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Editorial

China Business at a Crossroads: Institutions, Innovation, and International Competitiveness

As the world's fastest growing economy with over a billion population, China is a country that the world needs to know more about in order to understand and anticipate her global and regional impact. Toward this end, the current special issue seeks to advance knowledge about the changing institutions in China and their impact on China business from both the perspectives of foreign firms investing in China and Chinese firms expanding internationally. Four articles selected from a pool of over 50 submissions are presented here, each covering one or more of the country's changing economic, political, and technological institutions. Collectively, these four articles provide rich insights into the past, present, and future of China business that are useful for both academics and practitioners. They also identify areas where additional institutional changes will be needed in order for China and Chinese firms to compete successfully in the new innovation-driven global economy. These include: (1) developing informal institutions to support and reinforce the newly created formal institutions, (2) strengthening both the regulatory and normative protection of intellectual property as a societal value, (3) educational reform to encourage independent and creative thinking, and (4) further political reform including a loosening of the tight connection between politics and business.

Introduction

China currently has the fastest passenger train on earth, the largest growing middle-class for consumer products, and the greatest potential to challenge the economic, political, and technological dominance of the West. It is also the one country that the world needs to know more about in order to understand and anticipate her global and regional impact.

With its current population of 1.3 billion and an economic growth rate of between seven and ten percent over the past 35 years, China has recently surpassed the United States to become the world's largest economy based on purchasing power parity as well as the top destination for foreign direct investment (Tung, in press). These accomplishments are largely the result of the many institutional changes that have taken place within the country, including major economic, political, and technological reforms all done within the confines of a one-party rule system. While these institutional changes have helped transformed China's economy, will they be sufficient to enable the country to compete successfully in the future, particularly in the new innovation-driven global economy? If not, what other changes would be required for China's long-term sustainability?

The purpose of this special issue is to provide a forum for strategy and international business scholars to examine the changing institutions in China and their impact on China business from two perspectives: (1) foreign firms seeking to invest in China, and (2) Chinese firms seeking to expand internationally. Four papers are presented here, which were selected from over 50 submissions by scholars around the world. Two of the papers report an empirical study, one concerning foreign firms establishing R&D centers in China and the other about Chinese firms acquiring assets overseas. The other two papers are commentaries providing a critical analysis of China's institutions and other aspects of the society as they relate to the country's economic past, present, and future. A brief summary of the four papers follows.

Institutions and China business

In the lead article, "*The Transformation of China: Effects of the Institutional Environment on Business Actions*," Hitt and Xu (in press) provide an overview of some of the major institutional changes that have taken place in China and examine their influence on the behaviors of local and foreign firms. These changes include transitioning from a centrally-planned to

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a market-based economy through marketization, liberalization and privatization with corresponding reforms in the political, legal and regulatory structures. Examples of the latter are new property rights laws enacted in the late 1990s, along with the official recognition and sanctioning of entrepreneurial activities in the early 2000s. More recently, there have been significant changes made in regulations helping to improve intellectual property protection, corporate governance, and oversight of the Chinese stock market operations.

As noted by Hitt and Xu, while these formal institutional changes are all designed to support and enhance China business, both for foreign firms operating in China and Chinese firms competing internationally, their effectiveness has been hampered by weak and/or inconsistent enforcement at home. Furthermore, successful implementation of these institutional changes requires the development of corresponding social norms and mindsets that are compatible with and reinforce the new institutional arrangements. Currently, such informal institutional changes are either lacking or slow coming, resulting in a substantial gap between the "officially prescribed" and "socially operating" realities.

Looking ahead, as China continues to further develop its formal institutions and align them with corresponding changes in the informal institutions, the country should become even more attractive to foreign firms seeking investment opportunities. Such development will also benefit Chinese firms competing in the global marketplace, as they become more competent in business management from learning through joint ventures with foreign firms and accumulated knowledge from operating internationally.

The second article by Holmes et al. (in press), "*The Effects of Location and MNC Attributes on MNCs' Establishment of Foreign R&D Centers: Evidence from China*," is an empirical study of factors that affect decisions by foreign firms to establish R&D centers in China. As noted by the authors, such investment is a win-win for both the foreign firm and the host country. Benefits include helping the foreign firm to develop a worldwide learning and innovation capability and the host country to upgrade its technological capability through spillover effects, among others (Cheng and Bolon, 1993; Cheng and Rhee, 2002). Currently, there are more than 1600 foreign R&D centers in China conducting a range of R&D operations including new product and technology development for local or global markets, with many Chinese personnel working in high-paying engineering and technology-related jobs.

As reported by the authors, their study found that target industry growth, intellectual property protection, and industry investment in innovation have significant effects on foreign firms' decision to establish R&D centers in China. High industry growth and strong property protection both have a positive effect on foreign R&D investment. The effect of industry innovation investment, however, varies according to the level of intellectual property protection. At low levels of protection, industry innovation investment has a *negative* effect on foreign R&D investment due to higher expropriation risks. This negative effect weakens as intellectual protection increases, and moves in the direction of turning into a positive effect at high levels of protection. Additionally, the study found that foreign firms' experience in China helps compensate for weak intellectual property protection in making foreign R&D investment decisions.

