

2 The growth in freelancing

This thesis focuses on so-called self-employed, independent professionals. There are various other names and definitions that are used in the literature such as: independent professionals, freelancers, portfolio workers (Handy, 1985), contractors, and itinerant professionals (Barley & Kunda, 2004).¹ The term freelancer is probably the oldest of these names. According to Wikipedia this term was used first by Sir Walter Scott in his novel *Ivanhoe*, in order to describe a medieval mercenary warrior. Modern definitions define a freelancer or independent professional as someone *who sells his or her services to employers without a long-term contract* (Oxford English Dictionary) or as *individuals who create portfolios of self-employed work arrangements to contract their own skills in a variety of contexts* (Fenwick, 2003). The crucial characteristics of these definitions are: 1) independent professionals do not have a long-term relationship or contract with an employer or employee, and 2) independent professionals sell nothing more than their own knowledge, skills and abilities. In this study the terms freelancer, independent professional, contractor, and portfolio worker are all at some point used to refer to independent professionals, but independent professional and freelancer are our preferred terms.

As said, an independent professional is characterized by vending his/her own knowledge, skills and abilities. This characteristic separates independent professionals from most other entrepreneurs, for instance from owners of retail shops, who are also self-employed and may work independently from employers or employees, but these self-employed individuals sell other goods or services than their own knowledge.

Although we use the above definition, it is sometimes very ambiguous. A couple of insightful examples can be drawn from the world of furniture designing. Firstly, when a furniture designer just sells his or her skills as a designer by the hour to any furniture company (who may perhaps ask the designer to assist in creating a chair or table), the designer is clearly a freelancer. Secondly, as soon as the designer sells finished designs to the highest bidder, one may argue that the designer sells more than his/her knowledge, skills and abilities. The designer in fact sells a product. Nevertheless following our definition we would still classify the designer as a freelancer because: 1) the product/design that is sold is solely based on the designer's personal knowledge, and 2) the designer still works alone, independently from any employer or employee. Thirdly, as soon as the

¹ In the Netherlands, the term *zzp-er* (zelfstandige zonder personeel) is frequently used.

designer starts creating his designs and building real furniture, we would still characterize him as a freelancer, as long as the designer creates this furniture by him- or herself. Fourthly, when the designer decides to outsource the building activities of the furniture (for instance to a carpenter), we would still regard the designer as a freelancer, as he sells a product that is completely based on his own knowledge, skills and abilities and he has no long term relationships with employers or employees. Only when the designer does not outsource the building activities anymore, but hires employees to create the furniture, the designer stops being a freelancer and becomes an employer.

Another important definition is that of contingent workers. Nardone and Polivka (1989) define contingent work as “*any job in which an individual does not have an explicit or implicit contract for long-term employment or one in which the minimum hours worked can vary in a nonsystematic manner.*” The definition of contingent workers is also broader than the definition of independent professionals. Contingent labor includes self-employed independent professionals, but also includes employees of temporary service firms (e.g. Manpower) and workers provided by contract firms such as Accenture. Not all contingent workers are thus self-employed. Here Marler (2002) argues that a new type of contingent worker is emerging: the boundary less temporary worker. What distinguishes these boundary less temps from traditional temps is their preference for temporary work and their high level of skill and experience.

2.1 The growing number of independent professionals

Independent professionals are an extraordinary blend between entrepreneurs and employees. This is perhaps one of the two reasons why the amount of research on freelancers is rather limited. The other explanation is the sudden rise in the number of independent professionals in the last decades. In any case, our current knowledge about the practices and behaviors of this “*amateur entrepreneur*” is still meager.

2.1.1 Black vs. white – opposing views on independent professionals

As Smeaton (2003) summarizes, the current literature on freelancers basically represents two opposing beliefs. One is a positive view where self-employment offers opportunities for self-development, autonomy and creativity. In this view the shift towards a knowledge economy is interpreted as a new, more complex, stage in the technological evolution of capitalist economies. Knowledge is seen as more valuable and powerful than natural resources and large factories. Self-employment offers the freedom from the prisons that many organizations have become and provides the natural habitat for knowledge to blossom. In this view the growth of self-employed

is caused by employees who are longing for autonomy, freedom and creativity. These individuals consciously choose self-employment. Peter Drucker (1993) is one of the well-known proponents of this positive view on freelancing. He argues that we have moved into a post-capitalist phase, where knowledge workers own the key means of production and the tools of production.

