

Chapter 19

Sources of Institutional Capability for Innovation in China's Catching up Economy: An Explorative Study

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ABSTRACT

What are the sources of institutional capability of innovating firms in China's catching up economy? Firms may develop an institutional capability that offsets the risks of underinvestment in and inaccessibility of resources in the institutional context of a catching up economy. By combining insights from the resource-based view and institutional theory, the authors contribute to the institutional approach to innovation by suggesting that firms can take over certain institutional functions. In this explorative study of entrepreneurial software ventures in Zhejiang, China, the authors identify three sources of institutional capability: local knowledge sharing, legitimacy creation, and strategic flexibility. The findings suggest that the presence of these sources enhances the potential of a firm to create an institutional capability for innovation.

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INTRODUCTION

The institutional approach to innovation has emphasized the important role of institutional structure in supporting and molding efforts to innovate. Schumpeter and Freeman's economics of industrial innovation, studies on national systems of innovation or more generally on social systems of innovation and production assert that some economies are more innovative than others due to different institutional structures (Casper & Van Waarden, 2005). Institutions shape behavior - often reducing transactions costs - and provide incentives towards more or less productive economic activities (North, 1990). For instance, strongly enforced intellectual property rights, a well-functioning financial system, and an efficient labor market are often seen as necessary conditions for innovation (Edquist, 1997). With those conditions firms can credibly develop R&D capabilities and marketing capabilities. Without stable and supportive institutional conditions, economies are less likely to be innovative.

However, in some catching up economies, we find innovative activities without the presence of stable supportive institutional conditions. In particular, China draws the attention. A private sector is rapidly emerging with new business models, new organizational forms, and the development of new products and technologies. The emergence of new industries and the commercialization of knowledge-intensive technology such as TD-SCDMA, pictographic language software and new anti-malaria drug suggest that China is becoming more innovative. Private-sector driven innovation is changing China's industrial landscape (Huang, 2010). These developments are surprising from an institutional perspective on innovation. Emerging economies undergo substantial institutional transformation (Peng, 2003). Instead of reducing risk and uncertainty, institutions become a source of uncertainty, particularly regarding the formal protection of intellectual property, limitations in factor markets and higher search costs for re-

sources (Dixon, Meyer, & Day, 2010). Under such uncertain conditions, firms seem unwise to invest in and develop R&D and marketing capabilities. The question arises on how firms in uncertain institutional conditions then succeed in innovating. Prior research has focused on technology and R&D capabilities, largely neglecting the potential value of other capabilities.

Firms in emerging economies may develop alternative strategies to secure appropriability and mobilize resources. The literature on institutional voids suggests that firms may develop informal practices to overcome the constraints of uncertain institutions and 'fill the void' (Khanna & Palepu, 2000; Roth & Kostova, 2000). Previous research on emerging economies has usefully explored the use of informal institutions (Peng, 2003), the *guanxi* effect (Xin & Pearce, 1996; Perks, Khan, & Zhang, 2009; Siu & Bao, 2008), institutional coping strategies (Roth & Kostova, 2003), network strategies (Siu & Bao, 2008) and political strategies (Wan, 2005) by entrepreneurial firms. However, it remains unclear what the sources of such strategies and capabilities are.

Built on previous literature, we propose that firms may develop an institutional capability for innovation. Whereas previous research has mostly looked at institutional capability of countries, we contend that institutional capabilities at the organizational level may facilitate innovating firms in emerging markets. Institutional capability refers to an organizational capability that allows a firm to take over certain functions of institutions that otherwise reduce the risk and uncertainty of innovative activity. In this chapter we focus on the sources of institutional capabilities. Through an explorative qualitative study of 45 private software ventures in Zhejiang province, we identify three sources of institutional capability. We conclude by emphasizing the need for further research on institutional capability of innovating firms in catching up economies.

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