The Biggest Myth of the New Economy

Call it "The Network Effect," "Viral Marketing" or "The Law of Plenitude," but by any name, it still rings false.

By David S. Bennahum

NO BELIEF is more central to the New Economy than the principle — stated by Wired magazine co-founder Kevin Kelly — that "as the number of nodes in a network increases arithmetically, the value of the network increases exponentially." The most frequently cited example of this principle at work is the fax machine: The first one was pretty worthless, since it had nothing to communicate with; the next fax machine made the first one much more valuable; the third made the first two more valuable, and so on. Ultimately, the value of the fax machine "network" far exceeded the simple resale value of any individual machine.

This cornerstone of cyber-economics generally goes by the name "the network effect." It drives other conventionally accepted e-business concepts, such as "viral marketing." Also called "The Law of Plenitude," it is often rendered with the axiom "more is more." Each variation is titled in ways meant to defy traditional economics. Indeed, the laws of the New Economy presuppose a complete bouleversement of the old. But how real are these rules? Have we in fact discovered the secret for turning lead to gold by way of a ".com" suffix?

Alas, no. As it turns out, much New Economy thinking is little more than alchemy.

An inversion of the law of supply and demand, the network effect is self-consciously styled to refute the Old World premise that value derives from scarcity — the reason that diamonds, oil and college degrees are expensive, and bottled air relatively cheap. In the New Economy, a product may be cheap, but the network that grows around it can accrue enormous worth. An example is America Online Inc. By charging subscribers $19.95 a month, AOL has become one of the few profitable companies of the young Internet era. Yet AOL's shares, which trade at P/E ratios that far exceed 100, are priced beyond any possible mathematical calculation about future cash-flow growth. Rather, the price reflects the network effect: Investors are betting that the value of the network will become vastly greater than the revenues generated by subscriber fees. As long as the company can add new subscribers at a rate above 20 percent a year, it will be perceived as a success, and worthy of its lofty market capitalization.

Yet the cost of maintaining this blistering pace of growth defies long-term logic. At that rate, AOL will spend far more to acquire each new customer and compensate for de-

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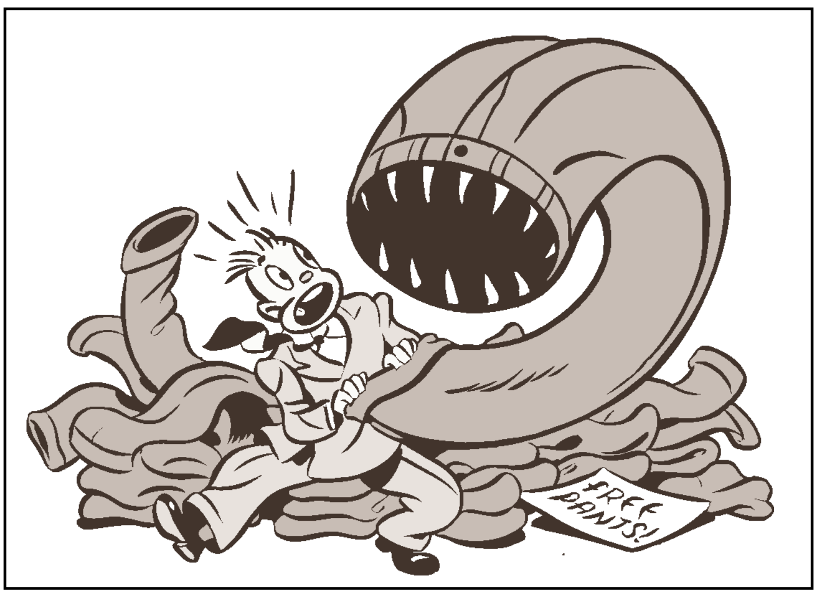

parting customers than it can possibly capture in revenues. In other words, the company's "value," as measured by market capitalization, is based on criteria that could destroy the company. The "more is more" logic is grounded more in metaphor than in economics.

A quick look at other entities whose value exists in the network, rather than goods or services, shows similar patterns of hallucinatory thinking. Let's return to the fax machine network. Faxes are powerful tools, but since no one actually owns the "fax machine network," the only revenues (aside from the cost of a phone call) come from selling the machines themselves — a low-margin, high-volume activity and hardly a business with much appeal. One would be hard pressed to find a credible entrepreneur looking to break into fax-machine manufacturing.

