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**The impact of network externalities and the role of governments on
internationalisation strategies in network industries –
A theoretical overview**

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Abstract

This theoretical paper explores the impact of *network externalities* and *the role of governments* on international strategies in network industries. It is argued that both characteristics have a major influence on how network companies determine their international market entry and operation modes, and the type of organisation strategies implemented. The paper discusses how these internationalisation processes differ from those suggested by more traditional theories based mostly on the internationalisation of manufacturing companies, and on service sectors other network industries. Propositions of the internationalisation strategies of these types of companies are developed.

Keywords: internationalisation process, globalisation, network industries, role of governments

INTERNATIONALISATION PROCESS THEORIES AND INTERNATIONALISATION OF SERVICES

The objective of this paper is to develop a number of propositions, based on prior research that describes the internationalisation process of service industry companies.

Internationalisation process theories were developed to explain *how* companies internationalise. This research is best illustrated by the stage theories, such as the Uppsala Model (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; 1990); Luostarinen's (1979; 1994) research in Finland; and Innovation Related models and theories (Bilkey and Tesar, 1977; Cavusgil, 1984). Generally these models can be referred to as 'process models' where the gradual and incremental nature of a firm's internationalisation tends to be the focus.

Process models also emphasize the role of *psychic distance* in a firm's internationalisation. The concept of psychic distance consists of cultural and physical distance (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977). That is, companies first enter countries that are geographically close or culturally similar in proximity to their own. Then gradually, as their international experience increases they enter more geographically and culturally distinct countries. Also, the process models suggest that companies start with less 'committed' operation modes, such as export, and gradually move towards more committed modes, such as foreign direct investments (FDI).

Recently, several researchers have argued that the process models were too linear, static, and too 'context specific' for trying to explain such a complex phenomena (Andersen, 1993; Benito and Welch, 1994; Bell, 1995; Andersen and Buvik, 2002). Also, Johanson and Vahlne (2003), one of the original developers of the process model, recognised the need to further develop these models, for example, by paying more attention to the interrelationship between companies as a factor in the internationalisation process.

Most researchers seem to agree that there are observable deviations from the mainstream pattern of the internationalisation process models. However, the degree to which this apparent deviation exists is unclear. Some studies have found that, in general, the process models are applicable (Luostarinen and

Welch, 1990; Luostarinen, 1994; Gankema et al., 2000); while some argued that there are several new sectors in which internationalisation development deviates from these traditional models (Andersen, 1993; Forsgren, 2002; Luostarinen and Gabrielsson, 2004); and some have found that the traditional models are largely irrelevant (Oviatt and McDougall, 1997). However, process models still seem to play an important role in the understanding of internationalisation (Luostarinen, 1994; Prasad, 1999; Tihanyi et al., 2005), despite not always fulfilling the purest definition of a general theory, which then would predict the internationalisation process of all companies (Luostarinen, 1994; Prasad, 1999).

During the last decade there has been continuous debate about how well the traditional theories have been able to explain the internationalisation of service companies. Despite the importance of the service sector in the world economy today, many researchers (Erramilli and Rao, 1993; Lovelock and Yip, 1996; Clark and Rajaratnam, 1999; Kundu and Contractor, 1999; Bryson, 2001; Javalgi et al., 2003; Bouquet et al., 2004) have argued that existing theories on internationalisation are still largely based on the experience of manufacturing companies. While some service MNCs are similar to manufacturing MNCs, others vary significantly (Aharoni, 1996), and services are not homogeneous in relation to their internationalisation strategies (Knight, 1999; Bouquet et al., 2004). Arguably, there is a need to identify the specific industry drivers and factors which affect globalisation strategies of companies in different industries (Lovelock and Yip, 1996; Westhead et al., 2001).

In addressing this need, some of the recent research on services internationalisation has covered individual service sectors and categories including business services (Roberts, 1999), hotel services (Dunning and Kundu, 1995; Alexander and Lockwood, 1996; Contractor and Kundu, 2000), retail services (Akehurst and Alexander, 1995; Rugman and Girod, 2003), and financial services (Cardone-Riportella et al., 2003).

