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How foreign firms achieve competitive advantage in the Chinese emerging economy: Managerial ties and market orientation

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ABSTRACT

As China experience unprecedented changes in its social, legal, and economic institutions, on what should foreign firms focus more to overcome this challenge, managerial ties or market orientation? This study investigates how managerial ties and market orientation affect competitive advantage and, consequently, firm performance in China. On the basis of a survey of 179 foreign firms in China, we find that both managerial ties and market orientation can lead to firm success—but in different ways. Market orientation enhances firm performance by providing differentiation and cost advantages, whereas managerial ties improve performance through an institutional advantage (i.e., superiority in securing scarce resources and institutional support). Institutional advantage, in turn, leads to differentiation and cost advantages and consequently superior performance.

1. Introduction

In recent years, foreign investment has poured into China, in the form of either joint ventures or wholly-owned subsidiaries, with an attempt to grab the huge potential of the world's fastest-growing markets. China, for example, has been rated the most attractive FDI destination for seven consecutive years by the world's leading executives since 2002 (FDI Confidence Index Survey, 2008). However, despite the attractiveness of the Chinese market, the unprecedented changes that occur in its social, legal, and economic institutions raise serious strategic challenges for foreign enterprises (Li et al., 2006; Zhou and Li, 2007). Intrigued by these challenges, researchers have demonstrated great interest in strategic issues facing firms operating in China. Two primary types of strategic choices seem to have emerged. The first relates to managerial ties and focuses on network-based strategies that use extensive social ties, based on personal trust and relations, to achieve business success (Li, 2008; Peng and Luo, 2000). The second deals with market-based strategies such as market orientation, which promote the importance of delivering superior customer value through quality products to achieve competitive advantage (Zhou et al., 2006; Zhou et al., 2008).

Despite the growing interest in this strategic issue, researchers continue to debate which strategy is more appropriate for emerging economies (Peng, 2003: 283). Some believe that managerial ties are more fitting because formal, market-supporting institutions are always difficult to develop in emerging economies, especially the legal systems that support the use of contracts (North, 2005). Because of this institutional void, managers often must rely more on their ties with the business community and/or government officials to conduct business and coordinate exchanges (Li et al., 2008; Peng and Luo, 2000). In contrast, other researchers have posited that as the construction of formal market institutions progresses, the role of managerial ties necessarily declines (Peng, 2003) and that a market orientation leads to better performance, as evidenced by the many state-owned enterprises that are losing ground to private, mainly market-driven sectors (Zhou et al., 2006). According to this perspective, the ultimate success of any business lies with its ability to serve its customers, which means that as China moves towards a market economy, firms should adopt more market-based strategies, such as market orientation, to improve performance.

Although this debate is highly significant, no study has examined the effects of managerial ties and market orientation simultaneously, leaving this question of strategic choice largely unexplored. Moreover, though both theoretical work and empirical evidence suggest that managerial ties matter in emerging economies, extant research has examined only the direct effects of managerial ties on outcome variables (Batjargal and Liu, 2004). This limited approach leaves “the harder and more interesting issues of how they [ties and networks] matter” largely unanswered (Peng and Luo, 2000: 486). In other words, what are the underlying processes by which managerial ties affect performance?

To address these research gaps, we develop a model (see Fig. 1) from the resource-based view (RBV) that examines how managerial ties and market orientation affect competitive advantage and

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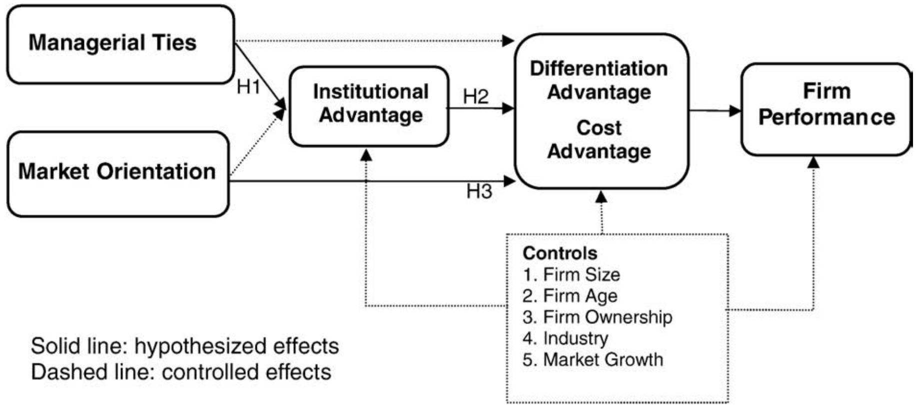

