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How do Regulatory Constraints Impact on Firm Innovation?

Ji Yan, Nengzhi Yao, Rebecca Yu Li and Kun Tian

Abstract

When facing regulatory constraints, how should a firm employ innovation sourcing strategies to bring better innovation outcome? Our research examines this question by investigating the dynamic interplay between regulatory constraints and firm innovation, examining how the former influences innovation sourcing strategies and, subsequently, innovation performance. Drawing from institutional theory, we argue that firms adapt their sourcing strategies to conform to regulatory pressures to maintain legitimacy, leading to diversification of innovation sourcing (e.g. employing a larger number of different sourcing strategies) that brings a favourable innovation outcome. However, regulatory constraints concurrently result in decreased technical efficiency that impedes innovation outcome, presenting a potential paradox in innovation regulation. Taking both benefits and costs of regulatory constraints into account, we propose an inverted U-shaped relationship between regulatory constraints and innovation performance, suggesting that a moderate level of regulatory constraints brings optimal innovation outcomes. Empirical evidence from a longitudinal analysis of UK firms supports our hypotheses, underscoring the complexity of balancing legitimacy with technical efficiency. Moreover, our findings reveal that working with government mitigates the negative impact of regulatory constraints, guiding firms to strategically assess to what extent sourcing strategies should be diversified. Through these investigations, we aim to offer a more definitive stance on the debate surrounding regulation and innovation and provide insights into the conditions under which regulatory constraints might serve as a boon or a bane for firm innovation.