The other, negative, institutional view highlights the damaging potential of self-employment. In this view self-employment is a cost-cutting exercise of larger companies, depriving people of guarantees and secondary benefits and making people vulnerable to market changes. In this view self-employed people are marginalized as mere suppliers of labor. The growth in self-employment has been caused by organizations that wanted to counter economic pressures and offered their employees freelance contracts with no perks or security. Employers seem to have the best of several worlds: a flexible, committed and cheap labor force, primary workers at secondary prices. This negative view often rejects the notion of a high-skilled knowledge economy. It emphasizes the unequal allocation of resources and the inherent limits to a technologically advanced high-skills economy, given the subordination of technology to the imperative of managerial control. Brown (2003) argues that the positive view ignores differences in the power of social groups, to enhance their employability at the expense of others. It presents employability as a mere technical problem of ensuring that labor market entrants have the skill sets that match the requirements of employers. Strengthening this view, Donnelly (2003) concludes that many independent professionals are not able to exercise greater control over their working arrangements than traditional employees do, as their flexibility is restricted by the needs of their employer(s), client demands and expectations, professionalism, network relations, and personal career ambitions.

The truth might lie in the middle of these views where independent professional growth is caused by both push and pull factors. Blanchflower for instance (2004, p. 4) concludes: *“These self-employed work under a lot of pressure, find their work stressful and come home exhausted. Further, they report being constantly under strain, that they lose sleep over worry and place more weight on work than they do on leisure. However, they are especially likely to say they have control over their lives as well as being highly satisfied with their lives.”* This moderate view is in line with the conclusions of a long list of authors (e.g. Ajayi-Obe and Parker, 2005; Anderson, 2008; Benz and Frey, 2008; Conolly, 2004; Guest, 2004, 2006), who all report that entrepreneurs are (on average) more satisfied with their jobs and life in general. They sacrifice income for organizational independence. This offers support for Leavitt (2007, page 253) when he says that *“large organizations are unhealthy environments for human beings”*.

2.1.2 Freelance growth in the Western economies

If one looks back over a long period a remarkable downward trend in the number of self-employed is visible. Based on long data sets in various Western economies, Blanchflower (2004) concludes that self-employment rates have declined over the last decades in most countries. In line with these conclusions Parker (2004) shows that in the US the self-employment rate has been in continuous decline since the 1870s, when the self-employment rate was over 40 percent. Lately, in line with the much published rise of the creative economy (Florida, 2002), there is evidence that this downward trend has been reversed and that the number of self-employed is slowly but steadily increasing again (see Table 1). In the US this revival is evident since the 1970s. In most western European countries, the slow increase in self-employment rates is visible since the end of the 1980s. The UK has experienced the longest period of self-employment growth. The number of self-employed has grown since 1956. Measures of UK self-employment increased especially in the 1980s, then showed some decline in the 1990s, but their numbers increased again in this millennium.

According to Arum (2004, p. 2), *“Self-employment can no longer be dismissed as an economic activity on the verge of withering away in response to processes of capital accumulation or in competition with large firms.”*

Audretsch and Thurik (2001) explain the re-emergence of entrepreneurship in Europe and North America with reference to increased globalization, which has shifted the comparative advantage towards knowledge-based economic activity. Several other authors (e.g. Thurow, 2003) argue that in the last decennia the advantage has moved from large corporations to small firms, because information technologies have reduced the importance of scale economies. On the other hand the growth in entrepreneurship may be somewhat of a surprise if one takes into consideration the fact that the relative wages between entrepreneurs and employees are switching in favor of employees (Folkeringa and De Jong-‘t Hart, 2007). This trend of decreasing relative earnings of employees versus entrepreneurs is observable in various Western countries (e.g. US, UK and Australia). In the Netherlands the wage of an average employee is since 2004 higher than the earnings of an average entrepreneur.

