Reebok's relationships with the Asian firms to whom they sub-contract the manufacture of shoes, McDonald's network of franchised restaurants, and independent companies that bottle and distribute Coca Cola under license. Another type of MNCN involves agreements between firms that normally compete in the same industry. These combinations are often referred to as "alliances" and are common in the airline industry.

Multinational Enterprises: (MNEs) Any firm consisting of permanent establishments in more than one country, resulting from direct investment abroad by a "parent" firm that owns part or all of the constituent entities (called "direct investment enterprises" by the IMF) and has an effective voice in their management. One key activity of MNEs is the assignment of parent-company employees to work as "expatriates" in the FDI enterprises.

Multinational Partnerships: a collection of offices that are jointly owned by a set of partners. Prominent examples, all from the service sector, include auditing firms such as Andersen, consulting firms such as McKinsey, and advertising firms such as Saatchi & Saatchi.

Multinational Corporations: (MNC) The parent firm is incorporated under the laws of the headquarter nation. For some reason, the United Nations calls these firms "transnational corporations" (TNCs). The largest MNCs are mainly producers of oil (Exxon-Mobil, Royal Dutch/Shell), autos (GM, Ford, Toyota), and electronics (General Electric, the current # 1).

While the terms MNE and MNC are commonly used, I had to invent the terms uninational and MNCN.

1.2 Six Forms of Separation

Globalization has been so persistently hyped (by its fans and critics) that many now talk as if we were all really living in a "global village." International business is indeed very important, especially in countries like Canada that export one third of what they produce and have extensive foreign ownership. Nevertheless we should still think of international business as being distinct from purely domestic business. There are a number of considerations that collectively differentiate international business. I call these the *six forms of separation*. The exact number and grouping of these distinctions is not very important (and indeed something that I have changed from earlier drafts). The key idea is that there are a number of related factors that make doing business across borders harder and riskier than doing it within national borders. Understanding these factors is essential for firms attempting to formulate a multinational strategy.

1.2.1 Political Separation

The political borders we see drawn on maps create the most obvious form of separation. Each nation has its own government that establishes and enforces its own laws.

One of the fundamental activities of national governments is to "secure" their political boundaries against "invasion" by unwanted people, products, financial transactions, and even ideas. Outward flows tend to cause less concern than inward flows; however, many governments do try to prevent so-called capital flight and all governments monitor outward flows of income to verify that relevant taxes have been paid.

The restrictions imposed on inward flows become apparent shortly after landing at a foreign airport. First, immigration officers try to restrict the movement of people. No nation that I am aware of has ever operated a fully open-door policy towards potential immigrants. Second, the would-be entrant must pass through customs, declaring which goods of foreign origin he wishes to enter the country with. Beyond certain limits, goods obtained abroad are subject to special taxes called tariffs or duties. Third, most international airports have foreign exchange counters where one can obtain the local currency. Most countries define a unique local form of money as the "sole legal tender" in that nation.

Temporary movement for the purposes of tourism is not very difficult and is actively encouraged by many countries. In some cases, such as the Canada-US FTA, countries have also facilitated movement of people who intend to supply services in the host country. Permanent movements are subject to more severe restrictions. Firms are usually legally required to give preference to domestic citizens in their hiring process when they are allowed to hire foreign workers at all.

Although tariffs have been lowered substantially over the last 35 years, especially by developed countries, exporters still face many important barriers. The difference is that barriers today are more likely to be triggered by actions of the exporter than before when they were part of a nation's overall trade policy. National governments also create a number of regulations that specify what goods and services can be sold and how they are to be produced. These regulations often have the effect of impeding provision of goods originating in countries with a different set of regulations. We will return to a discussion of protectionist trade policies in Chapters 4 and especially 5 and consider treatment of income flows by tax authorities in Chapter 12.

Inflows and outflows of financial capital used to be heavily restricted as well but now move fairly freely with a few important exceptions such as China. Canada is noteworthy in that it replaced its xenophobic Foreign Investment Review Agency with Investment Canada, an agency charged with attracting more investment. While internationally mobile capital draws much public attention today due to the rapidity and destabilizing consequences with which it moves from country to country, most capital remains in the country in which it is raised. The reasons for this are probably linked to forms of separation we will

discuss subsequently.

