



Internationalization and the performance of born-global SMEs: the mediating role of social networks

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Abstract

This paper offers a social network explanation for the purported relationship between internationalization and firm performance in the context of born-global small and medium enterprises (SMEs). We argue that home-based social networks play a mediating role in the relationship between inward and outward internationalization and firm performance. The mediating mechanism is attributed to three information benefits of social networks: (1) knowledge of foreign market opportunities; (2) advice and experiential learning; and (3) referral trust and solidarity. Using survey data from SMEs in the largest emerging economy of China, we found some support for this mediating role of social networks in the form of *guanxi*. The results imply that international business managers should consider social networks as an efficient means of helping internationally oriented SMEs to go international more rapidly and profitably.

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Introduction

Research on the internationalization of small and medium enterprises (SMEs) has recently captured growing interest of scholars (e.g., Oviatt and McDougall, 1994; Knight and Cavusgil, 1996; Autio, 2005; Rialp *et al.*, 2005). As observed today, international entrepreneurial SMEs are capable of exploiting global market opportunities more rapidly and efficiently. Among them, more and more SMEs participate in international activities shortly after their inception, an international born-global phenomenon (Rennie, 1993; Oviatt and McDougall, 1995; Knight and Cavusgil, 1996). It has been noted that internationalization (such as outward market seeking or inward foreign resource acquisition) tends to be a successful strategy for born-global SMEs to access and exploit the vast global business opportunities that were previously capitalized almost exclusively by large, established companies (Knight and Cavusgil, 1996; Madsen and Servais, 1997). Yet theoretical development in the performance implications of rapid internationalization has become a central topic of debate in the emerging international entrepreneurship field (Autio *et al.*, 2000; Zahra, 2005).



A review of the extant literature shows that, for the past three decades, international business scholars have sought to understand the internationalization–performance relationship. A variety of theoretical perspectives and frameworks have been advanced in the field, such as foreign direct investment theories (e.g., Grant, 1987; Tallman and Li, 1996), the theory of the multinational firm (e.g., Gomes and Ramaswamy, 1999), and an organizational learning perspective (Ruigrok and Wagner, 2003). Interestingly, empirical results based on these streams of research have been mixed and inconsistent. The findings ranged from a positive linear relationship to U-shaped, inverted U-shaped, or S-shaped relationships (see, Sullivan (1994) and Annavarjula and Beldona (2000) for a review). Recent research suggests that theoretical conceptualization of the relationship and empirical gaps continue to bedevil researchers (Thomas and Eden, 2004). Although most of these confusing results are generated from large, multinational firms, this internationalization–performance link is also complex and less conclusive in the context of SMEs, particularly among early internationalizing firms (Autio *et al.*, 2000; Zahra *et al.*, 2000; Lu and Beamish, 2001; Moen and Servais, 2002).

These mixed results represent a challenging and interesting issue in the literature. The issue is challenging because internationalization in SMEs is a complex phenomenon that may involve some intermediate steps that do not directly influence firm performance. It is interesting because recent theoretical development in the international entrepreneurship literature emphasizes how and why the dynamics of internationalization of born globals lead to superior performance (Etemad and Wright, 2003; Knight and Cavusgil, 2004; Oviatt and McDougall, 2005).

We believe that the conflicting results in the prior literature are due in part to the fact that existing studies have focused largely on the direct influence of internationalization on performance, and have ignored the indirect mediated effects. Therefore in this study we seek to shed light on the issue by examining the underlying mechanism of the influence of internationalization on firm performance. Particularly, seen from the theorization of internationalization defined as a dynamic process through which internationally oriented firms are engaged in a diverse range of cross-border network relations and exchanges (Welch and Luostarinen, 1993; Ellis, 2000), we propose home-based social

networks as a mediating factor linking internationalization orientation to firm performance.

Social networks, broadly defined as a web of personal connections and relationships for the purpose of securing favors in personal and/or organizational action (Granovetter, 1985; Burt, 1992), are at the core of network resources for the organizations involved (Adler and Kwon, 2002). In organizational settings, social networks may involve social relationships among individuals embedded in a formal structure of business connections, such as buyer–supplier relationships or strategic alliances (Björkman and Kock, 1995), but in this paper we focus on social networks as an informal structure of personal relations bounded in geographical, social, or institutional space (Hitt *et al.*, 2002; Sorenson, 2003). Such networks are mostly characterized as personal ties and connections that are built upon goodwill and trust (Chen, 1994). The social and spatial closeness of the actors form the basis of home-based social networks (Sorenson, 2003), the part not governed by the formal structure of business relationships.

For international entrepreneurial SMEs, we argue that home-based social networks represent an efficient means to respond to the demand of global supply chain networks. The rationale is that such network ties are vital for internationalizing SMEs to identify global market opportunities and to extend connections with foreign intermediaries (Ellis, 2000; Ellis and Pecotich, 2001). In addition, trust-based personal connections and referral can also facilitate the key capabilities of these firms in terms of the speed and flexibility of response to global markets (Oviatt and McDougall, 2005). These benefits are seen to reduce information and knowledge barriers, thereby facilitating successful cross-border business operations and improving transaction cost efficiency. Accordingly, home-based social networks are believed to be a critical factor in mediating the performance impact of internationalization (both outward and inward). This mediating effect would suggest that there is an underlying network-based mechanism through which a firm's international orientations contribute to its superior performance.

From an institutional point of view (Redding, 1991), such a network mechanism seems particularly important to newer, international entrepreneurial SMEs in emerging economies like China, where personal connections such as *guanxi* serve as the metaphor for doing business and understanding economic transactions (Redding, 1990; Luo, 2000).



In China, *guanxi* is a cultural characteristic, and its utilization in business dealings is a strategic response to the unpredictability of government action and control: thus it can substitute for formal institutional support (Xin and Pearce, 1996). In the context of internationalization, *guanxi* with outsiders is a crucial aspect of the internationalization process, and its workings are likely to replicate the networking processes inside China, following more or less the same rules. The absence of institutional trust, combined with the prevalence of active mistrust of strangers and severe shortage of reliable market information, leads to an absolute reliance on trust-based personal connections as a means for almost any transaction (Redding, 1991; Lovett *et al.*, 1999). Under these conditions, early internationalizing SMEs would find it more rational to exploit *guanxi*-related social networks and to extend them across borders for economic action.

Using a sample of SMEs in China, we find a significant mediating role of home-based social networks (*guanxi*). Our results uncover some new insights that help explain the pathway through which international orientations are translated into firm performance (export growth, profitability growth, and sales growth). This study lends support to the social network perspective on the internationalization of SMEs, in that a network-based approach is more than a description of the process (Chen and Chen, 1998; Ellis, 2000; Harris and Wheeler, 2005). Rather, it is linked to strategic value and performance outcomes in that it provides an efficient way of doing international business. The conclusion drawn from this study suggests that newly internationalizing SMEs can leverage home-based social networks to enhance firm performance in today's dynamic and turbulent business environment. Next, we review the internationalization literature and social network research, followed by the development of the mediating hypotheses.