The research to date on this sector has identified several characteristics which differentiate services from manufacturing industries. These are issues such as *intangibility* (Boddewyn et al., 1986; Erramilli, 1990; Clark et al., 1996; Lovelock and Yip, 1996; Knight, 1999; Javalgi et al., 2003), *inseparability* (Erramilli, 1990; Knight, 1999; Javalgi et al., 2003), *heterogeneity* (Erramilli, 1990;

Knight, 1999), and *perishability* (Erramilli, 1990; Enderwick, 1992; Lovelock and Yip, 1996; Winsted and Patterson, 1998). It has been argued that, because of these particular characteristics, it is much more challenging to deliver services internationally than using operation modes such as exporting, which is a commonly used mode in the manufacturing sector (Erramilli, 1990; Javalgi et al., 2003).

Several researchers have also classified services based around their business processes and service characteristics. One of the most well-known classifications is Erramilli's (1990) *hard- and soft-service*. He classified services based on the degree to which the service product is integrated with a physical product. For example, a music-CD is a hard-service and is thus more easily exportable than a concert which is a soft-service. Other classifications include Clark et al.'s (1996) *contact-based services*, *vehicle-based services*, *asset-based services*, and *object-based services*; and Boddewyn et al.'s (1986) three categories of *foreign-tradable services*, *location bound-services*, and *combination services*.

There is no doubt that, in regard to internationalisation processes, there can be significant differences between service categories (Vandermerwe and Chadwick, 1989; Lovelock and Yip, 1996). Some categories may internationalise in a similar way to manufacturing companies, especially when services are embedded in goods, as in hard-services (Erramilli, 1990) or object-based services (Clark et al., 1996). On the other hand, some categories may require very committed operation modes at the early phase of internationalisation, as location-bound services (Boddewyn et al., 1986), contact-based services, or asset-based services (Clark et al., 1996). Some sectors are more capital intensive and enjoy economies of scale advantages whereas others are more people intensive, and the effect of globalisation drivers varies across these different types of service companies (Aharoni, 1996). To summarize, it could be argued that due to their particular service characteristics, when compared to manufacturing companies, most service companies face additional internationalisation challenges which vary across service sectors.

Network industries are service industries with some unique characteristics. The industry sectors include airlines, utilities, some levels of banking and the telecommunications industry (Shy, 2002).

Ehret (2004) and Fjeldstad et al. (2004) argued that some traditional theories cannot adequately explain the internationalisation process of such sectors. The remainder of this paper therefore will examine the specific factors that may contribute to the internationalisation strategies of these types of companies.

NETWORK INDUSTRIES AND INTERNATIONALISATION

Economides (1996) suggested that in today's economies the role of network industries is fundamental. As already mentioned, network industries are special types of service industries, such as airlines, railways, utilities, telecommunications, banks, postal services, in which networks are an essential part of their operations (Economides, 1996; Shapiro and Varian, 1999; Glachant, 2002; Shy, 2002). Although these sectors share several characteristics with other service industries, they also have their own particular and distinguishing characteristics such as *complementarity*, *compatibility*, *interconnection*, *interoperability*, *network externalities*, *switching costs*, *scale economics of production*, and *the role of the government* (Economides, 1996; Shapiro and Varian, 1999; Liebowitz, 2002; Shy, 2002). This paper seeks to examine a number of these critical characteristics and will focus on network externalities and the role of governments.