Fig. 1. The conceptual model.

consequently firm performance. We suggest that in China, an important dimension of competitive advantage lies in a firm's superiority in securing scarce resources and institutional support, which we refer to as "institutional advantage." For example, Li (2005) suggests that access to land, capital, and human resources is critical to business success in China. Luo (2007) indicates that support from local government is important because the legal system is not reliable and subject to particularism and personal accommodation. We argue that both managerial ties and market orientation can lead to firm success but that they accomplish this goal in different ways: Managerial ties foster firm performance through an institutional advantage, whereas market orientation enhances performance by achieving differentiation and cost advantages. Overall, our efforts aim to shed some light on how to overcome deleterious institutional challenges and achieve competitive advantage in the Chinese emerging economy.

2. Conceptual development

2.1. The RBV framework

According to the RBV, a firm's competitive advantage stems from its unique assets and distinctive capabilities (Barney, 2001). However, a firm's unique resources do not automatically translate into superior performance; rather, unique resources lead to market-positional superiority which then lead to superior performance (Barney, 2001; Zhou et al., 2008). Competitive advantage literature commonly points to two types of positional superiority: differentiation and cost (Porter, 1985). *Cost advantage*, or cost leadership, arises when the firm operates at a lower cost than its competitors but offers a comparable product. The primary cost drivers include economies of scale, capacity utilization, and process management, etc. *Differentiation advantage* is achieved when customers consistently perceive a firm's offerings as superior to those of its competitors. A firm can differentiate itself in various ways, such as providing superior service, offering innovative features, developing a strong brand name, launching effective promotion, and so on.

2.2. Institutional advantage

Although extant literature has mainly focused on differentiation and cost advantages, recent research suggests that in emerging economies, competitive advantage often arises from nonmarket, institutional connections (Guillen, 2000; Peng et al., 2005), which we refer to as *institutional advantage*. A review of this literature suggests that institutional advantage offers essentially two benefits: superiority in obtaining scarce resources and superiority in gaining support from dominant institutions.

First, as the Chinese market is characterized by underdeveloped capital markets, a scarcity of skilled labor, and a lack of reliable market information (Li et al., 2008), business success rests critically in a firm's ability to secure scarce resources. Guillen (2000), for example, finds that close ties within business groups enable firms to gain a resource advantage including securing technology and know-how, arranging financial packages, obtaining land and establishing plants, hiring and training workers, and so forth. With this advantage, business groups excel in repeatedly entering a variety of industries, which is difficult for new entrants to duplicate or overcome (Li, 2005). Second, because market-supporting institutions such as legal systems and stable political structures are particularly difficult to develop in emerging economies (North, 2005), support from dominant institutions is critical for business success. For example, the Chinese government still plays a highly significant role in shaping, and even interfering in, economic actions through its initiation of new regulations and policies, grants of special permits, and imposition of various restrictions (Luo, 2007). Therefore, institutional support represents political capital that helps build a firm's public reputation, social legitimacy, and political effectiveness and that the firm can use to seize potential opportunities or counteract threats (Peng et al., 2005). In summary, institutional advantage offers a firm both tangible (i.e., securing resources) and intangible (i.e., support from dominant institutions) benefits.

2.3. Managerial ties as a source of advantage

Managerial ties refer to "executives' boundary-spanning activities and their associated interactions with external entities" (Geletkanycz and Hambrick, 1997: 654). Because economic actions are deeply embedded in networks of interpersonal relations, ties are important means for coordinating exchanges (Granovetter, 1985). Managers can use the social capital inherent in managerial ties to influence the allocation of resources and shape economic actions (Batjargal & Liu, 2004). The economic transitions make the role of ties more evident. In China, formal institutional constraints, such as laws and regulations, tend to be weak, so firms must rely on informal means such as interpersonal ties to facilitate economic exchanges (Li et al., 2008). In other words, managerial ties substitute for reliable government and the established rule of law (Xin and Pearce, 1996). Empirical studies further find that ties with government officials, as well as with top managers at other firms, positively affect firm performance (Peng and Luo, 2000).

As boundary spanners, managers function through their vital ties to the external entities on which their firms depend. In this sense, managers are brokers armed with useful ties and contacts (Geletkanycz and Hambrick, 1997). In China where market mechanisms and market-supporting institutions often are underdeveloped or under-enforced, top managers resort to networking to seek the institutional