Social networks in internationalization

Internationalization orientations

The existing internationalization literature suggests two distinct types of internationalization orientation: outward internationalization (e.g., seeking and selling in foreign markets, developing alliances with foreign businesses) and inward internationalization (e.g., utilizing management skills, new technology, and direct investment from foreign countries) (Welch and Luostarinen, 1993). It has been suggested that outward internationalization

orientation can stimulate firms to benefit from potential opportunities such as learning new technologies and the needs of international markets (Francis and Collins-Dodd, 2000; Zahra *et al.*, 2000; Ireland *et al.*, 2001) and from gains related to the scale and scope of economies achieved from larger volumes of sales and production made possible by revenue growth in the geographic extension of markets (Kogut, 1985).

In contrast, inward internationalization orientation can enhance firm performance through learning about or utilizing foreign technologies, management skills and capital investment (Buckley *et al.*, 2002). With proper digestion and utilization of complementary resources and capabilities introduced by foreign firms from more developed economies, local SMEs are able to enhance their competitive advantages and improve their performance. Wan and Hoskisson (2003) argue that, through access to more capable foreign partners, local firms could overcome inadequacy in production capacity and enhance institutional support.

However, prior literature focusing on the direct influence of internationalization orientation on firm performance has not yet explained why this influence exists. We draw on the social network theories and explain the performance implications of internationalization in SMEs. In line with the theorization of internationalization of SMEs as a process of social dynamics through networking strategies (Ellis, 2000; Harris and Wheeler, 2005), we postulate a mediating mechanism of social networks underlying the relationship between internationalization orientations and performance outcomes.

Social networks

While network relationships have long been recognized to be indispensable for SMEs to achieve international growth (e.g., Johanson and Mattsson, 1988; Coviello and Munro, 1997; Lu and Beamish, 2001; Hadley and Wilson, 2003), a particular focus on social networks has been limited to date (Ellis and Pecotich, 2001; Harris and Wheeler, 2005). Scholars have recently emphasized that informal social networks or networks of social relationships serve as the initial basis from which formal networks of business linkages are developed in new territories (Chen and Chen, 1998; Chen, 2003), and through which exporting relationships are formed (Ellis, 2000; Ellis and Pecotich, 2001). In particular, empirical findings support that social networks are vital to the identification of new opportunities

(Ellis and Pecotich, 2001), to gain access to foreign markets (Ellis, 2000), and to develop specific competitive advantages through the accumulation of international knowledge and/or the development of formal business linkages across borders (Styles and Ambler, 1994; Sapienza *et al.*, 2005).

In particular, Liesch *et al.* (2002) indicate that building and maintaining network relationships are considered an integral part of the internationalization process, as both outcomes and inputs into the process. As an outcome, it is imperative for internationally oriented SMEs to resort to relationship networks (such as *guanxi*) that can provide valuable information benefits (Ellis, 2000). As an input, the information benefits of social networks could influence the performance impact of internationalization strategies (McAuley, 1993; Liesch and Knight, 1999).

This stream of research draws our attention to the informal social network (e.g., *guanxi* in China, *kankei* in Japan, *immak* in Korea, or *blat* in Russia) as a preemptive strategy to access information and deploy the relevant resources in a timely and flexible fashion. Particularly, because it is embedded in the world's largest emerging economy (China), the *guanxi* network (Peng and Luo, 2000; Park and Luo, 2001) may offer a more fascinating context in which to explore the potential contribution of social networks to the internationalization process of SMEs. In addition, the focus on the emerging born-global SMEs from China's private sector presents the opportunity for a more complete understanding of the phenomenon of early internationalizing firms across the world markets (Rialp *et al.*, 2005).

Guanxi, as the Chinese version of social networks (Lin, 2001a, b; Tsui *et al.*, 2000), can be regarded as a form of relationship exchange that reflects the basic idea of network capitalism – a system of reciprocity, trust, and interdependencies that creates value through the effective use of social capital (Redding, 1990; Boisot and Child, 1996). In the business context, *guanxi* networks have been extensively studied (Xin and Pearce, 1996; Peng and Luo, 2000; Park and Luo, 2001). According to these scholars, *guanxi* networks are often characterized by informal interpersonal connections that are influenced by hierarchical Chinese cultural values and bonded with reciprocal expectations. Thus these social ties embody both the traditional Chinese culture and a conscious choice on the part of individuals opting for personalized contacts and relationships. Such social networks can provide unique information

benefits to those who are connected by exclusive or non-redundant personal ties, irrespective of whether the nature of the social relations is strong or weak (Burt, 1992, 1997). It is now widely recognized that *guanxi*-related networks are able to reduce transaction costs or increase transaction values through facilitated exchange of resources, information, and knowledge (Standifird and Marshall, 2000; Luo, 2003).

The mediating role of social networks

In this section we develop our key proposition that social networks mediate the performance impact of internationalization for SMEs. We explain that internationally oriented SMEs deploy home-based social networks as an efficient means of obtaining information resources and developing business connections not otherwise available, owing to the liability of their newness and smallness. Particularly, seen from the research on social networks within the sociology literature (Granovetter, 1973, 1985; Burt, 1992, 1997) and the multiple lines of empirical research documented in the management and international business literatures (Ellis, 2000; Ellis and Pecotich, 2001; Adler and Kwon, 2002; Harris and Wheeler, 2005), we draw out three particular information benefits to explain the mediating mechanism of home-based social networks:

- (1) knowledge of foreign market opportunities;
- (2) advice and experiential learning; and
- (3) referral trust and solidarity by a third party.

We content that these benefits can help internationalizing firms overcome the resource limitations that frequently constrain an SME's international expansion (Lu and Beamish, 2001) and establish legitimacy and credibility, and facilitate the development of new capabilities for international expansion at lower risks (Zaheer, 1995; Zaheer and Mosakowski, 1997). These benefits reinforce the idea that internationalization *per se* is not a sufficient condition for superior performance in the context of SMEs, particularly for young internationalizing firms (Zahra *et al.*, 2000; Zahra, 2005).

Theoretical nature of social networks

The central foundation of social network theories is the transmission of knowledge or useful information through interpersonal ties and social contacts with individuals (Mitchell, 1969; Rogers and Kincaid, 1969; Weimann, 1989). The relational theory of social networks (Granovetter, 1973,

1985) states that sporadic interactions of weak ties are effective means for gaining novel information and accessing to diverse pools of information sources. In contrast, strong ties are characterized by frequent and stronger social interactions, where information is perceived to be more trustworthy (Granovetter, 1985), and thus more effective in the transmission of tacit, complex knowledge for experiential learning (Borgatti and Cross, 2003; Sorenson, 2003).