Over the last half century there were three important trends in political separation. The first trend has increased the importance of political separation: there were 74 countries in 1950 and there are about 220 today. However, two other trends limit the power of these nations. Supra-national institutions were formed following World War II that exercised some influence on national policies. Despite extreme claims made by anti-globalization protestors, organizations like the United Nations, the World Trade Organization, International Monetary Fund still have only a limited amount of authority. The final trend is the proliferation of agreements between groups of countries to integrate their economies to varying extents. When they give up independent tariff policies, it is called a customs union. When they allow for free movement of labor and capital, it is referred to as a common market. Finally, the adoption of a common currency is called monetary union.

1.2.2 Physical Separation

Countries are often separated from each other by physical barriers such as mountain ranges (the Himalayas, Andes, Pyrenees, Alps all coincide with at least one national border) and bodies of water (e.g. the English Channel, the Great Lakes). In addition, most nations are far away from most of the rest of the nations of the world. As a result, foreign producers and consumers are generally more distant than their domestic counterparts.

One of the most well-established empirical facts in international trade is that the further apart two countries are, the less they will trade. In fact, there is what might even be called an economic "law": trade is inversely proportionate to distance. A country that is 10% further away from you will import 10% less of your goods, holding all other things constant. Similar distance laws operate on the migration of people and the flows of foreign direct investment (FDI).

While the business-impeding effect of physical separation is well-established, the causes of distance's strong negative effect are not fully understood. Krugman has commented that "measured shipping costs are quite small for most goods that can be shipped at all; yet trade falls off quite sharply with distance. This suggests [a role for] transaction costs involving the difficulty of maintaining personal contact, or perhaps differences in culture that are correlated with physical distance."[7]

Historically, a major impediment for international business transactions was the physical cost of communicating information over long distances. Before telegraph and then telephone cables, people had to travel in order for information to travel over long distances.[8]

[7] *Handbook of International Economics Volume 3*, page 1273. We consider the roles of personal contact and cultural differences in subsequent sections of this chapter.

[8] I am perhaps not giving enough credit to carrier pigeons and smoke signals.

Krugman elaborates in the following quote about how communication technology can facilitate international trade.

> While it is not clear why distance plays so strong a role in trade, a common guess is that it proxies for the possibilities of personal contact between managers, customers, and so on; that much business depends on the ability to exchange more information, of a less formal kind, than can be sent over a wire. If this is true, then we might argue that the advent of such innovations as long-range passenger jets, cheap intercontinental telephone calls, fax machines, and electronic mail permit an intensity of long-distance business relationships that was not possible in 1913. Steamships may have been quite efficient at transporting bulk commodities, but they were too slow to allow regular visits to headquarters; telegraphs may have allowed effectively instantaneous communication of futures prices and interest rates, but they lacked the bandwidth to allow the home office to transmit detailed production specifications and the factory to explain why they would not work." (Krugman, 1995, "Growing World Trade" *Brookings Papers on Economic Activity*)

Communication costs also make it difficult to monitor and coordinate the activities of the overseas affiliates of multinational enterprises. Over time modern electronic methods of communication are making it much easier to transfer text, sounds, and images at low costs over great distances. However, business travel has continued to grow in importance. This suggests personal visits to conduct business overseas probably remain important. These visits still consume significant resources, the most important of which being the manager's valuable time.

We shall argue in Chapter 4 that conventional transportation costs are more significant than Krugman suggests. However, Krugman is probably right to argue that shipping costs are just one part of why physical geography matters. Another important reason—also discussed in Chapter 4—is shipping *time*. Time in transit is an important cost of doing business over long distances.

1.2.3 Relational Separation

Local communities have webs of one-on-one interactions that we call social and business networks. We care particularly about the case of business networks which comprise relationships between buyers and sellers. In the terminology of network analysis, buyers and sellers are called nodes. Some nodes are connected to each other with links. There are many types of links. For instance, in a telecommunication network, the links might be fiber optic cable. In a business network a link usually corresponds to an ongoing history of exchange. Relational separation occurs when buyers and sellers residing in one country are mainly linked to each other and have few if any links with their counterparts

in a foreign country. Relational separation may not simply reflect an absence of past interactions. It is likely to also *cause* a reluctance to engage in future interactions. This is because buyers and sellers that are already connected tend to prefer to continue to trade with each other and they often shun "outsiders," those they have never interacted with before.