Table 1: The percentage of self employed in the economy

Country	1995	2005
Netherlands	10,5 ^a	11,1 ^a
Belgium	14,8	13,6
Germany	9,3	11,2
UK	12,7	13,9
US	7,3	8,3

* Source OECD (2006), ^a source CBS

These macro numbers in entrepreneurship obscure the profound economical shifts underneath these numbers. Most Western countries go through significant declines in the number of self-employed in the retail and agricultural sectors, which are offset by an increase in the number of entrepreneurial knowledge workers. The increase of self-employed work is especially visible in those knowledge-intense occupations which typically work on a project-by-project basis. Since the beginning of the 1990s a whole list of industries and occupations have been more and more dominated by independent professionals. There are freelance writers, web developers, programmers, interim managers, project managers, journalists, photographers, designers, architects, accountants, management consultants, secretaries, doctors, physiotherapists, lawyers, tax professionals, chemists and many, many more. Some sectors have seen mind-boggling shifts from traditional employment relations to freelance type contracts. Storey, Salaman and Platman (2005), for example, describe the shift in the media sector, where in less than a decade the majority of workers became independent professionals. All over the media industry, large employing organizations, such as television corporations, have cut their long-term staff and replaced these workers with freelance labor. Ursell (2000) estimated that independent professionals create about 60 percent of the total production of the UK media industry.

Drawing on Bureau of Labor Statistics (BLS) data, Spalter Roth (1997) estimated that 13.5 percent of all professionals in the US worked in one of the following three forms of contingent labor: 1) independent contractors, 2) employees of temporary service firms, and 3) workers provided by contract firms. In some areas such as Silicon Valley and New York City, these percentages are even higher.²

Ashford (2007) estimates that there were about 10.3 million independent contractors in the US in 2005, representing 7.4 percent of the workforce. This is a growth of 24 percent since 1995 when independent contractors represented 6.7 percent of the workforce.

2.1.3 Freelance growth in the Netherlands

In a recent study on entrepreneurship in the Netherlands, Bangma and Timmermans (2008) show that there has been strong entrepreneurial growth in the Netherlands in the last twenty years, with ever increasing numbers of new firms since the 1980s. The number of firms without personnel (in Dutch: *ZZP – Zelfstandige Zonder Personeel*) grew with 100,000 firms, or 32 percent over the period 1993-2006 (just over 2 percent per annum). The last two years of the study (2005

² Between 15 and 30 percent of all technical workers in Silicon Valley are freelancers. In New York the majority of workers in multimedia are freelancers.

and 2006) showed record numbers of start-ups³. In the Netherlands there is no information available on freelancers, but there exists information on firms without personnel. This entity can be a freelancer, but also a retailer with a small shop (e.g. a butcher or bicycle repair shop). It is important to note that until July 2008 these small entrepreneurs were not obliged to register, which probably have lead to underestimation of their true numbers.

A more detailed look into entrepreneurial growth at industry-level data (see Table 2), reveals that most of this increase of firms without personnel can be contributed to professional services (70,000 new firms). These are freelancers such as lawyers, accountants, consultants, architects, engineers, media and advertisement agencies and employment agencies. But the increase in construction firms has also been remarkable over the past years (40,000 new firms without personnel). Other industries with sizeable increases in the number of firms without personnel are: health care (7,300 new firms), educational services (+6,300 new firms) and the cultural sector (+9,900 new firms). The growth in these sectors has more than offset the self-employment losses in the agricultural industry (a loss of 35,000 firms) and the retail sector (a loss of 5,000 firms).

Table 2: Firms and employees working in Dutch professional services

Professional Service	1995		2005	
	Firms	Employees	Firms	Employees
IT consultancy	--	---	16,075	143,780
Research	295	31,305	2,110	29,590
Legal advice	2825	16,730	3,230	26,080
Fiscal and financial advice	3,180	35,998	6,395	58,370
Market and opinion research	2,040	7,290	2,885	10,485
Organization and economic advice	9,965	22,740	29,690	65,455
Advertisement and PR	6,250	16,220	11,130	27,190
Technical design	9,400	63,950	16,475	93,075
Personnel testing and selection	---	---	2,210	9,300
Labor regulations (ARBO)	---	---	1,015	14,215
Education and training	3,610	12,460	10,515	30,360
Employment agencies	640	69,790	4,215	97,450
Total	38,295	276,788	105,940	605,350

Source: Kwakman (2007)