The structural theory of social networks (Burt, 1992, 1997) also emphasizes the information value of social interactions and personal contacts. In particular, Burt's (1992) notion of 'structural holes' features both an appeal to the brokering opportunities of a social network full of disconnected contacts and an appeal to the advantages of the diversity of information and, implicitly, tacit knowledge and learning that could take place with access to timely information and referrals to other contacts in the network. Given that individuals linked within the same social network tend to have redundant information, the spread of novel information about new ideas and opportunities typically comes through those bridging ties that link individuals in separate networks of social relations (Burt, 1997).

Social network theories are of growing significance in various literatures, including organizational studies (e.g., Batjargal, 2003; Borgatti and Cross, 2003), strategic management (e.g., Adler and Kwon, 2002; Inkpen and Tsing, 2005), international marketing (e.g., Cunningham and Homse, 1986; Ellis and Pecotich, 2001) and the most recent entrepreneurship and international business research (e.g., Ellis, 2000; Harris and Wheeler, 2005). In the extant literatures, however, many different terms have been used to describe the meaning of social networks, such as social ties, interpersonal relationships, personal connections, social relations, and relational networks. According to Björkman and Kock (1995), the social network is the network of individuals who are linked through interactions consisting mainly of social exchanges, but information and business exchanges can also take place through those social relations. In their view, social networks are concerned with 'social relationships' that may have an impact on formal business relationships. As a result, they emphasize the broader notion of the social network to include personal relationships with business professionals and government officials, as well as with friends and relatives. Above all, the social network is

referred to as the totality of persons connected by social relationships within a bounded population (Burt, 1992).

In a series of writings, Lin (2001a, b) emphasizes that social networks or informal networks of relationships capitalize on network resources that occupy more formal strategic network relationships and result in significant organizational advantages. Such a conceptualization can be illustrated with the example that

a manager, through his or her own social relationships and personal connections, can help his or her company set up a joint venture with another company. In this case, organizational social capital is created on the basis of individual social capital.' (Inkpen and Tsing, 2005: 151)

Thus the social network perspective is regarded as more fundamental to the study of network relationships and effects. It provides a foundation for describing and characterizing a firm's set of formal networks of relationships and organizational actions (Gulati, 1995; Adler and Kwon, 2002; Hitt *et al.*, 2002; Inkpen and Tsing, 2005).

Information benefits as explanation for the mediating mechanism

Seen from the social network theories, personal ties and connections play the role of 'infomediaries' in facilitating exchange of the most valuable information. More importantly, the bridging ties that link people in separate social clusters can be extended to identifying foreign market opportunities and to facilitating exchanges and market transactions with foreign intermediaries (Ellis and Pecotich, 2001; Harris and Wheeler, 2005). Multiple lines of empirical research have confirmed the importance of social networks as conduits for information and knowledge flows in:

- (1) helping stimulate awareness of foreign market opportunities (Reid, 1984; Gould, 1994);
- (2) influencing export initiation (Ellis and Pecotich, 2001);
- (3) helping identify foreign exchange partners (Ellis, 2000);
- (4) providing tacit knowledge about international business practices (Eriksson *et al.*, 1997; Sharma and Blomstermo, 2003; Haahti *et al.*, 2005); and
- (5) helping sharpen international vision and managerial openness (Chen, 2003; Yeoh, 2004).

These studies emphasize the strategic value of social network ties in the context of internationalization for: (1) knowledge of foreign market opportunities;

and (2) advice and experiential learning about cross-border business operations.

Concerning the third benefit – referral trust and solidarity – it has been shown that social clusters of contacts can be an important source of referral for endorsement of an entrepreneur's personal trust or the assurance of economic transactions involved with external parties (Burt, 1997; Stuart *et al.*, 1999). Such referral trust often takes place because strong social norms and beliefs, associated with a high degree of closure of the social network, encourage compliance with business rules and customs (solidarity benefit of social networks), and thus reduce the need for formal controls (Adler and Kwon, 2002). The referral and solidarity benefit can be an effective means to enhance legitimacy and credibility, and reduce inferred uncertainty by external parties (Zaheer, 1995; Xin and Pearce, 1996).

Internationally oriented SMEs seek entrepreneurial opportunities and economic returns, requiring an appropriate mechanism for resources, information, and knowledge (Zahra *et al.*, 2000). Given the various benefits or strategic value of social networks, we assume that international entrepreneurs have the desire and effort in exploiting informal social ties with external entities and extending social interactions and clusters necessary for opportunity identification and resource mobilization. Therefore it is imperative for internationally oriented SMEs to rely on social networks for the particular information benefits in the course of internationalization. This explains the first mediating condition – how internationalization is related to the social network. Next, we explain the second mediating condition – how the social network is related to performance in the course of internationalization for SMEs.

Performance impact of social networks

There is a wealth of literature to support the link between social networks and firm performance. In the context of China, the strategic response mechanism of *guanxi* networks and their contribution to firm performance have been extensively studied. For example, Luo and Chen (1997) find that *guanxi*-based business variables such as sales force marketing and credit-granting have a systematic and favorable effect on a firm's profitability, asset turnover, and domestic sales growth. Peng and Luo (2000) demonstrated that managers' interpersonal ties with top executives in other firms and with government officials help improve business performance on market share and return on assets.

Wu and Leung (2005) further confirm the micro–macro link between managers' personal ties and firm performance. According to Park and Luo (2001), *guanxi* networks affect the flow of resources and a firm's interaction with the external environment, and benefit market expansion and competitive position of the firm, leading to improved performance outcomes, primarily on sales growth.

Yet the performance impact of social networks is not unique to China. In other countries, such as post-Soviet Russia, there is also evidence showing that informal social networks of entrepreneurs affect the performance of their firms (Batjargal, 2003). The information and resource aspects of personal networks are believed to benefit firms' financial indicators such as revenue and profitability (Peng and Luo, 2000; Batjargal, 2003).

In the course of internationalization for SMEs, the workings of *guanxi*-related social networks are seen to play an equally, if not more, important role in contributing to performance outcomes such as sales, profit and export performance. Zahra (2005) has drawn our attention to social and market learning as important sources of new and rich knowledge, enabling international new ventures to succeed in international markets. Yeoh (2004) validates that personal sources of information and social contacts and connections with other network individuals contribute positively to the export performance of internationalizing SMEs. A recent study of rapid internationalization of SMEs also lends support to the existence and importance of this micro–macro link (Loane and Bell, 2006). Loane and Bell (2006) find that internationalizing SMEs have exploited personal networks and social networks to gain an entrée to decision-makers in target firms, and gather knowledge and resources. Other studies into early internationalization have generally pointed to the information benefits of business and social networks, both within and beyond domestic markets, in relation to the growth and success in entrepreneurial firms (Sharma and Blomstermo, 2003; Harris and Wheeler, 2005).