One of the main activities of business networks is the spread of information. Members of the network transmit specific bits of useful information to each other. Examples of such "data sharing" include

leads: names of people who can provide (or who need) particular items. Most goods are not sold on organized markets and buyers must search for a product that meets their requirements. As a result of their own past searches and informal communication, other members of the network can refer the searcher to a seller they have discovered that makes the desired product.

blacklists: names of people who are known to be untrustworthy. The fact that businessmen can use their local connections to find out who has breached contracts in the past allows them to be more secure in signing contracts. Their lack of connections in foreign countries means that they do not know reputations and this increase *transaction costs* (see Chapter 4).

1.2.4 Environmental Separation

Individuals in different countries often behave quite differently. They produce and demand different products. One fundamental source of such differences is that countries differ in their natural environments. Here we have in mind differences in temperature, rainfall, altitude, water availability, soil types, and mineral resources. Large countries like Canada and Brazil also exhibit huge environmental variation within their borders. Nevertheless, nowhere in Canada can one economically grow bananas or coffee. Correspondingly, there is nowhere in Brazil where consumers demand snow tires for their cars.

As a general rule, nearby countries have more similar environments. Think of the oil-rich—and water-poor—nations of the Middle East. However, environmental differences are not a simple function of distance. One key determinant of temperature is latitude. Countries further from the equator have colder winters, cooler summers and also larger ranges in temperature. Tropical countries also seem to suffer from a more debilitating set of diseases, with malaria being the most prominent example. Due to these latitude effects, regions as far apart as Bordeaux, France and Hunter Valley, Australia grow wines with similar grapes.

The examples above suggest two conflicting effects of environmental separation on international business, and in particular trade in goods. Countries with different environments will often have greater opportunities to trade with each other because they will have one set of goods in abundance while another, scarce in their own country, will be abundant elsewhere. We consider this idea in greater depth in Chapter 3. In contrast, environment-induced differences

in demands will tend to limit trade opportunities (Chapter 6). Scottish wool sweaters will not be sought after in Indonesia (unless air conditioning becomes much much more prevalent)!

1.2.5 Developmental Separation

Countries differ dramatically in their levels of economic development. For instance, in Indonesia, notorious host to many of the "sweatshops" that sew together shoes for Nike, about 8% of its 209 million population (i.e. over 16 million) live on less than one U.S. dollar per day. These figures seem small, however, when contrasted with much of Africa. Africa's largest country, Nigeria, home to 111 million, has 70% of its population living on less than a dollar per day.[9] Life expectancy at birth is under 52 years in Nigeria, in contrast to 66 years in Indonesia, and about 79 years in Canada, Australia, and most of Scandinavia.

All the statistics in the preceding paragraph reflect 1999 data reported in the United Nation's *Human Development Indicators* which can be downloaded from the UN website. This document also reports on other indicators of human development such as literacy, access to clean water, and female participation in the economic and political spheres. The UN averages across several categories to generates a single number it calls the Human Development Index. One of the chief components of the index—and the one that economists tend to focus on—is income per capita. This focus is not as narrow-minded as it might sound because income per capita is highly correlated with many of the other indicators of development. Rich countries have higher education levels, better health, more extensive infrastructure, etc.

Higher levels of income per capita are also strongly associated with higher consumer price levels. This fact is illustrated for the fifty largest economies in the world using 2004 data from the World Bank's *World Development Indicators* in Figure 1.2. The horizontal axis of the scatter plot shows income per capita expressed as a percentage of the United States while the vertical axis shows prices of the typical consumers' purchases as a percentage of the prices of the same bundle in the US. The dotted vertical and horizontal lines intersect on a dot representing the US. Both axes are shown using a "log scale" in which differences correspond to proportional changes. That is why the gap from 10 and 20 is the same as the gap from 50 to 100. The figure includes a best fit line. It's slope tells us that each 10% rise in income leads to 4% higher prices. Furthermore, the statistical analysis shows that income per capita differences explain over 90% of the price level differences for this set of countries.

An important implication of Figure 1.2 is that a given income in US dollars will buy many more goods in a poor country, than it would, say in a rich country like Switzerland (CHE).[10] Switzerland has an income per capita (48

[9]There are, at this time, no Nike factories in Nigeria(`http://www.nike.com/nikebiz/nikebiz.jhtml?page=25&cat=activefactories`).