NETWORK EXTERNALITIES INFLUENCE ON INTERNATIONALISATION

Network externalities can be understood to exist when the value of a service for customers increases and the per unit production cost for the service provider decreases as the number of users rises (Economides, 1996; Glachant, 2002; Liebowitz, 2002; McGee and Sammut Bonnici, 2002; Shy, 2002). Network externalities have also been referred to as *production externalities* and *positive consumption* by Economides (1996), and play a key role in most network industries. For example, in the telecommunications industry, when the number of users rise, both the value of the service for customers increases and the per unit production cost decreases. However, in the airline industry or in the case of some virtual networks (such as the PC software businesses) the externalities in the production side are evident, but they are less obvious in increased value to customers (Liebowitz, 2002; Shy, 2002).

Generally, both production externalities and positive consumption provide a competitive advantage to larger companies and can result in a *winner take all situation* (Liebowitz, 2002). Proponents of the winner take all strategies base their assumption on positive consumption, which locks customers into the network of the first mover. The lock in, or switching cost, is based on the cost to a consumer of switching to another provider after they have already locked into the service (Liebowitz, 2002). This perception of '*first mover advantage*' or '*winner take all*' situation may result in very aggressive strategies. Companies may deliberately plan to make large initial losses and delay future profits. For example, in many internet-retail businesses these aggressive strategies have been common practise, although it has later become clear that, in some areas, these first mover advantages were not realised (Liebowitz, 2002).

In network industries the risks involved in rapid expansion are even greater than in many other service sectors, due to the fact that they are often very asset specific (Glachant, 2002). The risks of investing upfront to be a first mover may be too great for companies with limited resources. Thus, in a situation where a global strategy would be the optimal solution for a network company, it may be too risky a solution relative to the company's resources due to economies of scale. In addition to network externalities, the role of governments seems to be another contributing factor in network industries, as will be discussed in the next section.

GOVERNMENTS' ROLE IN NETWORK INDUSTRIES

Yip's (1989) research classified globalisation drivers into four main groups *market drivers, cost drivers, competitive drivers, and governmental drives*. His research also suggested that globalisation drivers differ between industries (see Yip, 1989; 2000). Aharoni (1996) argued that, when compared to manufacturing industries, Yip's four globalisation driver groups may influence services differently. For example, he stressed that government-related drivers had relatively high importance for services, in addition to generally more common market and cost drivers.

Due to the special characteristics and often strategic nature and intent of network industries, government policies and regulations play a significant role in their operations (Crystal, 1999; Sarkar et

al., 1999). Some explanation for this is inherently historic because often companies in network industries were previously government-owned monopolies, or at least were heavily regulated.

One reason for this has been the notion of natural monopoly within these industries, or at the very least the regulation of critical elements (Economides, 1996; Glachant, 2002). However, with the development of free trade the debate about the justification for this natural monopoly argument has emerged. For example, Economides (1996) argued that even in cases in which the entrant has higher production costs than an incumbent, there is a positive effect on society because of increased competition. Natural monopolies and the quest for greater competition have been questioned. This has resulted in recent deregulation developments which have caused network industries to enter more market oriented systems (Glachant, 2002). This deregulation has had a great influence on the structures in these industries, although this transformation is still ongoing and governments still play a significant role (Glachant, 2002).

An analysis of government effects on industry structures indicates that, in a monopoly, the value chains of network companies are highly vertically integrated (Economides, 1996; Contractor and Lorange, 2002; Glachant, 2002). However, deregulation has radically changed industry value systems in network industries. In order to maintain their competitiveness companies in these industries have undertaken significant restructuring (Aharoni, 1996). For example, deregulation and this restructuring have contributed to rapid internationalisation of these types of companies (Yip, 1989; Bonardi, 2004). An example of this can be found in the financial sector after the European Union (EU) made the decision to allow free capital flows across its member countries in 1992. This action created a sense of urgency for many European banks and financial companies to enter several European markets (Yip, 1989) a trend which was later followed in other service industries.

Deregulation activities such as these have also been complemented by privatisation developments in many network industries, such as airlines, railways, and utilities (Buckley et al., 2001). This has made it more possible for companies in these industries to diversify some of their activities, and at the same time acquire new operations or form joint-ventures of a scale that was not previously possible

(Buckley et al., 2001). Deregulation and privatisation in these industries has resulted in shifts up and down the value chain, and also enabled horizontal integration across national borders. Developments such as this, together with the perceived first mover advantages, has helped fuel the creation of large MNCs in these industries., Although industry structures remained mostly oligopolistic, competition increased.

