Internet economics flashcard

Cross-subsidies are the essence of the phrase “ there’s no such thing as a free lunch. ” That means that one way or another the food must be paid for, If not by you directly then by someone else in whose interest it is to give you free food. Sometimes people are paying indirectly for products. That free newspaper you’re reading is supported by advertising, which is part of a retailer’s marketing budget, which is built into its profit margin, which you (or someone around you) will ultimately pay for in the form of more expensive goods.

You’re also paying with a bit of your time and, by Ewing seen reading that newspaper, your reputation. The free parking In the supermarket Is paid for by the markup on the produce, and the free samples are subsidized by those who shell out for the paid versions. HOW CAN A DVD BE FREE? Phone companies sell calls; electronics companies sell gadgets. But cable giant Compact is in both those businesses and a lot more besides. This gives it flexibility to cross-subsidize products, making one thing free in order to sell another. To that end, Compact has given about 9 million subscribers free set-top digital video recorders.

How can it make that money back? Compact earns back the cost of Its DVD In 18 months. Add hidden fees. Compact charges a $20 installation fee to every new DVD Charge a monthly subscription. Compact customers pay $14 a month customer. To use the DVD box. Even if Compact paid $250 for its DVD’s-? a very high estimate-? Upsets other services. The boxes would pay for themselves within 18 months. Compact hopes to win over customers with free DVD’s, then interest them in services like high-speed Internet ($43 a month for 8 MBps) and digital telephony ($40 a month). That doesn’t count pay-per-view movies, which can cost $5 each.

In the gift economy, the cross-subsidies are more subtle. Blobs are free and usually don’t have ads, but that doesn’t mean that value isn’t being exchanged every time you evils. In return for the free content, the attention you give a flogger, whether in a visit or a link, enhances her reputation. She can use reputation to get a better job, enhance her network, or find more customers. Sometimes those reputation credits can turn into cash, but we can rarely predict the exact path-? it’s different each time. Cross-subsidies can work in several different ways: Paid products subsidizing free products.

Loss leaders are a staple of business, from the popcorn that subsidizes the loss-making movie to the expensive wine being not Just sold at a fraction of its cost but given away entirely. This can be as gimmicky as a “ free gift inside” or as common as free samples. This form of free is ancient, familiar, and relatively straightforward as an economic model, so we won’t focus on it much here. Paying later subsidizing free now. The free cell phone with a two-year-subscription contract is a classic example of the subsidy over time. It’s Just shifting phone service from a point-of-sale revenue stream to an ongoing unity.

In this case, your future self is subsidizing your present self. The hope of the carrier is that you won’t think about what you’ll be paying each year for the phone service but instead will be dazzled by the free phone you get today. Paying people subsidizing free people. From the men who pay to get into nightclubs where the women get in free, to “ kids get in free,” to progressive taxation where the wealthy pay more so the less wealthy pay less (and sometimes nothing), the tactic of segmenting a market into groups based on their willingness or ability to pay is a conventional part of pricing theory. E takes that to the extreme, extending the concept to a class of consumers who will get the product or service for nothing. The hope is that the free consumers will attract (in the case of the women) or bring with them (in the case of the kids) paying consumers or that some fraction of the free consumers will convert to paying consumers. When you walk through the striking interiors of Lass Vegas attractions, you get the view for free; in exchange the owners are expecting some people to stop and gamble or shop (or, ideally, both). Within the broad world of cross-subsidies, free models tend to fall into four main categories:

FREE 1: DIRECT CROSS-SUBSIDIES WHAT'S FREE: Any product That Entices you to pay for something Else. FREE TO WHOM: Everyone Willing to Pay Eventually, One Way or Another. When Wall-Mart offers a buy-one-get-one-free deal on DVD's, it's a loss leader. The company is offering the DVD below cost to lure you into the store, where it hopes to sell you a washing machine or a shopping basket filled with other goods at a profit. In any package of products and services, from banking to mobile calling plans, the price of each individual component is often determined by psychology, not cost.

Your cell hone company may not make money on your monthly minutes-? it keeps that fee low because it knows that's the first thing you look at when picking a carrier-? but your monthly voice mail fee is pure profit. Companies look at a portfolio of products and price some at zero (or close to it) to make the other products, on which they make healthy profits, more attractive. Free

1 . Direct Cross-subsidies Technology is giving companies greater flexibility in how broadly they can define their markets, allowing them more freedom to give away some of their products or services to promote others.

Urinary, for instance, has disrupted its industry by defining itself more as a full-service travel agency than a seller of airline seats. Your credit card is free because the bank makes its money from the service charge it imposes on the retailers you buy from. They, in turn, pass that charge back to you. (Of course, if you don't pay your bill off in full at the end of the month, the bank makes even more money from your interest.) FREE 2: THE THREE-PARTY MARKET WHAT'S FREE: Content, Services, Software, and More. FREE TO WHOM: Everyone. The most common of the economies built around free is the three-party system.