[10]ISO codes are standard abbreviations, available online at `http://en.wikipedia.org/`

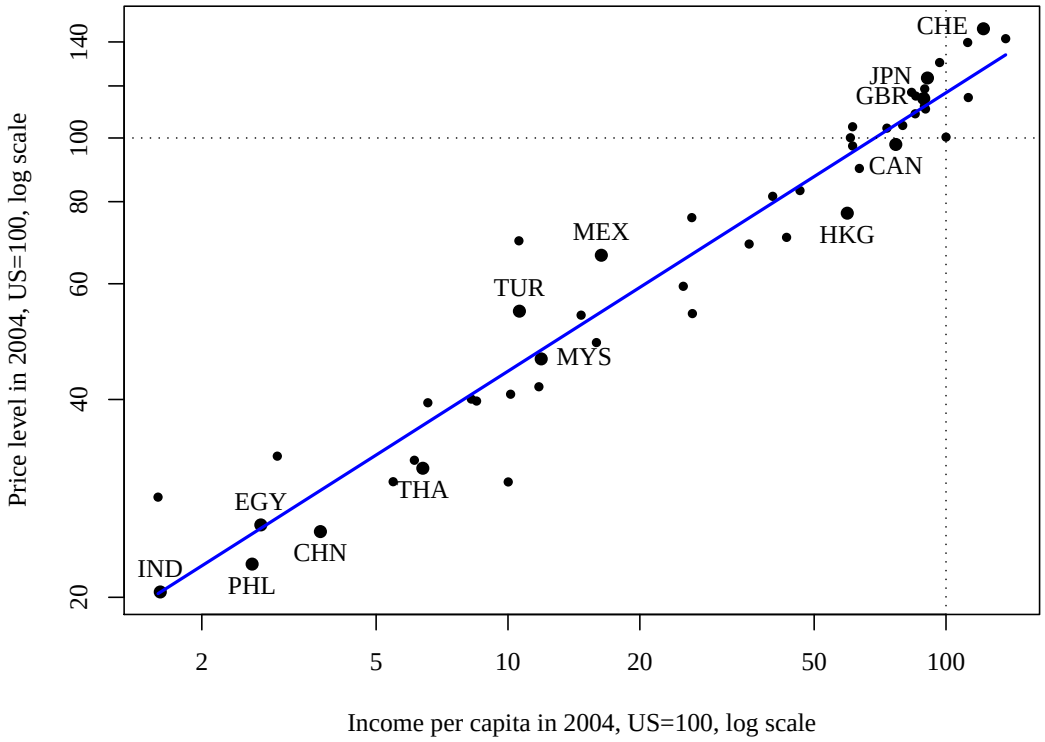

Figure 1.2: Richer countries are also more expensive

thousand USD) that is 75 times larger than India (640 USD). However, Switzerland's prices are more than 7.35 times higher. This means that the purchasing power of the average Swiss income is about *ten* times larger than the average Indian—a large multiple, certainly, but not nearly as large as the unadjusted income ratio.

The observation that prices rise with incomes is called the "Penn Effect" because the group of economists that documented this result was based at the University of Pennsylvania. Because of the Penn Effect we should not use compare the income per capita of one country to another without taking into account price differences. Incomes expressed in "purchasing power parity (PPP) dollars" are adjusted for price differences and are sometimes called "real" incomes. We will return to the concept of PPP and examine how market exchange rates relate to PPP exchange rates in Chapter 10.

Figure 1.3 depicts the incomes of 52 largest economies of the world as a staircase. The height of each step corresponds to income per capita in PPP US$. The width of each step is proportional to the population of each country. Thus, the area under each step corresponds to total income or gross national income (GNI) of each country. We see dramatic differences in real incomes across countries.

`wiki/ISO_3166-1_alpha-3`. While most of them are fairly easy to figure out, CHE is puzzling until you learn that Switzerland's Latin name is *Confoederatio Helvetica*.

