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**Chapter XI**

**Business Model Innovation  
in the Digital Economy**

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**ABSTRACT**

*A viable business model in the digital economy must follow the fundamental economic principles and be able to capitalize on the disruptive characteristics of the Internet commerce. This chapter presents an analytical method to assist business executive and entrepreneurs in evaluating and building a viable business model in the digital economy. This method is based on the concept of disruptive innovation, economies of scale and scope, and the theories of switching costs and transaction cost economics. It takes into account various cost models from both demand- and supply-side perspectives. The chapter contrasts the business transformation process and value creation strategies in the physical and digital economies, and discusses several e-commerce revenue models and pricing issues in the digital economy.*

## INTRODUCTION

Since the beginning of Internet commerce in the early 1990s, we have witnessed the first boom and bust cycles of the Internet economy. Is the Internet economy going anywhere? Is the e-commerce revolution over? The answers are yes and no, respectively. The current correction has forced a more cautious approach that focuses on feasible business models and solid performance. The Internet and e-commerce are here to stay. E-commerce will continue to enhance operational efficiencies and bring new opportunities for growth and competitive advantage.

Most of the failed Internet ventures did not have viable business models and feasible long-term strategies. Their business models failed to ask the two fundamental questions of the Internet economy:

- Does your e-commerce business model follow the fundamental principles or economic logic of the Internet economy?
- Does your e-commerce business model capitalize on the “disruptive attributes” of the Internet economy?

These two questions lead business executives to consider several strategic questions regarding building and implementing a viable e-commerce business model:

- What are the components of a viable business model in the Internet economy?
- What are the disruptive attributes of the Internet, and how do you capitalize on them for competitive advantage and profits?
- How do transaction costs and network effects in the Internet economy change a company’s competitive position?
- How do the cost and pricing structures in the Internet economy differ from the traditional industrial economy?
- What are the new economies of scale and scope in the Internet economy?

This chapter first defines and identifies several business models in the digital economy. We then identify and discuss a number of disruptive characters of Internet commerce, and compare and contrast the business transformation process and value creation strategies in both physical and digital economies. The next section presents an analytical method to evaluate and determine a viable business model in the digital economy. The approach takes into account various cost and revenue models from both demand- and supply-side perspectives. Finally, we offer our conclusion.

## BUSINESS MODELS IN THE DIGITAL ECONOMY

Each firm that exploits the Internet should have an Internet business model, i.e., how it plans to make money now and how it plans to do so in the long term using the Internet (Afuah & Tucci, 2001). A business model is the method of doing business by which a company can generate revenue to sustain itself (Rappa, 2002; Turban, King, Lee, Warkentin, & Chung, 2002). It describes the basic framework of a business. It also tells what market segment is being served (who), the service that is being provided (what), and the means by which the service is produced (how) (Chaudhury & Kuilboer, 2002).

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