Clearly, in spite of substantial structural changes to industry which resulted in increased competition in most developed countries, government control remained significant Therefore, regulation was still used to control network externalities in bottleneck situations (Economides, 1996). This meant that governments maintained rules for interconnection, and often also for industry standards, as it was necessary to ensure the compatibility of services to limit the power of incumbent operators (Economides, 1996).

Glachant (2002) claimed that the traditional economic models, based solely on competitive issues, do not explain all the activities of companies in network industries. He argues that more contemporary models, incorporating the role of governmental institutions, should be applied. Bonardi (2004) asserted that, in addition to economic strategies, it is also necessary to understand a company's political strategies in these types of industries. These findings support Yip's (1989) and Aharoni's (1996) arguments discussed earlier.

Although Glachant's (2002) research did not focus on the internationalisation aspect of network industries, it could be argued that government regulation played an important role in the internationalisation processes of these companies. Bonardi (2004) emphasised the importance of relationships that network companies have developed with home country governments over many years, and how this impacted upon both the domestic and international activities of these companies. As Enderwick (1992) argued one cannot predict how government ownership and intervention may affect the internationalisation of a company

As discussed, governments' role in network industries has been instrumental through the regulation of domestic markets and the ownership of network companies. In addition, the role of home governments has also been important in supporting the activities of companies in international markets (Crystal, 1999). This has been necessary because in respect to their ability to enter foreign markets, companies in network industries have often faced greater barriers than companies in other sectors (Ramamurti and Sarathy, 1997; Crystal, 1999). For instance, companies in network industries have often faced challenges where host countries do not offer reciprocal access to their markets, irrespective of whether entry is direct or through an alliance (Crystal, 1999). As Clougherty (2001) explains, governments act as mediators to protect domestic companies from the influence of globalisation. Many governments deem it to be necessary to protect domestic companies against, for example, US-based service companies, which may have an international competitive edge due to the large size of their domestic market and the economies of scale that result (Crystal, 1999). Although protective barriers and regulations are decreasing because of liberalisation developments, such as the WTO requirements, the process takes time (Crystal, 1999). Due to these recent developments, in many cases the domestic government's role has become critical in assisting the international activities of companies in network industries

Developments such as these have resulted in asymmetric strategies - the blending of defensive and offensive strategies. Somewhat paradoxically companies try to prevent the entry of international competitors into their own domestic markets while at the same time attempting to vigorously compete in international markets themselves (Bonardi, 2004). This asymmetry means that the role of both home and host governments has become very important (Bonardi, 2004). These network industry companies have tried to get their governments to influence another foreign government's decisions on issues such as regulation in their country (Crystal, 1999). Depending on the motivations and agreements between the three parties (the two countries and the company), different asymmetric strategies have emerged, and as a result global strategies are not always available (Bonardi, 2004).

This asymmetry has influenced the internationalisation strategies of companies in network industries in many areas. Firstly, it has affected how companies have been able to integrate their operations

across different countries, as often defensive and offensive strategies have required totally different actions. In addition, asymmetry often has had a great impact on the level of foreign direct investment (Ramamurti and Sarathy, 1997; Crystal, 1999). This has a direct impact on the operational strategies of companies. Also, in many cases this asymmetry has forced companies to avoid other developed markets and enter developing countries with fewer requirements for reciprocal access (Bonardi, 2004). In summary, the political influence that governments can yield in relation to the internationalisation processes of companies in network industries varies significantly from applying to most manufacturing companies (Crystal, 1999).