In The Netherlands the strong growth in the number of self-employed has run parallel with a decline in the average size of companies, reflecting the fact that self-employed growth is concentrated in a relatively limited number of freelance professions. The increase in professional labor was accompanied with a decrease in the average size of a professional firm. Was the average size of a professional service firm in 1995 approximately 7.2 employees, in 2005 this was reduced

³ These records years were followed by a new record of the number of start-up firms (103.000) in 2007 (CBS). 2008 promises to be another record year (if the credit crisis does not lead to more caution at potential entrepreneurs): in the first six months almost 58.000 new firms started.

to around 5.7 employees. This reduction was visible in all professional sectors. Looking at the size distribution of professional services firms in Table 3, one can conclude that the majority of professional service firms are small. Almost 70% of all firms have no personnel (i.e. they are probably freelancers), and about 95% of firms have less than 10 employees. The percentage of firms without personnel is the highest for segments such as organization and economic advice (80%), education and training (79%), and advertisement and PR (73%).

Table 3: The size of Dutch professional service firms (2005)

# employees	# Firms	Percentage
0 employees (i.e. self-employed)	72,610	68.5%
1-5 employees	21,770	20.5%
5-10 employees	4,930	4.7%
10-20 employees	3,350	3.2%
20-50 employees	2,055	1.9%
50-100 employees	660	0.6%
100 + employees	565	0.5%

Source: Kwakman (2007)

2.2 An explanation of freelance growth: The Theory of the Firm

Most authors who write about freelancers (e.g. Morris, 2004) argue that competitive pressures, deregulation, global competition, and a focus on short-term results, are the driving forces behind the growth of independent professionals. In this view, increased competitive pressures have heightened the need for flexibility and low cost (Capelli, 2004; Kalleberg, 2001). Although these explanations are valid in certain cases, they do not do justice to some of the true underlying causes. Any explanation of freelance growth should be based on our knowledge of the advantages of markets and firms: the Theory of the Firm.

2.2.1 Transaction Cost Economics

Transaction cost economics (TCE) is the most influential theory of the firm and is widely used by both researchers and practitioners. But there are many variations and formalizations of TCE (see Gibbons, 2005). In all variants of TCE there are two main assumptions. Firstly, individuals within a firm are assumed to be rationally bounded (Cyert and March, 1963). In spite of best efforts to deal with the complexity of the world around them, individuals are limited in their ability to plan for the future. As market contracts are per definition incomplete, costly mechanisms to monitor and enforce contractual performance may be needed. The second assumption underlying TCE is that of opportunism. Although not all parties are prone to opportunism, the assumption of bounded rationality suggests that it is costly to identify untrustworthy individuals beforehand.

The second assumption implies that contracting parties may take advantage of incomplete contracts. Both assumptions lead to the prediction that simple interactions are matched with simple modes of governance (such as markets) and complex interactions with more complex forms of organization (such as hierarchies). Within TCE, there are two major concepts: transaction costs and firm-specific knowledge. According to Robert Coase (1937), the main reason to establish a firm is to avoid the transaction costs of the price mechanism. Williamson's (1975) theory of the firm stresses the importance of firm specificity. He argues that the determinants of transaction costs are: 1) frequency, 2) firm-specificity, 3) uncertainty, 4) limited rationality, and 5) opportunistic behavior. In Williamson's view firm-specific knowledge brings actors (e.g. a firm and an employee) in a situation where they are dependent on each other and where rents can be better divided between both actors in a hierarchy than via the market mechanism.

Since its early foundation, TCE has had many critics. Kogut and Zander (1996), for example, argue that firms are more than just vehicles for lowering transaction costs. Firms provide loci of identification, and the organizational backdrop against which knowledge and experience could be shared and applied. In line with this thinking Goshal and Moran (1996) argue that application of TCE is bad for practice as it focuses on market failure, and does not consider the unique advantages that firms possess. They claim that the advantage of organizations over markets, does not lie in overcoming opportunism through hierarchy, but in leveraging the human ability to take initiative, to cooperate, and to learn. They follow Barnard (1938), who also argues that organizations fail when they are unable to create the social context necessary to build the trust and commitment that are needed for maintaining cooperation. In another study Goshal and Nahapiet (1999) contend that: 1) social capital facilitates the creation of new intellectual capital, 2) organizations are advantageous to the development of high levels of social capital and, thus, 3) it is because of this dense social capital that firms have an advantage over markets in creating, and sharing intellectual capital.