Here a third party pays to participate in a market created by a free exchange between the first two parties. Sound complicated? You encounter it every day. It's the basis of virtually all media. In the traditional media model, a publisher provides a product free (or nearly free) to consumers, and advertisers pay to ride along. Again, radio is " free to air," and so is much of television. Likewise, newspaper and magazine publishers don't charge readers anything close to the actual cost of creating, printing, and distributing their products.

They're not selling papers and magazines to readers, here selling readers to advertisers. It's a three-way market. In a sense, the Web represents the extension of the media business model to industries of all sorts. This is not simply the notion that advertising will pay for everything. Media companies make money around free content in dozens of ways, from selling information about consumers to brand licensing, subscriptions, and direct e-commerce (see Chapter 9 and the back of the book for a more complete list). Now an entire ecosystem of Web companies is growing up around the same set of models.

Free 2. The Three-Party Market Economists call such models “ two-sided markets,” because there are two distinct user groups who syntactically support each other: Advertisers pay for media to reach consumers, who in turn support advertisers. Consumers ultimately pay, but only indirectly through the higher prices on products due to their marketing costs. Means more spending at merchants and more fees for issuing banks), operating system tools given free to application software developers to attract more consumers to the platform, and so on.

In each case, the costs are distributed and/or hidden enough to make the primary goods feel free to consumers. FREE 3: PREMIUM WHAT’S FREE: Anything That’s Matched with a Premium Paid Version. FREE TO WHOM: Basic users. This term, coined by venture capitalist Fred Wilson, is one of the most common Web business models. Premium can take different forms: varying tiers of content from free to expensive, or a premium “ pre’ version of some site or software with more features than the free version (think Flicker and the $25-a-year Flicker Pro). Again, this sounds familiar.

Isn’t it Just the free sample model found everywhere from perfume counters to street corners? Yes, but with a pretty significant twist. The rotational free sample is the promotional candy bar handout or the diapers mailed to a new mother. Since these samples have real costs, the manufacturer gives away only a tiny quantity-? hoping to hook consumers and stimulate demand for many more. Free 3. Premium But for digital products, this ratio of free to paid is reversed. A typical online site follows the 5 Percent Rule-? 5 percent of users support all the rest.

In the Premium model, that means for every user who pays for the premium version of the site, nineteen others get the basic free version. The reason this works is that the cost of Irving the nineteen is close enough to zero to call it nothing. FREE 4: MONETARY MARKETS WHAT’S FREE: Anything People Choose to Give Away with No Expectation of Payment. This can take several forms: Gift Economy From the twelve million articles on Wisped to the millions of free secondhand Altruism has always existed, but the Web gives it a platform where the actions of individuals can have global impact.

In a sense, zero-cost distribution has turned sharing into an industry. From the point of view of the monetary economy it all looks free-? indeed, it looks like unfair competition-? but that says more about our horologists ways of measuring value than it does about the worth of what’s created. The incentives to share can range from reputation and attention to less measurable factors such as expression, fun, good karma, satisfaction, and simply self-interest (giving things away via freelance or Scraggliest to save yourself the trouble of taking them to the dump).

Sometimes the giving is unintentional, or passive. You give information to Google when you have a public Web site, whether you intend to or not, and you give aluminum cans to the homeless guy who collects them from the recycling bin, even if that's not what you meant to do. Labor Exchange You can get access to free porn if you solve a few Captors, those scrambled text boxes used to block spam bots. Ironically, what you're actually doing is using your human pattern-matching skills to decipher text that originated on some other site, one of interest to spammed that uses such Captors to keep them out.

Once you solve it, the spammed can gain access to those sites, which are worth more to them than the bandwidth you'll consume viewing titillating images. As far as they're concerned, it's a black box-? they put scrambled Captors in and they get deciphered text out. But inside the box, it's the unwitting free labor of thousands of people. Likewise for rating stories on Dig, voting on Yahoo Answers, or using Google's 411 service. Every time you search on Google, you're helping the company improve its ad- targeting algorithms.

In each case, the act of using the service creates something of value, either improving the service itself or creating information that can be useful somewhere else. Whether you know it or not, you're paying with your labor for something free. Free 4. Monetary Markets Piracy This describes nothing so well as online music. Between digital reproduction and ere-to-peer distribution, the real cost of distributing music has truly hit bottom. This is a case where the product has become free because of sheer economic gravity, with or without a business model.

That force is so powerful that laws, copy protection, guilt trips, and every other barrier to piracy the labels could think of failed (and concerts, merchandise, licensing, and other paid fare. But others have simply accepted that, for them, music is not a moneymaking business. It's something they do for other reasons, from fun to creative expression. Which, of course, has always been true for most musicians anyway. A TEST OF FREE IN DAILY LIFE Let's see how this taxonomy lines up with the sort of free we encounter every day.