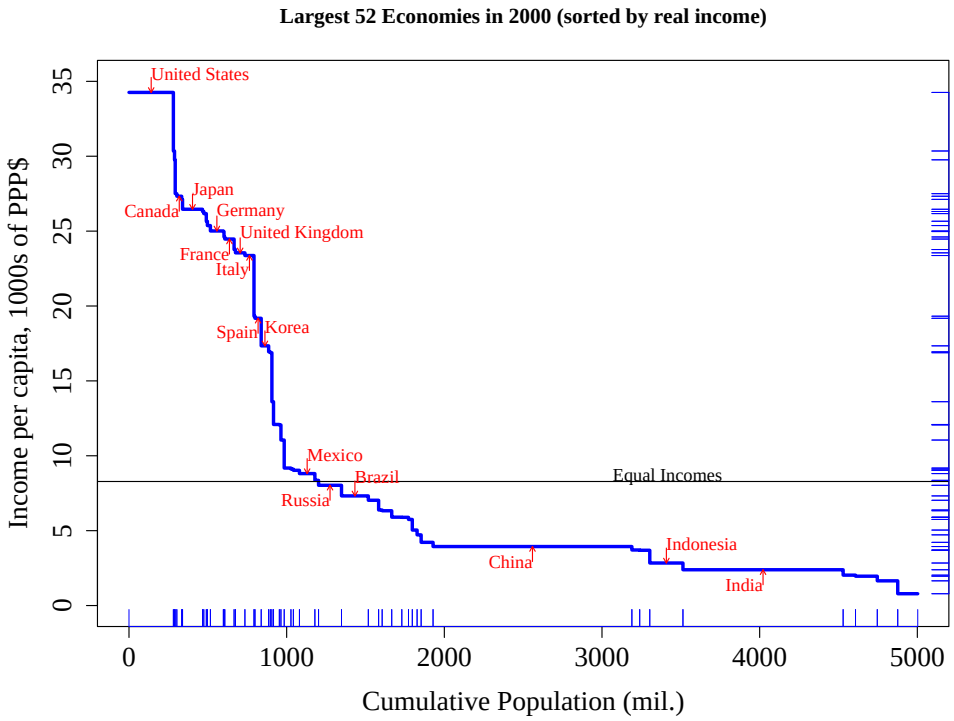

Figure 1.3: The distribution of world income

The long horizontal line shows the hypothetical income that would result from redistributing all the world's income equally (assuming, in a wildly unrealistic way, that such a thing could be accomplished costlessly). We would all have to settle (in this imaginary world) with the standard of living currently enjoyed by the average Russian or Brazilian.

These figures point to one of the most important issues in the world today: Why are citizens of some countries so much richer (on average) than citizens of other countries? Many people think they know the answer but no single answer is fully satisfactory. To begin thinking about the issues, it's useful to break down income per capita into its underlying determinants. First total income is just the sum of wage earnings and investment income. If there are L active workers paid an average of w in annual wages and a capital stock of K generate annual investment returns of r_K, then total income a country is given by

$$Y = wL + r_K K.$$

Dividing by the population, N, we obtain income per capita of

$$y = Y/N = w(L/N) + r_K(K/N).$$

This gives a simple answer to the question of why some countries are rich: they must have some combination of higher wages, higher labour force participation

(L/N), higher returns to capital, or higher average asset holdings (K/N). Many economists in the 1950s and 1960s focused on the last item. The thought that "capital deepening" (increasing K/N) was the main cause of economic development. If this were true, solving world poverty would mainly be about increasing savings and also reallocating loanable funds to the poor countries.

There is now widespread consensus that capital deepening is not enough. Most of the variation in incomes per capita can be traced to variation in wages. As we will see in the Chapter 2, a country cannot have sustainably high wages without high productivity. But what generates the big differences in productivity between countries? One thing that is certainly important is education. But for evidence that education is not enough, we can see immigration of highly educated people from poor countries to the rich countries. Many of these migrants are motivated by the belief that their skills are worth more in the wealthy countries. The reason is that the high income per capita countries have, on average, better "institutions." We cannot delve very deep into this topic here but is an area of active research among economists. One of the strong findings is that there is a remarkably tight relationship between various measures of the rules of society and income per capita. Richer countries tend to have stronger legal institutions than poorer countries. They are more likely to have democratically elected governments (the exceptions being mainly oil-rich nations) and to have lower rates of crime and corruption.

Corruption is something that is very hard to define, but most of us feel we know it when we see it. The Wikipedia defines corruption as "the misuse of public power for illegitimate, usually secret, private advantage." World Bank economists Kaufmann, Kraay, and Mastruzzi aggregated data from 31 different organizations to rate every country on perceptions of how well it manages to control corruption. Figure 1.4 plots corruption differences with respect to the US against relative incomes (not corrected for price differences). We observer a very strong relationship: higher incomes per capita are associated with lower perceived corruption. A reasonable inference is that if somehow a country can find a way to control corruption, then its economy can perform at a higher level, generating more wealth. Unfortunately, the ability to control corruption may be a consequence of historical and cultural events that took place decades or even centuries ago.