TCE seems capable to explain (part of) the recent growth in the numbers of independent professionals. Firstly, the introduction of the internet has possibly lead to lower transaction costs (e.g. search and hiring costs). It is nowadays possible to search, find, and hire genuine experts everywhere in the world, to a fraction of the costs before the internet era. It is much easier for organizations to rely on the market mechanism and establish a true networked organization than in the pre-internet age. Anderson's (2006) famous long-tail effect is not only applicable to

products and services, but certainly also to freelancers. Secondly, the increased level of (process) standardization across organizations since the 1980s, due to business process redesign, technology advancements and outsourcing, has decreased the importance of firm-specific knowledge in favor of industry and task-specific knowledge (Gibbons, 2004). This is another TCE explanation for looser ties between firms and individuals, as both parties have become less dependent on each other. However, it is also the case that current transaction costs in many freelance markets are still substantial. As an indicator for the size of transaction costs one might look at the fees of employment agencies. In The Netherlands it is not uncommon for these fees to be around twenty percent of professional fees, and these fees can be as high as forty percent in some occupations. These high costs point to the fact that it is still hard for demand and supply to find each other, due to 'soft' transaction costs which are related to reputation risk, limited market information, and product heterogeneity. In Chapter 3 these soft transaction costs are shortly discussed as they are important in freelance markets.

2.2.2 Resource-Based View of the Firm

Although the resource-based view (RBV) of the firm (Barney, 1991) is not a theory of the firm in the sense that its original purpose is not to explain the boundaries of the firm, it is highly influential in thinking about the essence of the firm. Key to the RBV theory is that resources determine sustainable competitiveness.⁴ These firm resources can be anything: highly-qualified employees, access to distribution channels or deep financial pockets. The theory specifies four criteria in two pairs, that must be satisfied in order to obtain sustainable competitive advantage. The first pair of criteria relates to the imperfectness of product markets as profitability requires imperfect competition: resources have to be scarce and valuable. The second pair of criteria relate to the imperfectness of factor (or resource) markets; the underlying resources should be costly to imitate and difficult to substitute for. So, the RBV theory says that whatever strategy is suggested, the fit of the underlying resources must meet this set of four criteria. The resource-based view has been hugely influential. Not only in management theory, but perhaps even more so in management practice. Especially the work of Prahalad and Hamal (1990) on core competences, has hugely influenced the behavior of firms regarding alliance forming and outsourcing (Ireland, 2002). The decisions of organizations to outsource activities or to form partnerships are time and again based on their understanding of their own core competences. This emphasis on core competences has led to a revolution in the last decades. The traditional value chain of Porter

⁴ In this thesis the terms endowment and capability are sometimes used as alternative for the term resource. The sum of a set of resources is given the term capital. Accordingly, the term financial capital is used to distinguish all financial resources (e.g. cash, bank accounts, shares, money deposits) and term human capital is used to delineate all human capabilities (e.g. individual and collective knowledge, skills and abilities).

(1985) has become unbundled. The focus on core competences has led to a proliferation of new markets. Activities that used to be bundled within one firm have become separated. Market relations now govern where once the hierarchy of the firm allocated resources. This has created many new companies who specialize in one area of the value chain, with new upcoming firms providing specific solutions in various value areas such as IT, HR, finance, and operations. The organizational energy to ever increasing specialization seems to be as forceful as ever as companies not only outsource their supporting functions, but increasingly also their core functions. Even traditional core activities, such as: marketing and sales, design and production, are nowadays brought outside the directive of the firm.

All in all, the resource-based view has been very influential in stressing the importance of core capabilities. It stresses the importance for firms to clearly define and focus on the dynamic set of capabilities that create sustainable competitiveness. This, at least in part, fueled the outsourcing trend of the last two decades and opened up new industry architectures for independent professionals to work in (Jacobides, 2004).