Browsing a newsstand recently, I noticed a cover line on Real Simple magazine: " 36 Surprising Things You Can Get for free. " It's the sort of thing you'll see on any newsstand in any month, so it seemed a fairly representative sample with which to test the framework. On how the first half of Real Simile's examples distributed. You'll note that some of the examples have elements of several models, and others have competitors that use models that fit into different categories. (1-800-freezer's impetigo, Google 411, isn't ad-supported. Also, government services are a special class of cross-subsidy, since the link between your taxes and the services you receive is indirect and diffuse. I Free Example I Apple Store classes I Althea club trials I I Baby music classes I I Ben and Jerry free Cone Day I Free Model I Free 1: Simple cross-subsidy I they're betting you'll buy something I ditto I I Online photo printing (free samples) I Small business classes (government-funded) Lou pay taxes I I BBC language classes (bedposts) I cross-subsidy if you're British and pay taxes; gift economy if not

I I Popularity dialer (free excuse calls) 1 411 I Free reminder emails I Skippy (free phone calls) phones) support kids) online) Scraggliest barter I free 2: Ad-supported I free 3: Premium (free & paid versions) I(paid versions can connect to cell I Kids night on Broadway I(parents I OMIT Openhearted (free classes I Free pets on I Freelance I free 4: Monetary markets I I Museum (grants/donor funded) I I Paperbacks. Com perfect, and it's not hard to find exceptions and hybrids, but this framework will serve us well in the chapters to come.

THE THREE PRICES This book is mostly about two prices-? something and nothing-? but there is onetime a third price that we can't ignore: less than nothing. That's right, a negative price: You get paid to use a product or service, rather than the other way around. This is more common than you might think. Online, you can see this trend in things like Microsoft paying you to use their search, but it actually has a long tradition in conventional marketing. You find it in instant rebates and cash-back marketing, and in the cash rewards, frequent flyer miles, and other payments you get for using credit or loyalty cards.

Of course, few of these are really less than nothing; in most cases your wallet will open sooner or later. But what's interesting about these schemes is that although they're not really free money, consumers often treat them like they are. For instance, a cash-back rebate invokes a very different psychology from simply saving the money in the first place. Studies of how people spend the $1, 000 (or whatever amount) check they get when they buy a new truck (or, more to the point, finance it) show that they tend to spend it like a lottery winning-? an unexpected windfall, even though it's really Just a loan against future payments.

Guys buy golf clubs their wives would never normally let them purchase, and their ivies don't stand in their way, despite the fact that they know they'll be paying that money back over the years to come, Just like a credit card debt. In Dan Rallies book Predictably Irrational there's a great example of negative pricing. In one instance, he told his class at Mitt's Sloan School of Business that he would be doing a reading of poetry (Walt Whitman Leaves of Grass) but didn't know what it should cost.

He handed out a questionnaire to all the students, half of whom were asked if they'd be willing to pay $10 to hear him read, and the other half of whom were asked if they'd be willing to hear him read if he paid them $10. Then he gave them all the same question: What should the price be to hear him read short, medium, and long versions of the poem? The initial question is what behavioral economists call an " anchor," which calibrates a consumer's sense of what a fair price is. It can have a dramatic effect on what they'll ultimately pay.

In this case, the students who had been asked if they would pay $10 were willing to pay, on average, $1 for the short poem, $2 for the medium, and $3 for the long. Meanwhile, the students who had been anchored to believe that Rarely should pay them did indeed demand that: They wanted $1. 30 to listen to the short reading, $2. 0 for the medium one, and $4. 80 to endure the long reading. Rarely notes that Mark Twain illustrated this with Tom Sawyer, who somehow got the other boys to be so envious of the fence-painting exercise that they not only took over his Job but paid him for the privilege.

However, there is a cautionary tale in this for those who would pay people for what they would otherwise expect to be paid themselves for. Twain observed: “ There are wealthy gentlemen in England who drive four-horse passenger-coaches twenty or thirty miles but if they were offered a wage for the service, that would turn it into work and they old resign. ” All these are examples of what Derek Severs, the founder of CD Baby, calls “ reversible business models. ” A real-world instance of this is the music clubs in Los Angels that are charging bands to play in the club, rather than paying them as usual.

The bands value the exposure more than the cash, and if they’re good they can graduate to the usual sort of gigs. In China, Severs notes, “ some doctors are paid monthly when their patients are healthy. If you are sick, it’s their fault, so you don’t have to pay that month. It’s their goal to get you healthy and keep you healthy so they can get paid. ” In Denmark, a gym offers a membership program where you pay nothing as long as you show up at least once a week. But miss a week and you have to pay full price for the month.

The psychology is brilliant. When you go every week, you feel great about yourself and the gym. But eventually you’ll get busy and miss a week. You’ll pay, but you’ll blame yourself alone. Unlike the usual situation where you pay for a gym you’re not going to, your instinct is not to cancel your membership; instead it’s to redouble your commitment. Preadolescences. Com gets income from the phone companies instead of customers, because they know which phone company each person is using to call them.