EFFECTS ON MARKET STRATEGIES

Despite the criticism and more recent research findings on internationalisation process models, *psychic distance* still seems to explain the variation apparent in the international performance and effectiveness of firms (Evans and Mavodono, 2002). For this reason, theories based on manufacturing companies predominantly support the argument that companies first enter culturally and physically close markets. Also some service sectors, such as business services, which internationalise by following their domestic industrialised customers abroad (Aharoni, 1996), often start their internationalisation by entering countries with small psychic distance, although this phase of their internationalisation may be more rapid than in manufacturing industries .

However, several studies have also reported the '*psychic distance paradox*'. Evans et al.(2000) and Tihanyi et al.(2005) argued that due to the opportunities they offer in many industries it is more attractive for an organisation to enter different markets with greater psychic distance. In these cases the psychic distance paradox is apparent as companies from highly developed countries can actually perform better in developing markets.

As discussed, governments' actions have created an environment in which asymmetric strategies prevail in network industries. For example, neighbouring countries may have political ambitions which prevent reciprocity, or there may be other interventionist government measures which shape the industry structure. In many cases this has caused that the barriers for network industry companies to

entry foreign market to be lower for developing countries, in which governments welcome foreign investment, than entering neighbouring developed countries. Moreover, the first-mover advantage, winner take it all situation, and an oligopolistic industry structure, all largely caused by network externalities and the role of the government, as discussed earlier, result in companies in network industries implementing aggressive strategies in their internationalisation. This leads to the first proposition in this paper:

Proposition 1: Companies in network industries enter physically and culturally distant markets early, often even earlier than neighbouring and developed countries, and the role of psychic distance is less significant in their internationalisation than traditional theories would suggest.

EFFECTS ON OPERATION STRATEGIES

Boddewyn et al. (1986), in their classification, noted that in general FDIs, or alternative committed non-equity operations, are required more often in the internationalisation of services compared to manufacturing companies. Whereas Aharoni's (1996) research on business services claimed that the investments in fixed assets are not as large as in services, which are more people intensive. Both these issues could result in services entering international markets more rapidly with committed entry modes.

Proposition 2A: Companies in network industries enter international markets with more committed operation modes than traditional theories based on manufacturing industries suggest, and do it more rapidly.

However, as discussed, in network industries which are asset-specific and location-specific services, the investment required is higher than in most other services, thus increasing risks and creating pressures to internationalise more carefully. Partly because of this, and partly due to some host government regulations discussed earlier, network industries often use joint-ventures as an operation mode to share the risks and to overcome host government restrictions.

Proposition 2B: Companies in network industries enter international markets with less-committed operation modes and less rapidly than business services or other non- asset-specific service companies.

One challenge to traditional internationalisation theories has been the rapid emergence of strategic alliances (Dunning, 1995), as they can offer a flexible and rapid means for a company to internationalise. Alliances can include contractual agreements or informal relationships, such as R&D cooperation and long established buyer-supplier relationships, and also cooperation through equity investments such as joint ventures (Hamel et al., 1989; Gulati et al., 2000; Contractor and Lorange, 2002). In many traditional internationalisation theories this was somewhat overlooked, as they often classified operation modes either as direct investments or as non-committed modes such as exporting. Alliances have become an alternative means for many companies to achieve necessary economies of scope and of scale that would not have been possible using internal resources alone (Dunning, 1995; Bartlett and Ghoshal, 1998; Dunning, 2000; Gulati et al., 2000)

In network industries several characteristics support the creation of international alliances. It is one way to achieve greater economies of scale rapidly, and to overcome some of the challenges created by network externalities and first-mover advantages. In the 1990s, the structures of most network industries were still oligopolistic in many markets, a fact which may have further increased the challenges of market entry and service compatibility. It seems that alliances were essential means to overcome these barriers during the very early phase of internationalisation in these industries (Economides, 1996; Crystal, 1999). Moreover, in order to offer quality services companies needed to ensure interconnection and interoperability across borders. This, Economides (1996) argued, underlined the importance of network links, in spite of different ownership structures between entities. This was partly achieved by government regulation, but also by entering into alliances with other network industry organisations.