2.2.3 Knowledge-Based View of the Firm

The knowledge-based view (KBV) of the firm (Grant, 1996; Spender, 1996) is a special case of the RBV. Where the RBV treats knowledge as a generic resource, the knowledge view sees knowledge as the most strategically significant resource of the firm and emphasizes its special characteristics. The knowledge-based view claims that knowledge-based resources are usually difficult to imitate and socially complex and that, because of this complexity, knowledge is the major determinant of sustained competitive advantage and superior corporate performance. The relationship between organizational knowledge and competitive advantage is moderated by the firm's ability to integrate and apply knowledge (Grant, 1996). The broader the scope of knowledge being integrated, the harder it is to replicate. In order to facilitate the transfer of existing knowledge to different areas of the firm and to stimulate the creation of new private firm-specific knowledge, firms may use various knowledge strategies. The traditional focus of KBV on integration and dissemination of knowledge implies that common knowledge is more important than deep specialist knowledge. The recent work of Felin and Hesterly (2007) is important for the knowledge-based view of the firm, especially in the light of the independent professional. In a detailed analysis between collective and individualist approaches to the KBV, they show that the heterogeneity of knowledge is nested in individual employees and not in collective routines and other practices. Where traditional protagonists of the knowledge-based view have encouraged the application of collective-level instruments which facilitate, generate,

integrate, and transfer knowledge to obtain competitive advantage, Felin and Hesterly argue that KBV scholars should consider individual-level explanations for new value creation.

Kogut and Zander (2003) use the knowledge-based view as a basis for defining the boundaries of the firm. They see a firm as a community in which there exists a body of knowledge regarding how to cooperate and communicate. The value of the firm is determined by its role and participation within the broad knowledge network (Kogut, 2000). What determines the boundaries of the firm is not the failure of the market, as in transaction economics, but the firm's efficiency of the process of creating and transferring knowledge vis-à-vis the market. In line with the work of Kogut and Zander but focusing on the ability of a firm to generate (instead of integrate or transfer) knowledge, Nickerson and Zenger's (2004) theory suggests that the decomposability of a problem in various sub-problems, determines the optimal governance structure. Highly decomposable problems are best handled by markets, medium decomposable problems are best handled by authority hierarchies and non decomposable problems are best handled by consensus hierarchies.

2.2.4 Property Rights Theory

A property right is the exclusive authority to determine how a resource is used. This includes the right to use the good, the right to earn income from the good, and the right to transfer the good to others. Seminal works in classical property rights literature include Alchian and Demsetz (1972) and Demsetz (1967). The modern property rights approach builds on Grossman and Hart (1986). The Grossman-Hart model of property rights is one of the first formal models of the cost and benefits of integration. In property rights theory, the allocation of property rights determines the allocation of surplus and optimal investment policies.

Foss and Foss (2005) link RBV with property rights theory and see resources as bundles of property rights to attributes. The resource value that an owner can create, depends on the bundle of property rights that she holds for the attributes of the resource, the constraints imposed on these property rights and the costs of trading them. The value of the resource is significantly influenced by transaction costs and strategic opportunities arise when the transaction costs of defining, protecting, capturing, and exchanging property rights change. Liebeskind (1996) brings strategy, the theory of the firm, and property rights theory together, when she argues that the property rights concerning knowledge are still very weak and costly, to enforce and that because of this firms are better equipped than markets to protect the value of knowledge.

The area of property rights is very interesting, as the distribution of property rights among the various professions is very skewed. Some professions, such as: artists, architects, journalists and writers, have medium to strong property rights, while other professions, such as: management consultants and IT professionals, have almost no property rights. On the one hand, if a musician composes a new song, the rights to this song belong to the individual. An artist, such as a sculptor, has lifelong rights to his/her creation and even a client cannot change a work of art without permission. On the other hand, most patents in innovative areas, such as: high-tech and bio-tech are not registered on the name of individuals, but registered on behalf of large firms. Almost all firms explicitly state in their employment and freelance contracts that the property rights of innovations automatically transfer to the firm. Large firms often use their contracting power in the labor market to force individuals to accept these conditions. Even a freelance profession with strong property rights, such as journalists, is often forced to transfer the rights of articles to the media companies that hire them.

Nevertheless, according to Williamson (2000) property rights are the institutional rules of the game and will only change very slowly (i.e. every 10-100 years). Thus changes in property rights cannot have fueled the recent growth in independent professionals.