Social networks often are critical to providing the type of information that can help firms reduce the risk and uncertainty inherent in international operations (Liesch *et al.*, 2002). Moreover, these networks have the advantages of transmitting personal and experiential information more effectively, being flexible and adapting more quickly to changing circumstances (Burt, 1997; Liesch *et al.*, 2002). The speed and flexibility of response that such loose network ties make possible may repre-

sent a key capability that underpins the rapidity of born-global internationalization (Oviatt and McDougall, 2005). In particular, with the capability of speed and flexibility, social networks monitor the aforementioned information benefits more effectively than they can be monitored bureaucratically (Standifird and Marshall, 2000), which adds the time value to the success of rapid internationalization.

Given the various benefits or strategic value of relationship networks, we postulate that internationally oriented SMEs can make use of *guanxi*-related social networks to save information search costs (knowledge of foreign market opportunities), lower risks and uncertainties in foreign markets (advice and experiential learning), and reduce transaction costs (referral trust and solidarity). Through extending the relationship ties necessary for opportunity identification, resource mobilization and market learning (Harris and Wheeler, 2005; Zahra, 2005), the performance impact of internationalization is enhanced.

Hypotheses

In the previous section, we provide a theoretical explanation for the mediating conditions and mechanisms of social networks regarding the relationship between internationalization and performance. In considering the conceptual distinction between outward and inward internationalization processes (Welch and Luostarinen, 1993), we further articulate the mediating function of such network ties underlying each path of the internationalization orientations, and develop our key hypotheses related to *guanxi* networks in the empirical setting of China.

The mediating path for outward internationalization orientation

Internationalizing SMEs face constraints arising from their intrinsic deficiencies in resources and capabilities. They are vulnerable to environmental changes at both home and abroad. Such constraints make internationalization a daunting challenge to most SMEs (McDougall and Oviatt, 1996). Added to the challenge, internationalizing SMEs from emerging economies also face the liabilities of foreignness and newness. By accessing information and knowledge base, an internationalizing SME can expedite its learning process and minimize risks (Eriksson *et al.*, 1997; Leonidou and Theodosiou, 2004). Hence social networks offer a potentially efficient way to overcome resource and capability

deficiencies and enhance the likelihood of success for internationalizing SMEs.

For the choice of outward internationalization among internationally oriented SMEs, the embedded social networks are needed, as such networks can act as bridging ties that are flexibly connected in some way to a particular foreign market (Ellis, 2000). Given the particular information benefits derived from the key sources of personal connections (e.g., knowledge of foreign market opportunities; advice and experiential learning; and referral trust and solidarity by a third party), we expect the mediating function of *guanxi*-related social networks to the performance impact of outward internationalization. Such mediation seems critical to reduce the information and knowledge barriers or improve the quality of exchanges for the success of the exporting behavior (Ghauri *et al.*, 2003; Leonidou and Theodosiou, 2004), an important mode of outward internationalization for SMEs (Welch and Luostarinen, 1993).

Similarly, in the growing number of cases of the sharing of manufacturing chains between specialized SMEs from a world of developing and developed countries (Donckels and Lambrecht, 1995; Etemad *et al.*, 2001), including the special case of exchange relationships between the original equipment manufacturer (OEM) suppliers in developing countries and their developed country multinational buyers, *guanxi*-related networks would be an elegant and efficient response to this fact of life, serving to tie together an otherwise highly diffracted system (Ellis, 2000). This is mainly because referral trust and solidarity derived from such network ties establish reciprocity and moral obligation. As such, transactions come to be guaranteed by bonds of interpersonal trust, thereby leading to transaction cost efficiency (Standifird and Marshall, 2000). Moreover, as a result of trust-based personal connections, the speed and flexibility of response would be made possible, the key capability of *guanxi* networks that underpins the attraction of Chinese SMEs (e.g., Chinese OEM suppliers) in world markets.

The above discussions lead to the following hypothesis concerning the path of outward internationalization:

Hypothesis 1: *Guanxi*-related social networks mediate the relationship between outward internationalization orientation and firm performance.

The mediating path for inward internationalization orientation

We further argue that a similar rationale can be applied to the path of inward internationalization orientation. The complexity of domestic market environments in emerging economies imposes constraints on inward internationalization of SMEs. Such constraints inflate the liabilities of smallness and newness, and make an SME's inward internationalization a challenge as well. In China, home-based social networks represent an important source of information and knowledge to SMEs for developing new organizational capabilities (Park and Luo, 2001). Hence such network ties are more likely to be exploited by SMEs for enhancing the likelihood of success in inward internationalization.

In the extant internationalization literature, it has been shown that sustaining successful international business relationships is highly desirable by both exporters (outward internationalization) and importers (inward internationalization) (Evangelista, 1996). This is because international trade and collaboration is an exchange process that begins with the exchange of information regarding the matching of a product or foreign technology with a perceived market need at home or abroad (Toyne, 1989; Liang and Parkhe, 1997).

Seen from this perspective, we expect that the particular information benefits of social networks can be more or less equally critical, regardless of the directional nature of internationalization orientations. Like the case of outward internationalization, firms with inward orientation can also make use of the key sources of social networks for:

- (1) the knowledge of a foreign-sourced product or technology for their home markets;
- (2) advice and experiential learning about foreign partners and arising business opportunities; and
- (3) referral endorsement to build trust to attract foreign technologies, capital and management skills.

These particular information benefits may drive the performance impact of the inward internationalization orientation – the mediating function.

Given the absence of institutional trust, the prevalence of mistrust of strangers in business dealings, and the severe shortage of reliable market information – conditioning features inside China (Redding, 1991; Xin and Pearce, 1996) – there are also practical benefits to be derived from connectivity with many more third parties, especially with

local government and other supporting agencies (Peng and Heath, 1996). The potential benefits would involve establishing both internal and external legitimacy, obtaining valuable business information, and/or reaching business deals from the protection of referral endorsement and solidarity, all of which are expected to lead to transaction cost efficiency and better performance outcomes (Peng and Luo, 2000).

In addition, from the lens of outsiders operating inside China, there is evidence showing the strategic response of foreign companies to build a broad range of *guanxi* networks for business opportunities, local resources or protection there (Björkman and Kock, 1995; Davies *et al.*, 1995; Luo, 1997; Yi and Ellis, 2000; Wang and Ellis, 2002). Following the logic, the performance outcomes of inward internationalization for local firms could be enhanced by accessing the brokering opportunities of home-based *guanxi* networks with the network ties developed by foreign firms at the home market (Burt, 1997).

Taken together, the following hypothesis is proposed concerning the path of inward internationalization:

Hypothesis 2: *Guanxi*-related social networks mediate the relationship between inward internationalization orientation and firm performance.

