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Essay: The Economics of Giving It Away

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[In a battered economy, free goods and services online are more attractive than ever. So how can the suppliers make a business model out of nothing?]

Over the past decade, we have built a country-sized economy online where the default price is zero -- nothing, nada, zip. Digital goods -- from music and video to Wikipedia -- can be produced and distributed at virtually no marginal cost, and so, by the laws of economics, price has gone the same way, to \$0.00. For the Google Generation, the Internet is the land of the free.

Which is not to say companies can't make money from nothing. Gratis can be a good business. How? Pretty simple: The minority of customers who pay subsidize the majority who do not. Sometimes that's two different sets of customers, as in the traditional media model: A few advertisers pay for content so lots of consumers can get it cheap or free. The concept isn't new, but now that same model is powering everything from photo sharing to online bingo. The last decade has seen the extension of this "two-sided market" model far beyond media, and today it is the revenue engine for all of the biggest Web companies, from Facebook and MySpace to Google itself.

In other cases, the same digital economics have spurred entirely new business models, such as "Freemium," a free version supported by a paid premium version. This model uses free as a form of marketing to put the product in the hands of the maximum number of people, converting just a small fraction to paying customers. It's an inversion of the old free sample promotion: Rather than giving away one brownie to sell 99 others, you give away 99 virtual penguins to sell one virtual igloo. (Confused? Ask a child: This is the business model for the phenomenally successful Club Penguin.)

With physical stuff, samples must be doled out sparingly -- there are real costs to be paid. With bits, the free versions are too cheap to meter and can be spread far and wide. That's why so many people businesses (expensive!) are turning into software businesses (cheap!), which is why your cranky tax accountant has morphed into free TurboTax online, your stockbroker is now a trading Web site and your travel agent is more likely a glorified search engine.

All this worked well in a rising economy, where non-monetary riches such as attention (Web traffic) and reputation (Google PageRank, which determines how high your site will appear in a search) could be turned into cash with the wave of a venture capitalist's wand or a well-timed acquisition. But this year, for the first time since 2001, the overall tide of investment and advertising won't rise. Indeed, it will almost certainly fall. Venture capital has dried up, Google is killing products rather than buying them, and Yahoo can barely support itself, much less look for others to fund. What does that do to Free as an economic model?

From a consumer perspective, it should only help. After all, when you have no money, \$0.00 is a very good price. Expect the shift towards open source software (which is free) and Web-based productivity tools such as Google Docs (also free) to accelerate. The cheapest and coolest computers today are "netbooks," which sell for as little as \$250 and either ship with free versions of Linux or super-cheap old versions of Windows. The people who buy them don't load Office and pay Microsoft hundreds of dollars for the privilege. Instead, they use online equivalents, as the netbook name implies, and those tend to be free.

These same consumers are saving their money and playing free online games, listening to free music on Pandora, canceling basic cable and

watching free video on Hulu, and killing their landlines in favor of Skype. It's a consumer's paradise: The Web has become the biggest store in history and everything is 100% off.

What about those companies trying to build a business on the Web? In the old days (that would be until September of last year) the model was pretty simple. 1. Have a great idea. 2. Raise money to bring it to market, ideally free to reach the largest possible market. 3. If it proves popular, raise more money to scale it up. 4. Repeat until you're bought by a bigger company.

Now steps 2 through 4 are no longer available. So Web startups are having to do the unthinkable: come up with a business model that brings in real money while they're still young.

This is, of course, nothing new in the world of business. But it is a bit of a shock in the Web world, where "attention" and "reputation" are the currencies most in demand, with the expectation that a sufficient amount of either would turn into money someday, somehow.

The standard business model for Web companies that don't actually have a business model is advertising. A popular service will have lots of users, and a few ads on the side will pay the bills. Two problems have emerged with that model: the price of online ads and click-through rates. Facebook is an amazingly popular service, but it also an amazingly ineffective advertising platform. Even if you could figure out what the right ad to serve next to a high-school girl's party pictures might be, she and her friends probably won't click on it. No wonder Facebook applications get less than \$1 per 1,000 views (compared to around \$20 on big media Web sites).

Google has built an enviable economic engine on the back of its targeted text ads, but the sites on which they run rarely feel as flush. Running Google's AdSense ads on the side of your blog, no matter how popular it may be, will not pay you even minimum wage for the time you spend writing it. On a good month it might cover your hosting fees. I speak from experience.