These findings are significant in suggesting that continued economic growth and enhancement in intellectual property protection will both be needed in the future to attract a continuous and greater inflow of foreign R&D investment to China. While in recent years China has greatly increased its R&D expenditures in both the industry and university sectors, such investment will not help attract foreign firms to establish R&D centers in China until there is sufficient intellectual property protection in place. The latter would require not only formal institutional changes in enacting new laws and regulations, but also the development of informal institutions including new mindsets and societal values that are supportive of intellectual property protection and lead people to behave accordingly.

In the third article, "*Why are Chinese Firms not Financially Competitive in Cross-Border Acquisitions: The Role of State Ownership*," Guo et al. (in press) investigated the effect of state ownership on the premiums that Chinese firms pay when acquiring assets overseas. Their study was motivated by existing evidence that firms from emerging economies, including those from China, often pay very high "acquisition premiums" that are well above the average premiums paid by U.S. acquirers. If not corrected, such practice will in the long run threaten the underlying financial health and profitability of Chinese firms competing internationally.

Drawing from the economics and international business literatures, the authors developed a theoretical explanation for the high premiums paid and applied it to the case of Chinese firms doing acquisitions overseas. Their findings support the hypothesized effect of state ownership and show that the premiums paid were even higher for acquisitions (a) made in developed vs. developing nations and (b) by subsidiaries of state-owned firms that were privately owned vs. subsidiaries with state ownership. They also found that the acquisition premiums were higher in the energy, manufacturing, and natural resource industries that have strategic importance to China.

As noted by the authors, state-owned enterprises (SOEs) from China have multiple objectives in making decisions on cross-border acquisitions. Unlike privately-owned firms, SOEs are branches of the Chinese government and thus need to consider national-political interests and societal welfare in addition to profit. Furthermore, because SOEs have privileged access to financial support from governments and are often less efficient in terms of corporate financial management, they are not as concerned as other firms in spending extra money to achieve their desired objectives. While such behavior (e.g., paying very high acquisition premiums) may seem irrational to Western observers, it is perfectly acceptable to the Chinese government who is the owner and controller of the SOEs involved. This also explains why few Western firms have out-bid Chinese SOEs in cross-border acquisitions when approaching it from a purely business perspective, as mentioned in the article.

The final article by Tung (in press), "*Opportunities and Challenges Ahead of China's 'New Normal'*," focuses on the future of China business and identifies a set of opportunities and challenges to China's long-term sustainability, particularly as they

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affect foreign firms' decision to invest in the country. Opportunities include: China's involvement in forming and promoting regional economic integration through free trade agreements with countries in the Asia-Pacific; use of its sizable foreign reserves to finance development at home and abroad including the establishment of the Asian Infrastructure Investment Bank; and upgrading of its people's science and technology skills through massive R&D spending. Challenges include: ageing of China's population and the resulting decline in productivity; institutional weakness, corruption, and growing income inequality which fuel social discontent and slow economic growth; and increased economic nationalism and newfound confidence on the world stage as manifested in China's recent more aggressive behaviors in dealing with foreign firms operating in the country, as those mentioned in the article.

According to the author, the three identified opportunities will open up new avenues for foreign firms to profit from their investment in China, including using China for "reverse innovation" and also as a springboard to enter other markets that are part of the new regional alliances such as those in the ASEAN, Central and South Asia, as well as the Middle/Near East. As for the challenges, they will all make China business more difficult and less profitable for both foreign and domestic firms. Among the three, the most troubling is the increased economic nationalism and newfound confidence on the world stage; they have the potential of making China a less desirable place for foreign firms to do business and also creating hostility and resentment from other countries toward Chinese firms seeking to expand overseas.

China business in an innovation economy

Abundant cheap labor, low operating costs, lax government regulations, and rapid economic growth with a population of over a billion have been among the major reasons why foreign firms seek to invest and conduct business in China. These are also some of the factors that provide a home-based advantage for Chinese firms to compete in overseas markets (Child and Rodrigues, 2005; Luo et al., 2010). As the world economy becomes increasingly innovation- rather than efficiency-driven, how would this affect China business as it relates to both foreign and domestic firms?

For the foreign firms, China business has traditionally concentrated on conducting low-cost manufacturing of products in China for export back home and/or for sales in other world markets. More recently, as China's economy becomes more developed and its consumers become more affluent, foreign firms started treating China as a major market for revenue generation. Some have also started doing R&D in the country, with aims to develop customized products for local consumers and also to leverage these products through "reverse innovation" for sales in other world markets (Holmes et al., in press; Tung, in press). As the labor and other operating costs in China have increased substantially in the last decade (Morris, 2015), many foreign firms are now considering moving their China-based manufacturing to less expensive locations such as Vietnam and other less-developed countries.