After this rather superficial investigation of why incomes differ so greatly, we should now ask how income differences matter for the strategies of multinational enterprises. I see five important mechanisms.

1. Poor countries are much more likely to disintegrate into civil wars or even anarchy (Rwanda, Somalia, and Afghanistan are recent cases).

2. The ubiquity of corruption also raises the costs of doing business for the MNE's subsidiaries. Although some firms may be tempted to use the corruptibility of public officials to their advantage, local firms will usually hold the advantage.

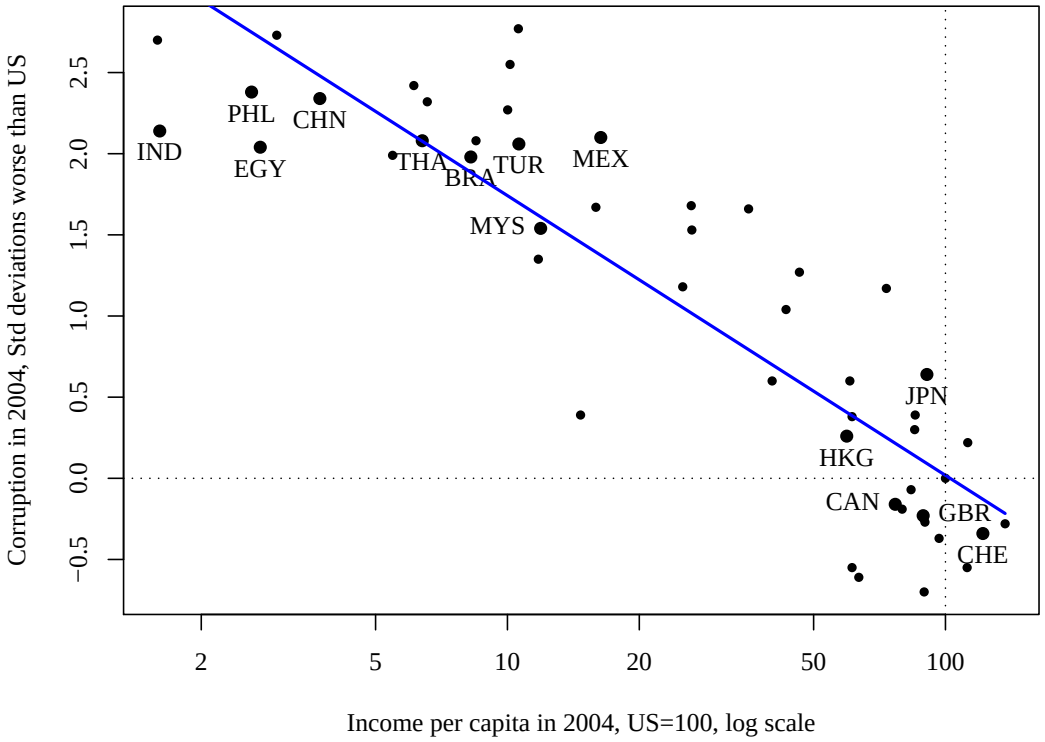

Figure 1.4: Higher income countries have better control of corruption

3. Managers from rich countries will generally view work in poor countries as a hardship due to these countries' relatively undeveloped physical and legal infrastructures. The MNE must generally offer its employees extra compensation to induce them to accept assignments in poor countries.

4. The typical consumer in a rich country has very different demands from those in poor countries. Many goods exhibit strong positive income effects. Demand for some goods, called "luxuries," increases more than proportionately with income. Examples include cars, diamond rings, and perhaps health care. Meanwhile, poor countries have relatively high demand for "necessities."

5. Differences in average incomes reflect in part differences in human and physical capital per person. Rich and poor countries will have gains from trade associated with their differences in "factor proportions." In particular rich countries will tend to export goods and services that allow them to exploit their high levels of education and capital, while importing goods made by unskilled labourers.

We consider many of the issues above in greater detail in later chapters.