2.2.5 Principal-Agent Theory

Holmstrom and Milgrom (1991, 1994) see firms as systems of incentives. Their theory can be seen as an accidental theory of the firm. Instead of focusing on the make-or-buy problem, their study focuses on an incentive problem between a principal and an agent. Their study starts with 2 observations. Firstly, compensation for contractors generally provides for task-specific payments, with risks borne by the agent, whereas with employees all risks are typically borne by the firm and the employee is paid a flat fee or salary. Secondly, performance is often difficult to measure. In these situations, complex incentive structures that reward performance in some but not all dimensions can greatly distort the behavior of the agent. Holmstrom and Milgrom conclude that low-powered incentives are used as a key mechanism for inspiring cooperation and coordination. In comparing the terms on which in-house insurance sales agents typically operate in comparison with independent sales agents, Holmstrom and Milgrom find that the choice between freelancing and traditional employment appears to be driven by the relative ease or difficulty of measuring key aspects of performance, more than by the extent of investments in firm-specific human capital.

Blair (2005) finds it unlikely that the ease of measurement is the driving factor of integration. She argues that some production line workers, such as in the automobile industry, are paid by fixed

wages and others, such as workers in garment factories, are more likely to be paid piece rates. In other words, apparel workers are often compensated and treated more like freelancers than employees. In both cases, the activities of the worker are very easy to measure. But in the garment factory, individual workers can set their own pace at separate sewing machines, whereas in large automated factories, individual workers must learn to function at a pace set for them by the machines and by the other members of the team.

Also contrary to Holstrom-Milgrom's assumptions, flexible rewards, such as: options, bonuses and performance-pay, are almost never used in freelance contracts (with the possible exception of CEO's, if one sees them as freelancers with temporary pre-defined contracts). Flexible incentives are much more prevalent in traditional employee relations. Freelancers are almost always paid a fixed fee per time period (e.g. day or hour). This is perhaps because the performance of knowledge workers is often hard to measure (intangible) and because the principal has the power to terminate the employment relationship at any time (e.g. when the professional fails to deliver). One might even argue that this termination option is the main reason why it necessary to implement complex incentives for regular employees and not for freelancers, as the threat of immediate termination provides enough incentive for the freelancer.

2.3 A synthesis of TCE with RBV

The resource-based view is envisioned as a comprehensive model of organizational strategy and has incorporated transaction costs within the RBV (Peteraf, 1993). Transaction costs are in RBV an important driver of one of the four conditions for competitive advantage: imperfect mobility.⁵

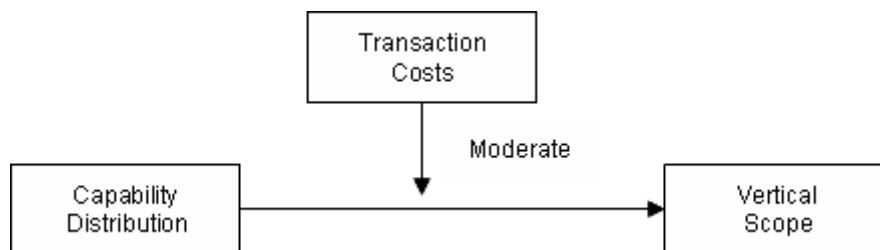
Although RBV theory includes transaction costs, several authors have lately made attempts to further integrate RBV and TCE, as RBV and TCE deal with partly overlapping phenomena. Williamson (1999) himself points out that a firm's history and capability endowments matter to boundary choices. He argues that RBV complements TCE in explaining scope. Where TCE focuses on the conditions of exchange, RBV focuses on the conditions of production. According to Nooteboom (2004) TCE overlooks the constraints on the ability to choose among alternative governance modes, whereas the RBV tends to ignore issues of governance. These theoretical considerations on the complementary scopes of both theories are strengthened by empirical

⁵ The implications of the diminishing transactions costs on the strategic position of firms, and the boundaries of firms are discussed in Chapter 11.

studies, which show that integration questions are often guided by both transaction and capability issues (e.g. Poppo and Zenger, 1998; Jacobides and Hitt, 2004). In Jacobides (2005) view, in a static situation, for market transactions to occur parties must find specialization advantageous. This includes both sufficiently different capabilities (RBV) and low transaction costs (TCE). At the core of Jacobides' argument lies the observation that productive capabilities are heterogeneous across the various parts of the firm. According to Jacobides (2005, p. 397), *“Even in environments where primary resources are quite homogeneous, different organizations are likely to display significantly different ways of accomplishing approximately the same thing, displaying different efficiencies as a result”*.