As economic competition shifts from efficiency to innovation, firms need to develop new ideas (products, services, technology, business models, etc.) with high value-add, or apply existing ideas in new and better ways to gain an advantage over competitors. To do this, they need to invest heavily in R&D and hire employees who are creative and self-motivated to challenge the status quo and generate new ideas for improvement. While most innovations in the commercial sector are of an incremental nature for small gains, the highly successful companies such as Apple and Google (now Alphabet) know the importance of investing in cutting-edge R&D to develop disruptive (Christensen et al., 2015) and/or breakthrough innovations (Gassmann et al., 2010) for big payoffs.

Is China a desirable location for innovative companies from overseas to conduct R&D for a competitive advantage? Does China offer the best conditions to help innovative companies develop new ideas with high value-add that they can't find in other countries? If not, what changes would China need to make for improvement?

As mentioned earlier in discussing the Holmes et al. (in press) study, the main factor that attracted foreign firms to establish R&D centers in China is target industry growth, which means potential for increased sales of customized products for an expanding local market. Their study also found that the currently weak intellectual property protection in China is not conducive to attracting foreign R&D investment, particularly in industries where there is high innovation investment due to increased expropriation risks. While China has in recent years introduced new laws to help strengthen intellectual property protection, their effectiveness has been hampered by weak and inconsistent enforcement, as noted in the Hitt and Xu (in press) article. This problem is made worse by the lack of supportive social norms and mindsets among the general population to guide behavior in protection of intellectual property. Given this, foreign firms might be reluctant to conduct the highest value-add R&D in China and limit the work there to the lower-level R&D until further improvement in intellectual protection is achieved.

Apart from the lack of strong intellectual property protection, China's current educational system is also a potential barrier to attracting foreign firms to conduct the most innovative R&D in the country. Compared to many Western societies such as the United States, the teaching method used in most Asian countries including China emphasizes lecturing, memorization and conformity to established norms and practices (Dello-Iacoo, 2009; Kim, 2007). Challenging the status quo and questioning or debating for the purpose of generating new ideas are strongly discouraged both in the classroom and the society at large. Such environment is not helpful in preparing students to be creative and undertake initiatives at work with the goal of producing the next disruptive or breakthrough innovation. If China is to compete successfully in the innovation-driven global innovation, both in terms of (1) attracting foreign firms to conduct high value-add R&D in the country and

(2) helping domestic firms to be innovative in product and technology development at the highest levels, the current educational system will need to be reformed to prepare graduates who can function effectively in an innovation economy.

Finally, the tight connection between politics and business in China, with the government at all levels having major influence on decision making in the commercial sector, is a potential liability for Chinese firms, particularly the state-owned enterprises (SOEs), to innovate at the highest levels. As noted in the Guo et al. (in press) article, SOEs have privileged access to financial support from the government but they need to incorporate national–political interests and social welfare in making business decisions. This often results in outcomes that are less economically efficient or optimal for the firms, such as paying ultra-high premiums in cross-border acquisitions, which could threaten their viability in the long run.

In the case of innovation, major advancement often requires challenging the status quo and pushing the envelope to find new and better ways to do things and solve problems. Given the current one-party rule in China and the dominating role that the government has in influencing behavior in all areas of society including the research community in both the public and private sectors, challenging the status quo and pushing the envelope are not behaviors that are socially encouraged or supported. Until there is further political reform including a loosening of the tight connection between politics and business in China, Chinese firms in general and the SOEs in particular may find it difficult to innovate and compete at the highest levels in the new global economy. The current path will lead China to continue developing largely imitative and incremental innovations rather than disruptive or breakthrough innovations. However, this will be increasingly constraining because as China catches up, the pool of ideas to imitate will be rapidly depleted (Shinkle and McCann, 2014).

Conclusion

By all indications, China business is currently at a crossroads both from the perspectives of foreign firms seeking to profit from doing business in China and domestic firms seeking to expand overseas and compete in the global marketplace. Many of the success factors of the past have either substantially faded (e.g., cheap abundant labor and lax regulation in China) or become a liability (e.g., tight connection between politics and business among Chinese firms) due to recent changing conditions both within and outside of China, as pointed out in the preceding discussion and also by the four articles included in this special issue. While this transition will present many challenges to both business executives and public policymakers in China as well as those in countries involved in China business, it will also open up new opportunities for investment and other commercial pursuits that can benefit both sides.

From the perspective of strategy and international business scholars, this transitional period will present exciting opportunities for interdisciplinary research on China business either as a focal phenomenon of investigation or a research setting for studying social and organizational change (Cheng et al., 2011, 2014). As Tung (in press) has suggested in her article, China's Silk Road project represents a new form of regional economic integration that is unprecedented in both scale and scope. It will provide a setting for scholars to investigate a much more complex set of country diversity factors than NAFTA and the EU, and examine their impact on various issues of economic integration and their yet unknown resolutions. Correspondingly, the shift in the basis of world's economic competition from efficiency to innovation will be a big challenge to China and China business. Will foreign firms reduce their manufacturing investment in China with a corresponding increase in high value-add R&D? Will China loosen its political control at home to allow greater independent and critical thinking to facilitate individual and collective creativity at a higher level? If so, how will China do that and at what pace and with what level of commitment? These and other crossroad challenges will make China and China business a fascinating topic for strategy and international business research in the coming decades. This special issue has taken the first step, and we invite the readers to join us on the remaining journey!

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