What about the oldest trick in the book: actually charging people for your goods and services? This is where the real innovation will flourish in a down economy. It's now time for entrepreneurs to innovate, not just with new products, but new business models.

Take Tapulous, the creator of Tap Tap Revenge, a popular music game program for the iPhone. As in Guitar Hero or Rock Band, notes stream down the screen and you have to hit them on the beat. Millions of people have tried the free version, and a sizable fraction of them were ready and willing to pay when Tapulous offered paid versions built around specific bands, such as Weezer and Nine Inch Nails, along with add-on songs. (The Wall Street Journal is pursuing a strategy of blending free and paid content on its Web site.)

At the other end of the business spectrum there's Microsoft, which now has to compete with the free word processors and spreadsheets of online competitors such as Google. Rather than complain about the unfair competition (which would be ironic), Microsoft created Web versions of its business software and offered them free to small and young companies. If your firm is less than three years old and under \$1 million in revenues, you can use Microsoft's software without charge under its BizSpark program. When those companies get bigger, Microsoft is betting that they'll keep using its software as paying customers. In the meantime, the program costs it almost nothing.

But extracting a business model from free is not always easy, especially when your users have come to expect gratis. Take Twitter, the fantastically popular (and free, of course) 140-character messaging service where people update the world on what they're doing, one haiku-like snippet at a time. After taking over the world, or at least the geeky side of it, it now finds itself having to actually make enough money to cover its bandwidth bills. Last year it hired a revenue guru to try to find a business model and has announced that it intends to reveal its strategy early this year. Speculation as to what that will be ranges from charging companies to have their "tweets" recommended to consumers (which is a bit like "friending" the Burger King on Facebook) to certifying identity to avoid impersonation. The revenue officer has his work cut out for him.

Meanwhile YouTube is still struggling to match its popularity with revenues and Facebook is selling commodity ads for pennies after its effort to charge for intrusive advertising led to a user backlash. And news-sharing site Digg, for all its millions of users, still doesn't make a dime. A year ago, that hardly mattered: The business model was "build to a lucrative exit, preferably in cash." But now the exit doors are closed and cash flow is king.

Does this mean that Free will retreat in a down economy? Probably not. The psychological and economic case for it remains as good as ever -- the marginal cost of anything digital falls by 50% every year, making pricing a race to the bottom, and "Free" has as much power over the consumer psyche as ever. But it does mean that Free is not enough. It also has to be matched with Paid. Just as King Gillette's free razors only made business sense paired with expensive blades, so will today's Web entrepreneurs have to not just invent products that people love, but also those that they will pay for. Not all of the people or even most of them -- free is still great marketing and bits are still too cheap to meter -- but enough to pay the bills. Free may be the best price, but it can't be the only one.

Chris Anderson is the editor in chief of Wired magazine, and the author of "The Long Tail" and "Free," which will be published in July.

Something for Nothing

A sampling of free services and content online.

hypem.com

The Hype Machine monitors hundreds of music-related blogs, and lets users listen to songs posted on those blogs for free -- just type in the name of a band or track. (It's also a good place to find out what's new and popular in the music blogosphere.) Songs can't be downloaded, but Amazon and iTunes links appear next to most tracks.

kayak.com

Compare fares from multiple vendors, including airlines and online travel agencies, on this fare-search site. Kayak breaks down itineraries by airline, time of day, number of stops and length of layovers. It also lets users exclude turboprop aircraft or regional jets from searches. You have to go directly to the vendor to buy the ticket though (a link is provided).

picnik.com

A free photo-editing site that doesn't require registration or software downloads. Users crop and adjust photos within their browser window --

special effects and frames are available, too -- and can post images to sites like Flickr or Facebook without leaving Picnik. A premium account (\$24.95 a year) offers features including batch photo uploading, advanced editing tools and no ads.

pogo.com

Play free online or downloadable games -- including card, puzzle, word and board varieties -- at this ad-supported site from Electronic Arts. More than 100 games are available including Scrabble, Monopoly and Trivial Pursuit. A paid account (\$5.99 per month, or \$39.99 per year) gets rid of ads and provides access to more games.

shopittome.com

Billed as the online alternative to a personal shopper, this service emails members when retailers mark down their favorite designers. Users specify their preferred sizes and brands, and choose how frequently they want to be alerted. Tracked brands include Prada and Theory; the site searches a limited number of retailers including Saks, Nordstrom and shopbop.

-- Juliet Chung

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