Methodology

Sample and data collection

Data for this study were collected from the SMEs located in China's economically developed Eastern Province of Zhejiang (adjacent to Shanghai). Zhejiang is widely regarded as an exemplar of China's transition from a centrally planned economy to a market-based economy. More importantly, firms from this region are generally considered among the most entrepreneurial and internationally oriented enterprises in China. As most SMEs in this region are developing an international orientation from start-up, this makes them a suitable target for our research.

Many previous studies have recognized the difficulties in collecting primary data from firms in China (e.g., Peng and Luo, 2000; Brouthers and Xu, 2002). In order to remedy the problems, such as low response rate, distrust, and managers' unwillingness to respond, we used local research assistants to conduct interview-based questionnaire surveys with top managers. A group of 12 senior-level

business students from a well-respected local university were trained to conduct face-to-face field visits during the period July to August 2003. Each of those selected students was provided with financial support to go back to his or her hometown and serve as a local interviewer. This was considered an important means of gaining access to the respondents. The research assistants were instructed to take, in person, an official letter (issued by the local university) to the top managers of the selected firms, and they were urged to spend most of their allotted time building trust with managers prior to conducting the questionnaire survey.

At the locations to which those interviewers could gain access, a sample of 250 firms (with 50–500 employees and annual sales of no more than 30 million yuan) was randomly selected from the *Zhejiang SME Directory*. Roughly 30 enterprises were selected in each of the target township areas. Further, among those selected firms, 87 did not meet the basic criteria for born-global firms: (1) the number of years delayed – three years or less from domestic establishment to internationalization (including exporting and importing activities); and (2) the significant export involvement – at least 10% of sales from exporting. These criteria are arbitrarily used in previous studies on early internationalizing firms (e.g., Zahra *et al.*, 2000). Our use of born-global firms to test the postulated research proposition – the mediating role of social networks – was an effort to capture the growing interest of the most recent literature on the phenomenon of born-global internationalization (Rialp *et al.*, 2005).

After the screening procedure, a qualified sample of 163 firms remained for follow-up. Through formal and informal sources of information, we got the names of top managers from the remaining sample, and the official letters were then prepared and addressed directly to the individuals identified. This made it easier to gain managers' willingness to respond to our survey. An effort was made to describe clearly in the letter the purpose of the survey and why managers should assist with the study. The participating managers were told that they were cordially invited to participate in a research project about the internationalization of SMEs in China. They were promised a summary survey report if needed. A souvenir (a leather wallet) was given to managers who were willing to partake in the survey, as a token of our appreciation.

Thirty-four firms were further dropped from the survey for the reason of either unwillingness to participate or unavailability of key individuals in

the sampled firms. Thus the final sample contains a total of 129 SMEs. The annual sales of the sample ranged from 1 million yuan to 30 million yuan, with a mean value of 9.6 million yuan. Most of the enterprises (85%) had been in business for at least 5 years. The products manufactured included a diversity of consumer and industrial goods. A majority of the respondents had worked in their present organization (80%) and in their current position (67%) for at least 3 years. Most of the managers (87%) were between 25 and 50 years of age and had attended management training programs (80%). All respondents were involved with strategic business activities, as defined by their position or role and decision-making responsibilities. The positions of the respondents include general managers (28%), vice-general managers (20%), marketing managers (30%), and business directors (22%).

To ensure data validity, a follow-up telephone interview was conducted with 30 respondents (who were randomly selected from the sample) by one of the researchers shortly after the main survey was completed. We asked them to indicate their responses to a set of selected questions used in the previous questionnaire. The post-survey reports were fairly consistent with the survey responses (Pearson correlation coefficients ranged from 0.84 to 0.93). This suggests that the respondents provided reasonably valid responses in the main survey interviews. This approach seems to be practical yet effective enough to ensure the validity of data collection, especially when it involves Chinese senior managers (Peng and Luo, 2000). We also tested the existence of common method bias with Harman's one-factor test (Podsakoff and Organ, 1986). More specifically, common method concern is high if a single factor can be extracted to explain a majority of the variance of the data. Results of the factor analysis did not indicate a single-factor structure, suggesting that common method variance is not a critical concern in the sample.

Measures

As part of a large-scale research project on the internationalization of SMEs in China, the survey questionnaire we used contained, in addition to the measures reported in this paper, a number of other measurement items, such as international market orientation, entrepreneurship, and marketing strategy. In this paper, we focus on the measures pertinent to the purpose of our research (i.e., outward and inward internationalization orientation

strategies, *guanxi* networks, export performance, profitability performance, and sales performance) as well as on the baseline information for both respondents and their enterprises.

We created a number of new measures specifically for the study. The *inward-internationalization orientation strategy* scale ($\alpha=0.73$) consisted of three items:

- (1) utilized advanced management skills from foreign countries;
- (2) utilized advanced and new technology from foreign countries; and
- (3) utilized foreign direct investment.

The outward-internationalization orientation strategy ($\alpha=0.89$) was measured using two items:

- (1) aggressively seek foreign markets; and
- (2) develop alliances with foreign partners.

These two sets of measures manifest the conceptual distinction between outward and inward internationalization developed by Welch and Luostarinen (1993).

Guanxi networks ($\alpha=0.82$) represent different types of network ties that include:

- (1) cultivate ties with local government agencies;
- (2) utilize local social networks; and
- (3) strengthen ties with local communities.

All three of these sets of measures (inward and outward internationalization orientation strategies, and *guanxi* networks) were scaled from 1 (primary focus) to 4 (not important all).

As frequently used in previous studies (e.g., Park and Luo, 2001), business performance is referred to the most recent 3 years and measured by three self-reported financial indicators: *export growth* (i.e.,

percentage of primary product export sales to total sales over the past 3 years), *profitability growth*, and total *sales growth*. Profitability growth was measured relative to the average of the enterprise's relevant industry. Partial correlation coefficients between these focal variables are summarized in Table 1.

Results and analysis

The key objective of this study was to examine the mediating role of *guanxi*-related social networks in the relationship between internationalization and performance. Recall that our first hypothesis (H1) focuses on the mediating path for outward internationalization, whereas the second hypothesis (H2) is concerned with the mediating path for inward internationalization. Figure 1 presents our model with the mediation of *guanxi* networks. We estimated this model using a structural equation approach with the software called AMOS (Arbuckle, 1999). As shown in the figure, the overall goodness-of-fit statistics indicated a reasonable model fit ($\chi^2=94.26$, d.f.=56; GFI=0.895; AGFI=0.874; CFI=0.912; RMSEA=0.064). Thus this model was accepted for further hypothesis testing.