Likewise, e-mail is ubiquitous, yet the selling of e-mail programs is a terrible business; most consumers get free e-mail programs bundled with their free Web browsers. The only company capable of selling an e-mail reader is the Microsoft Corporation, and that is because its program, Outlook, is bundled as part of an office suite, and rarely sold on its own.

In these and other cases, New Economy theorists assume that what's good for consumers is good for business. That is a subtle, potentially fatal, error. Free products are indeed good for consumers — but they are rarely good for business. Yet, in effect, freebies (a personal computer, personal finance software, streaming-media client applications) are the premise behind many of today's Internet companies. In most cases, scrutiny of the business model reveals the giveaway service to be a loss leader, designed to aggregate a large number of people, with the entrepreneur gambling that this audience's value to marketers will offset the financial loss from providing a product below cost.

But this is hardly a new economic theory. In fact, it is the basis of the network television industry, in which both studios and networks essentially give away their programs to consumers, in return for selling that aggregated audience to advertisers. This is the thinking behind AOL:

Illustrations by Mark Matcho

Officially it is not a dial tone, but rather a "convergence play" with an "audience" for its "content" that constitutes a fabulous one-stop buy for online marketers.

When applied to the ubiquitous Internet, however, the network television model, which is dependent on the scarcity of spectrum space, begins to disintegrate. If everyone is giving away goods at or below cost to gather networks of people, then networks of people may themselves become commodities. Indeed, as such networks proliferate, the value of providing a new network diminishes, while the difficulty of attracting members' attention increases.

One recent, little-noticed response to this obvious flaw in the "more equals more" axiom has been the proliferation of niche networks ("We sell pants! Just pants!"). But there is always another network around the corner with an even more lucrative offer ("Free pants!").

Free pants are a boon to consumers; it is hard to see how any business could fail to fail with such a top-line offering. This is the real network effect — one rarely discussed. Investors in Internet companies that equate "user base" with "market capitalization" are like the depositors in the Albanian funds that paid 100 percent annual interest rates. Much as the hapless East Europeans saw their life savings disappear, today's savvy Internet investors may find their self-managed, day-traded 401(k)'s destroyed by the inability of any economy, new or old, to support loss-making companies.

Most of the other tenets of the New Economy derive from the network effect, and each, in its way, exhibits a similar loopiness, grounded in the use of metaphor, rather than arithmetic, to justify its accuracy. Consider "The Law of Generosity," a.k.a. "follow the free." According to New Economy logic, if the value of a network increases in proportion to the number of people using it, then the most valuable things of all will be those that are given away. Plenty of successful high-tech companies give away goods: Microsoft's Internet Explorer Web browser, Qualcomm's Eudora e-mail program, Sun's Java language. Their presumption is that only by giving away products can companies build loyalty, and thereafter capture revenue for a premium product or ancillary service.

But in most cases, The Law of Generosity might better be called "The Rule of Power." Microsoft gave its browser away because its primary goal was to overcome the upstart Netscape Communications Corporation (now part of AOL). Sun Microsystems Inc. created Java and dispensed it gratis to overcome the threat that Microsoft might edge its way from the personal computer market into the workstation market. In both cases, the companies used their existing dominant market position, and their ability to finance loss-making operations, to lock competitors out of their businesses. Rather than resembling New Economy thinking, the axiom "follow the free" calls to mind efforts by 19th-century robber barons to dominate the steel, coal, oil and railroad industries. In fact, as U.S. District Court Judge Thomas Penfield Jackson ruled late last year in the Justice Department's case against Microsoft, The Law of Generosity actually goes under another name: antitrust.

At the end of the day, cash flow is cash flow, and no amount of free goods or booming subscriber lists can camouflage the fact that investors ultimately want a return on their capital. When that return fails to materialize, the New Economy will be revealed for what it is: the old Roman lottery, rediscovered by Charles Ponzi in 1920, reinvented and repackaged by the Web in the 1990's. With the latest polls revealing Internet growth fatigue — the growth rate in the number of American users fell from over 60 percent per year to 13 percent in the last half of 1999 — the bottom of the pyramid is starting to thin out. Customer-acquisition costs are soaring, while attention and loyalty are declining. That means the raw fuel powering most dot-coms — eyeballs — is becoming scarce and expensive.

Which is the basis of my own New Economy play. I have two eyeballs for sale (fine condition). Bids can be sent to davidsol@panix.com. Priority is given to cash offers, although stock options in listed companies (NASDAQ preferred; no vesting, please) or barter trades for appropriate consumer goods (color television O.K.; flat-panel plasma display preferred) will be entertained.

Reprint No. 00102