In addition, compatibility in the systems offered to end customers, motivated companies to cooperate further (Shy, 2002). Alliances offered an opportunity to cooperate with other companies in R&D and

production, which was especially important in industries with rapid international expansion of innovations (Contractor and Lorange, 2002). So, as a result of general deregulation developments and the following unification of standards across borders, alliance formation intensified, with many network industry companies such as utilities, financial institutions, and airlines entering into international alliances (Contractor and Lorange, 2002). Furthermore, it would appear that for companies from countries with more limited resources, alliances offered an opportunity to expand internationally at a lower risk. This may become more important especially in asset-specific sectors such as most network industries. This discussion leads to the following proposition:

Proposition 2C: Companies in network industries enter alliances at the very early phase of their internationalisation process.

EFFECTS ON ORGANISATION STRATEGIES

Stopford and Wells (1972) argued that the form of MNC organisation develops in stages, starting from international, then through two alternative paths of worldwide product or international area organisation, towards a global matrix organisation. This view would also support internationalisation process theories that, as previously noted, suggest international commitments are gradually increased. Bartlett and Ghoshal's (1992) subsequent classification was based on Stopford and Wells' research and defined four different types of MNCs: *international*, *multinational*, *global*, and *transnational*. These depend, on a company's environment and the development phase in which it operates.

Using Bartlett and Ghoshal's (1992; 1998) classification, most traditional companies export products from their domestic manufacturing plants in the early phase of their internationalisation, and are deemed to be *international*. Later, when more adaptation and larger investments in host markets are required, companies apply *multinational* or multidomestic strategies, decentralising their decision-making and committing more resources internationally. However, as globalisation development accelerates, many companies transfer to *global* companies with standardised strategies and centralised organisation forms. This pattern was especially evident in the electronic manufacturing industry, with many Japanese MNCs introducing global strategies. The fourth organisational structure in Bartlett and

Ghoshal's (1992; 1998) definition is a *transnational* company, which combines some of the benefits of a multinational strategy and some of a global strategy - organisational decentralisation is emphasised but the firm has regional competence centres. However it typically utilises global enablers by sourcing resources and sharing knowledge internationally.

As argued in the literature on service internationalisation more generally, international organisation service structures vary, when compared to manufacturing companies. As a result, a network industry factor such as 'limited cooperation' between different governments (resulting, for example, in different technological standards or different regulations) may have made it more challenging for management to implement global strategies (Bonardi, 2004). Benefits in implementing a global strategy do not arise easily in this type of asymmetric environment. The emphasis on domestic markets is in defensive political strategies, whereas in international markets more expansive and growth oriented offensive strategies are required. Thus, multidomestic strategies seem to be more common in several network industries (Sarkar et al., 1999; Bonardi, 2004). Moreover, multidomestic strategies are also more feasible when a company is not able to enter most major markets and/or when it enters both developed and developing countries (Bonardi, 2004). As noted in the discussion on market strategies, this often is the case in network industries.

Often it is assumed that global strategies in deregulated network industries fit only the very few major dominant players (Bonardi, 2004). However, as multidomestic strategies do not require entry to each major target market globally, they may better fit network industry companies, especially those with more limited resources.

Proposition 3: Companies in network industries follow multidomestic, rather than international or global strategies.

SUMMARY

In summary, while the benefits of the traditional process theories have been acknowledged, this paper also suggests that, an approach that is more contingency-based, such that it pays attention to special characteristics of an industry, can increase our understanding of a firm's internationalisation process. Network industries are an identifiable group within the service sector that share many similar characteristics and the internationalisation processes of network industry companies seems to follow a particular path. This discussion therefore suggests that more focused research on this sector demands our attention because of their uniqueness. Some of the characteristics and factors influencing the internationalisation of network industries including the influence of network externalities and the role of governments have been highlighted. Based on this theoretical discussion, propositions on the particular market, operation, and organisation strategies have been developed.

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