Examination of the mediation effects

To examine the extent to which *guanxi* networks mediate the influence of outward and inward internationalization orientations on performance measures, we relied on the three-step mediated regression approach recommended by Baron and Kenny (1986). To meet the first mediation condition, we found that both outward and inward internationalization orientations are significantly related to *guanxi* networks (outward: $\beta_1=0.16$; inward: $\beta_2=0.25$), thus satisfying the first condition of mediation (Baron and Kenny, 1986: 1176).

Table 1 Correlation results

Variables	X_1	X_2	X_3	X_4	X_5	X_6	X_7	X_8	X_9	X_{10}	X_{11}
Outward internationalization X_1	1.00										
Inward internationalization X_2	0.50**	1.00									
<i>Guanxi</i> X_3	0.24**	0.34**	1.00								
Export performance X_4	0.49**	0.10	0.22**	1.00							
Profitability performance X_5	0.08	0.01	0.24**	0.13*	1.00						
Sales performance X_6	0.09	0.23**	0.04	0.32**	0.20*	1.00					
Firm age X_7	0.12	0.09	0.09	-0.04	-0.09	-0.07	1.00				
Firm ownership X_8	0.07	0.04	0.11	-0.13	-0.01	0.17*	0.08	1.00			
Competition intensity X_9	0.09	0.18*	0.07	-0.18*	-0.20**	-0.01	0.04	-0.07	1.00		
Market uncertainty X_{10}	-0.05	-0.03	-0.06	0.10	-0.17*	0.00	0.09	-0.02	-0.10	1.00	
Technology complexity X_{11}	-0.10	-0.19*	-0.08	0.10	0.08	0.09	-0.05	-0.11	-0.12	0.06	1.00

* $P < 0.05$; ** $P < 0.01$.

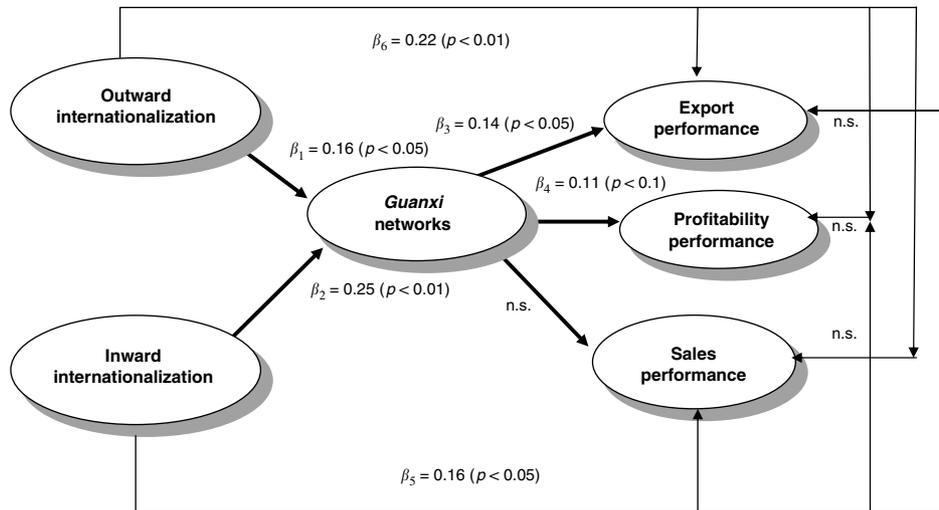


Figure 1 Estimated results of structural equation analysis with mediation effect. Note: n.s.=not significant; $\chi^2(56)=94.26$; $P=0.000$; CFI=0.912; GFI=0.895; AGFI=0.874; RMSEA=0.064. We also added several control variables into our model to test whether firm and industry factors (such as firm age, firm ownership, competition intensity, market uncertainty, and technology complexity) might change the mediation results. We found that, with all the controls across the three performance measures, only firm ownership ($\beta=0.23$) had a significant influence on sales performance. Competition intensity was negatively related to profitability performance ($\beta=-0.28$) and export performance ($\beta=-0.17$). In addition, the mediation results remain the same in direction and do not have any significant change. Thus we conclude that, even with the additional control variables, the mediating function of *guanxi* networks remains.

To test the second mediation condition, we estimated a new model that specifies only the direct paths between internationalization orientations (outward and inward) and the three performance measures (export growth, profitability growth, and sales growth). It was found that, without the presence of the mediator of *guanxi* networks, outward internationalization orientation is significantly related to all of the three performance measures: export performance ($\beta=0.41$), profitability performance ($\beta=0.17$), and sales performance ($\beta=0.20$). At the same time, inward internationalization orientation is significantly related to both export performance ($\beta=0.21$) and sales performance ($\beta=0.29$), but not to profitability performance ($P>0.10$). These results satisfy the second condition of mediation, except for the profitability measure in the case of inward internationalization.

Finally, after entering the mediator of *guanxi* networks, the results indicated that *guanxi* networks are significantly related to both export performance ($\beta_3=0.14$) and profitability performance ($\beta_4=0.11$), but not to sales performance ($P>0.10$) (see Figure 1). Focusing on the two significant paths, we found that outward internationalization orientation no longer significantly

affects profitability performance ($P>0.10$) in the presence of the mediator of *guanxi* networks. This suggests that *guanxi* networks fully mediate the performance impact of outward internationalization on profitability growth. Also, we found that there is a substantial reduction, though still significant, in the coefficient (from 0.41 to 0.22) for the direct link between outward internationalization and export performance after entering the *guanxi* mediator. Thus *guanxi* networks partially mediate this link. As a result, H1 is largely supported for the performance measures of export growth and profitability growth.

In considering inward internationalization, we found that, after entering the mediator of *guanxi* networks, inward internationalization orientation no longer significantly affects export performance ($P>0.10$). Thus *guanxi* networks fully mediate the influence of inward internationalization on export performance. Although we also observed a substantial reduction in the coefficient (from 0.29 to 0.16) for the link between inward internationalization orientation and sales performance, the insignificant relationship between *guanxi* networks and sales growth does not allow us to claim any mediation effect on the performance measure of sales growth. The mediation effect of *guanxi* net-

works on profitability performance was not considered, because the second condition of mediation (the link between inward internationalization and profitability performance) was not met. Therefore H2 is largely supported for the performance measure of export growth, but not for profitability or sales performance.

Testing of alternative explanations

We rigorously tested the mediation effects by considering alternative explanations in two ways. First, we specified a rival model without the mediation path of *guanxi* networks, as shown in Figure 2. We compared our conceptual model (Figure 1) with this rival model based on several different criteria, including (1) overall goodness-of-fit indices, and (2) parsimony as measured by the root mean square error of approximation (RMSEA).