1.2.6 Cultural Separation

Not all differences in the behavior of people from different countries can be attributed solely to differences in natural environment or wealth. Instead, there is an important role played by social interactions. This final form of separation is easy and interesting to talk about informally but very difficult to analyze rigorously. Furthermore, even more than the prior forms of separation, cultural separation embraces an almost overwhelming diversity of phenomena.

We are all aware of the stereotypical ways that citizens of different nations are reported to differ. They are even the subject of many jokes. One that I believe unlikely to be considered offensive goes as follows: "Q. What's the difference between Heaven and Hell? A. Heaven is where the police are English, the bankers are Swiss, and the cooks are Italian. Hell is where the cooks are English, the police are Swiss, and the bankers are Italian." The notion behind the joke is that certain characteristics of these different European groups lead them to be good at some occupations and bad at others. These attributes do not seem like responses to environmental differences. Rather, to the extent they are real, they are presumably cultural inheritances.

Many claims about national cultures amount to little more than crude stereotyping. We should always recognize that huge variation exists *within* countries. Furthermore, we should be skeptical of simplistic explanations of cultural differences. For example, in Deresky's (2003) *International Management: Managing Across Borders and Cultures*, we obtain (on page 109) the following account of German culture:

> Christianity underlies much of German culture—more than 96 percent of Germans are Catholics or Protestants. This may be why Germans tend to like rule and order in their lives, and why there is a clear public expectation of the acceptable and the unacceptable way to do things. Public signs everywhere in Germany dictate what is allowed or "verboten" (forbidden). Germans are very strict with their use of time, whether for business or pleasure, frowning on inefficiency or tardiness."

This quote raises a couple of issues. First, can we believe the reported religiosity of the Germans? The CIA World Factbook lists just 68% of Germans as Christians. Presumably this is based on self-descriptions. It may not characterize actual beliefs and practices. The Pew Research Center conducted a survey in 2002 that found that only 21% of Germans said that "religion plays a very important role in their lives." Suppose we overlooked these problems and were willing to stipulate that Germans are very Christian. We still should not infer that this would explain their supposed insistence on order and punctuality. The CIA Factbook shows that 89% percent of Brazilians are Christians and the Pew Center found that 77% considered religion very important. Although the data show them to be more Christian than Germans, few visitors to Brazil would form the opinion that Brazilians relish order and punctuality. If there really are

fundamental differences between Germans and Brazilians on these issues, they almost certainly *do not* arise from differences in the prevalence of the Christian religion.

How then can we explain German punctuality? It seems likely that most Germans today are both punctual and Christian because they inherited these attributes from their parents who inherited from theirs, and so on. In addition, Germans *have* to be punctual because they interact on a regular basis with other Germans who are punctual and expect it of others. A German who moved to Brazil might well gradually find himself slipping on his timeliness after he arrived at a few social invitations on time only to find the hosts still taking their showers.

These two explanations for German punctuality correspond to the two principle mechanisms of "cultural transmission" discussed by Cavalli-Sforza (1999). This geneticist suggested an analogy with biological mechanisms of transmission. One is the "vertical" method, by which one generation passes on characteristics to the following one. In biology, the primary vertical mechanism is the inheritance of genes. In society, the vertical mechanism is something we might call "traditions." Examples include recipes, home remedies for illness, and religions. The second mechanism is horizontal transfer between members of the same generation. The biological example is the spread of a virus from host to host through infection. We will discuss both mechanisms in turn.

While biologists now have a very clear understanding of how genes are passed on, we have little precision in understanding vertical cultural transmission. The basic idea is that parents instruct their children at an age in which they are "impressionable." The mechanism seems to be one of "imprinting." During childhood, tastes, like the ability to learn a language, are flexible and respond to stimuli from parents. Over time children become accustomed to certain levels of sweetness in chocolate, or tenderness in meat. Once established, these preferences may be difficult to shake in adulthood and then be passed on to the next generation. If citizens in one country prefer their products to have certain attributes that are not considered desirable in other nations, this may create an impediment for foreign suppliers. Cavalli-Sforza presents some evidence to support the idea that children tend to acquire the religion of their mother and the political party affiliation of their father.

