Organizational Behaviour and Human Resources Division
Seminar Series

‘The Political Economy of Innovation in China’

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Abstract

Innovation is the one of most important drivers of long-term firm profits and national economic growth, especially for developing countries. Developing countries can move from middle-income to high-income status by shifting from copying others’ innovations toward creating innovations themselves. But weak formal institutions, such as the rule of law protecting property rights, may inhibit innovation by reducing returns to innovation. Informal institutions – specifically, social relations – may substitute for weak formal institutions by facilitating co-operation and increasing trust. One common form of social relation is political connections, meaning ties between firms and government. We study the impact of political connections on innovation in China, one of the largest middle-income countries. We focus on listed firms, which are a strategic site for research on China. In addition to testing opposing arguments about political connections – they foster or stifle innovation – we assess how these effects vary with the strength of the rule of law, and probe two causal mechanisms, level of spending on R&D and effectiveness of R&D spending. Empirical analyses show that negative effects of political connections outweighed positive effects, and that effects become more negative as rule of law became stronger and markets developed. Finally, political connections did not affect R&D spending, but they did reduce the efficiency of R&D spending.

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