In comparing the two model SEM results, we can see that the overall goodness-of-fit indices of the mediation model are slightly higher than those of the rival model (i.e., CFI=0.912 vs 0.905; GFI=0.895 vs 0.886; AGFI=0.874 vs 0.851). In addition, whereas CFI does not explain parsimony difference, RMSEA does adjust for parsimony in the model. It is also a desirable parsimony assessment since it is relatively insensitive to sample size. RMSEA results do support the rigor and justification

of the proposed model over the rival (RMSEA=0.064 in the former and 0.078 in the latter). The rival model of non-mediation effects is less parsimonious than the one with mediation effects of *guanxi* networks. As such, our conceptual model is further justified as an appropriate basis for hypothesis testing.

Second, we added several control variables into our model to test whether firm and industry factors (such as firm age, firm ownership, competition intensity, market uncertainty, and technology complexity) might change the mediation results. *Firm age* was measured by the number of years in business. *Firm ownership* was scaled with a dummy variable (1=privately owned, 0=otherwise, i.e., collectively owned or joint ventures) owing to differences in *guanxi* utilizations between private and other ownership structures in China (e.g., Park and Luo, 2001). In addition, some items were selected from the literature to measure the industry factors (e.g., Luo, 1999). Specifically, *competition intensity* was measured with the question ‘How competitive is the market of your main product/industry?’ (1=not competitive at all; 6=very competitive). *Market uncertainty* was measured with the question ‘How would you perceive unpredictable factors influencing the market of your main product?’ (1=few; 6=many). And *technology com-*

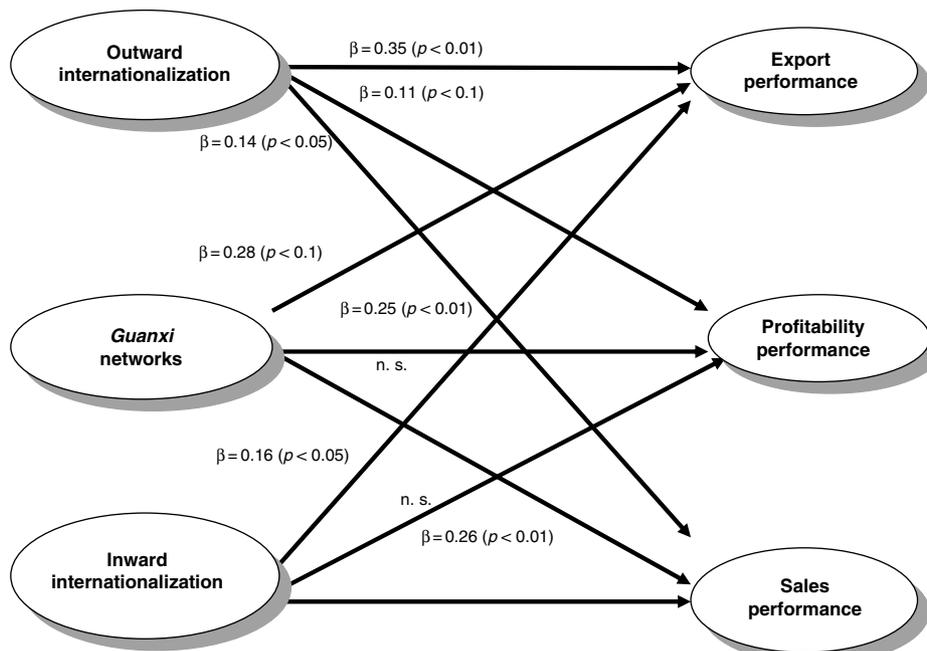


Figure 2 A rival model of non-mediation effect. Note: n.s.=not significant; $\chi^2(6)=12.26$; $P=0.000$; CFI=0.905; GFI=0.886; AGFI=0.851; RMSEA=0.078. We also considered several firm and industry control variables (such as firm age, firm ownership, competition intensity, market uncertainty, and technology complexity).

plexity was measured with the question 'How would you evaluate the industry technology of your enterprise?' (1=labor intensive; 6=technology intensive).

We found that, with all the controls across the three performance measures, only firm ownership ($\beta=0.23$) significantly influences sales performance. Competition intensity was negatively related to profitability performance ($\beta=-0.28$) and export performance ($\beta=-0.17$). In addition, the mediation results we found are the same in direction and do not significantly change. Thus we conclude that the control variables cannot explain the mediating function of *guanxi* networks.

Overall, these results suggest that, although higher degrees of outward and inward internationalization orientations are likely to be associated with higher business performance, *guanxi* networks play a significant role in mediating the performance impact of internationalization. Next, we provide a discussion of the implications of our findings.

Discussion and conclusions

Prior research has suggested a direct link between internationalization and firm performance. However, overall results have been mixed in the extant literature. Drawing from the broader claim of social network theories, we probe for an underlying network-based mechanism, and point out that internationalization orientations (outward/inward) influence firm performance via home-based social networks. Seen from the standpoint of social dynamics of the internationalization process (Ellis, 2000; Harris and Wheeler, 2005), we argue that internationalization orientations require such network ties to have a positive performance impact. This is so because internationalization orientation alone may not necessarily bring about sufficient information and knowledge on the part of the internationalizing firm to take risks and rapidly capture market opportunities at home or abroad. Therefore it seems reasonable that internationally active entrepreneurs rely on the readily available interpersonal ties and social interactions to obtain the particular information benefits (such as knowledge of potential market opportunities, personal advice and experiential learning, and referral trust and solidarity) that eventually lead to improved performance outcomes.

Such an emphasis on the role of social networks is likely to be more crucial in terms of speed and

flexibility for the implementation of a born-global internationalization strategy. Notably, the current literature on the internationalization process of born-global firms has been limited largely to exploratory and descriptive analyses, and thus lacks theoretical foundation and academic insight (Rialp et al., 2005). Our research is a timely response to the gap. By adopting a social network perspective emphasizing the role of interpersonal ties and social interactions, we develop an important explanation for born-global internationalization. Born-global SMEs that operate in the broader appeals of social networks are believed to enjoy a rapid and experiential learning advantage, and therefore find it relatively easy to achieve the performance consequences of early internationalization. Indeed, in the context of born-global SMEs, network resources most suited for explaining firm internationalization may not be about the use of established business networks, but about the rapidity and scope of informal social networks developed by the entrepreneurs from those firms (Chetty and Campbell-Hunt, 2004; Etemad, 2004; Harris and Wheeler, 2005). Our study advances the argument by demonstrating the important role of home-based social networks (*guanxi*) in underlying the born-global internationalization. Recognizing social networks as an efficient means of helping internationally oriented SMEs to go international more rapidly and profitably contributes to the social network theory to the study of internationalization for SMEs.

The results obtained from the Chinese business context generally support our key proposition concerning the mediating role of *guanxi*-related social networks. But there are some variations of the mediation effects across the three performance measures. As shown, we see strong support for the mediation effect on export performance, some support on profitability performance, and little support on sales performance.