The role of parental instruction explains why some families might be consistently Christian or even consistently punctual across generations but why are German families in general different from Brazilian families? *Differences between nations arise when most or all of the people in a nation share a common set of relatively recent ancestors who were not the ancestors of most people in the other nation.* We can see this "common heritage" effect most clearly by considering one example of culture that has been transmitted vertically in most countries: the surnames of men. Names like Zhang and Li are much more common in China than in Spain where names like Garcia and Martinez are more common. Another example, more relevant for international business is that initial

instruction in language is done by parents. Thus, the words we use in different countries tend to be similar to the words used by our common ancestors.

Differences in culture have important effects on the employment relationships at overseas affiliates of multinational enterprises. In general, it may be difficult to simply replicate practices that work well in one country to another country. As a very trivial example, a nine to five work day might be the norm in countries colonized by England but, in countries colonized by Spain, there is often the expectation of an afternoon nap (or *siesta*) period prior to restarting work.

The vertical mechanism of cultural transmission is important but it tends to acquire real force when combined with horizontal mechanisms. The latter operate between peers, or members of the same generation. Individuals tend to share beliefs and behaviour patterns with other members of the groups with whom they interact. There are a number of reasons for such conformity. The first might be a simple instinct to imitate. "Monkey see, monkey do" is a saying that conveys the idea of mindless imitation. In reality, humans *and* monkeys are more sophisticated. Some Japanese researchers have studied the social behaviour of macaque monkeys. One of their remarkable findings was a young female named Imo who introduced a method for cleaning the grain given to them by researchers. She dropped it in water at which point the dirt would sink. Soon other juvenile monkeys picked up this trick and then it spread to the adults. This example illustrates the idea that much imitation arises through learning from the examples of others. This monkey example suggests a possibly useful dichotomy for thinking about imitation.

Conformism: The imitator's final objective is simply to conform with behaviour of others. That is the key desire is just to "fit in" with what others are doing.

Social learning: I copy you, not because I want to be like you, but because we are both trying to solve the same problem and I believe your solution will work for me too. For instance, I might be trying to choose a restaurant in an unfamiliar neighborhood. I might follow others into a crowded restaurant even if I don't like crowds because I think that they know the restaurant is good.

A third type of imitation arises from the benefits of coordinating on "*conventions*." In order to be compatible, members of a group adhere to standards. Examples of conventions include

- rules of the road: driving on the right hand side in France but on the left hand side in Britain in order to avoid head-on collisions.

- manners: the incentive to be punctual depends strongly on whether the other people convening at a pre-announced time are expected to be punctual. A Brazilian who moves to Germany will find it in his interest to be more on time in Frankfurt than he would be in Rio de Janeiro.

- languages: sounds and written characters that facilitate communication. The word "dog" is a convention used to refer to a particular species of furry, four-legged carnivores. The words "cachorro," "perro," and "chien" would serve equally well. Indeed it is a convention to read from left to right. Without this convention we wouldn't be able to distinguish between the animal and the deity.
- currencies: tokens that can be used to obtain valuable goods instead of relying upon barter. Their usefulness depends crucially on whether other people view them as valuable.
- systems of measurement: kilos, liters, inches, etc. The value of conventions can be illustrated by a case where there is none: bales of hay. When you pay $6 for a bale you may obtain 100 pounds worth or just 30!
- product interfaces: plugs for electricity connections, paper types (A4 vs 8.5-by-11 inches), etc.

We will return to the issue of conventions and their importance in Chapter 6. Currencies are the topic of Chapter 10. For now, note that horizontal pressures to conform tend to help lock in place patterns of behavior and belief that were first learned from parents. I was born in Germany to American parents. The first language I learned was my parents' language. However, had we stayed in Germany, I would probably have come to prefer and be more competent in German, the language of my peers. Parental transmission and peer influence work together strongly when people do not migrate very far from their birthplace.

1.3 Looking Forward

The six forms of separation can matter for domestic business, especially in large, varied countries. But they will usually be *vital* issues for international business. Thus the study of multinational strategy is the study of making business decisions when the six forms of separation are important.

The book proceeds as follows. Like most firms, we begin with exporting and importing, and tackle issues raised by overseas investment later. We first analyze the gains from trade and then enumerate the many costs of cross-border goods and service transactions. Next we apply the four elements of multinational strategy—*factor advantages*, *trade costs*, *scale economies*, and *market sizes*—to the decision of which multinational form best suits each firm. We then take up issues of central importance to firms that invest overseas: exchange rate risk, political risk, taxation, and expatriate assignments.

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