Specifically, this study reveals that:

- (1) *guanxi* networks mediate the performance impact of outward internationalization on both export growth and profitability growth, but not on sales growth; instead outward internationalization is found to directly affect sales growth;
- (2) *guanxi* networks mediate the performance impact of inward internationalization only on export growth, suggesting possible inward-outward connection (Korhonen et al., 1996) among the internationalizing SMEs in our sample.



For profitability performance, there is no significant relationship between inward internationalization and profitability growth, and thus this particular path is not considered for any mediation effect. As far as sales performance is concerned, the mediation effect is not supported because of the insignificant link between *guanxi* networks and sales growth (Figure 1).

Several conclusions can be drawn from these results. First, there is little difference in the extent to which *guanxi* networks mediate the performance impact on export growth between inward and outward internationalization orientations. This confirms our expectation that *guanxi* utilization is relatively comparable to both directions of internationalization strategies, especially in the context of China. But, at the same time, the mediation effects of *guanxi* networks on other performance measures may vary, depending on the outward or inward internationalization orientation.

This leads to our second conclusion: there seems to be a significant difference in the mediating function of *guanxi* networks on the performance measure of profitability between outward and inward patterns of internationalization, with a stronger impact in the case of outward internationalization. The reason might be that the inbound network costs would be substantially higher than the outbound network costs, therefore causing insignificant or lower profitability growth in the case of inward internationalization. In fact, previous scholars (Park and Luo, 2001) have noted the high costs of building and utilizing *guanxi* networks, and the limited impact on firm profitability inside China.

And finally, to our surprise, the mediating effect of *guanxi* networks does not seem to be associated with sales performance for either outward or inward internationalization orientations, although we do find the direct impact of internationalization (outward/inward) on this performance measure. We speculate that the information benefits of social networks may have more to do with 'quality' performance (export growth and profitability growth) than with 'quantity' outcomes (sales growth) of the internationalizing firms. But, given the reported evidence on the link between *guanxi* networks and sales performance inside China (Park and Luo, 2001), further validation is needed in a research context similar to that of the current study.

Implications

In theory, this paper suggests that the social network perspective can explain the performance

outcomes of internationalization, with a useful implication for the emerging born-global internationalization of SMEs. Our model adds an important insight into the knowledge and learning framework of early internationalization (Autio *et al.*, 2000; Zahra *et al.*, 2000). While international entrepreneurial firms are assumed to build on their knowledge capabilities and leverage them to achieve superior performance in international markets (Knight and Cavusgil, 2004), our approach underscores the importance of external networks of personal relationships. It recognizes that social networks can provide unique value and opportunities arising from the transmission of information and knowledge through social connections with others (Granovetter, 1985; Burt, 1992). On the basis of the results from this study, we conclude that there is an efficient network-based mechanism that facilitates the impact of internationalization on performance outcomes. Thus social network ties can have benefit not only for export initiation and foreign market entry (Ellis, 2000; Ellis and Pecotich, 2001), but also for performance consequences. This is a useful extension of the social network approach to the study of internationalization for SMEs.

Even though the importance of network relationships in the internationalization of SMEs has increasingly been acknowledged in entrepreneurship and international business research (e.g., Coviello and McAuley, 1999; Johanson and Vahlne, 2003; Haahti *et al.*, 2005), the underlying premise seems to focus more on formal business relationships or social relations embedded within the formal structure of business networks. According to Peng and Luo (2000), social networks or *guanxi* in the Chinese context are mostly characterized as informal managerial ties or interpersonal relationships among managers and governmental officials. One may argue that such local *guanxi* networks may not provide firms a significant advantage on their strategic growth through internationalization, as social network is typically embedded in the local social fabric that lacks international connections. Our research provides a useful complement to previous studies that have focused on *guanxi*-related social networks as a source of competitive advantage within the domestic setting. We demonstrate that a locally based social network can be extended to the success of early-internationalizing SMEs, a finding that can be applicable not only to inward internationalization but also to outward internationalization.



Given that the *guanxi* network is a crucial aspect of the internationalization process, and its workings replicate the networking processes inside, there are important implications for the increasingly globalized structuring of manufacturing chains in China. *Guanxi* is an elegant and efficient response to the sharing of manufacturing (such as OEM) in networks of collaboration between Chinese SMEs and foreign multinational corporations. The key functions of *guanxi* networks seem to lie in their speed and flexibility of response, which underpin the attraction of the Chinese SMEs in world markets. Such a key capability of *guanxi* networks can be further enhanced with the use of advanced telecommunications technologies and the consequent de-structuring of bureaucracy in China.

In practice, this study shows that social networks, though locally rooted, can extend their impact to a firm's strategic growth in the course of internationalization. Being able to access to a sparse social network, internationally oriented entrepreneurs may become more informed and capable for capturing growth opportunities for better firm performance. This highlights a critical implication for international entrepreneurs to recruit more brokering opportunities of social ties into their personal social networks.

For policymakers, the evidence from this study supports the view that the government's export assistance programs and supporting services for the internationalization of SMEs could benefit more from the strategic focus on cultivating interpersonal networking capabilities and experiential learning opportunities through social interactions (Welch *et al.*, 1998; Fischer and Reuber, 2003; Ghauri *et al.*, 2003). Such a network-based approach would be more useful for early internationalizing or born-global SMEs from the less developed economies owing to the smallness and newness of these firms to the world markets (Riddle and Gillespie, 2003).

Further research and current limitations

Further research is needed to validate our research model and the findings by way of more comprehensive measures and control variables. In particular, given the complexity of social networks and environmental dynamics in China (Luo, 2003), we contend that more attention should be devoted to

exploring possible variations of the mediation effects we found along some key organizational and environmental factors. Also, future research efforts may wish to extend our study by investigating the connection between informal social network ties and formal business relationships in the course of internationalization, and bring the connection to performance implications of internationalization for SMEs. It may also be worthwhile extending our research to contrast with an entirely local market strategy and then explore the relative importance of social networks in relation to performance outcomes. Furthermore, the criteria for defining born-global firms need to be further refined in order to capture the true meaning of born-global internationalization (Knight and Cavusgil, 1996). In addition, we believe that some case examples would be useful to better frame an early internationalization phenomenon of SMEs, and a more significant insight could be offered from using both in-depth case analysis and survey-based quantitative analytics (Knight and Cavusgil, 2004). This is acknowledged as another future research endeavor.

We also acknowledge that Chinese SMEs may represent ideal examples of weak organizations with strong, locally based social networks; however, we believe we have taken an initial step toward developing a baseline model of the mediating function of social networks in the internationalization of SMEs. After all, the prospect of internationalizing SMEs from the world's largest emerging economy is considered to be particularly appealing to the world markets. We expect that research that emphasizes social networks is a promising approach to gain a better understanding of the internationalization of born-global SMEs worldwide (Oviatt and McDougall, 1995), especially with the rising concern of network capitalism across different countries (Redding, 1990; Boisot and Child, 1996; Oleinik, 2004).

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