Jacobides (2005) and Jacobides and Winter (2005) argue that markets do not exist and are nothing but facades. In comparing the market with one's own capabilities, the firm in essence judges itself against the other firms within the industry. Transaction cost is therefore nothing more than a moderating function on the integration discussion (see Figure 1).

Figure 1: The static relationship between transaction costs and capabilities



Source: Jacobides (2006)

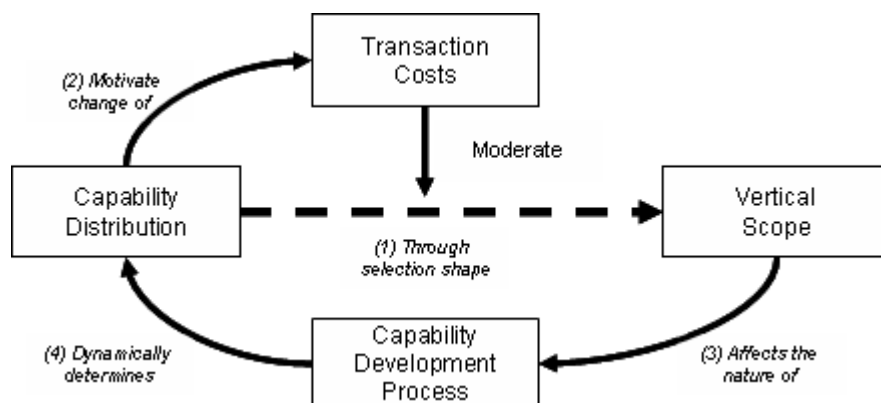
Jacobides and Hitt (2005) further state that to understand any firm's vertical scope, a systemic and dynamic view of the whole industry is needed, as the constantly changing transactional and capability conditions determine the possible choices on the menu and the preferred alternative of an individual firm. In line of path-dependency thinking, they argue that industries often start off being integrated, and therefore the question is not whether a firm will integrate or not, but rather whether a firm has the opportunity to choose if it will be integrated or specialized. Traditionally, TCE does not ask the question whether firms are offered the 'make or buy' choice.

Disintegration is a fresh phenomenon that can be currently witnessed in various industries, such as: automobiles, biotech, pharmaceutical, and financial services. The computer industry is probably one of the best examples. Here IBM was once the most important producer. Nowadays the industry has a multitude of segments, including component manufacturers, software and operating system providers, specialized assemblers, resellers, consultants, and much more. This

revolution is visible in every industry where disintegration occurred. The core of the industry, its identity and its competitive dynamics are radically transformed, even for the players who choose to remain integrated. Vertical disintegration creates a new specialized ecosystem that competes and sometimes partly cooperates with old integrated systems. Although disintegration has overpowering effects, our knowledge of this phenomenon is limited.

The study of Jacobides suggested that TCE indicators, such as: opportunism and asset specificity, are not useful in predicting disintegration and market creation. Based on his experience in the mortgage industry Jacobides developed a new model explaining disintegration. In his model there are 2 motivational factors driving disintegration: 1) **gains from specialization**, which result when there are differences in the needed knowledge, skills and abilities (e.g. managerial styles or knowledge bases) along the value chain and 2) **gains from trade**, which emerge whenever there are capability differences between specific firms in an industry, or when firms can expand only one part of the value chain, making reliance on the market desirable. These two motivators in turn generate two enabling processes. The gains from specialization create partitioning of firms along the value chain. The gains from trade start a process of co-specialization in which firms find ways to reduce transaction costs and seek templates for exchange across firm boundaries. When, as a result of these two processes, coordination is simplified and information becomes standardized, a new market emerges. Jacobides' dynamic model thus explains the ubiquitous trend in disintegration in many industries and service sectors. It points to the path dependency and draws attention to the importance of critical mass, that is necessary to develop new standards of communication and information in order to create new markets.

Figure 2: The dynamic relationship between transaction costs and capabilities

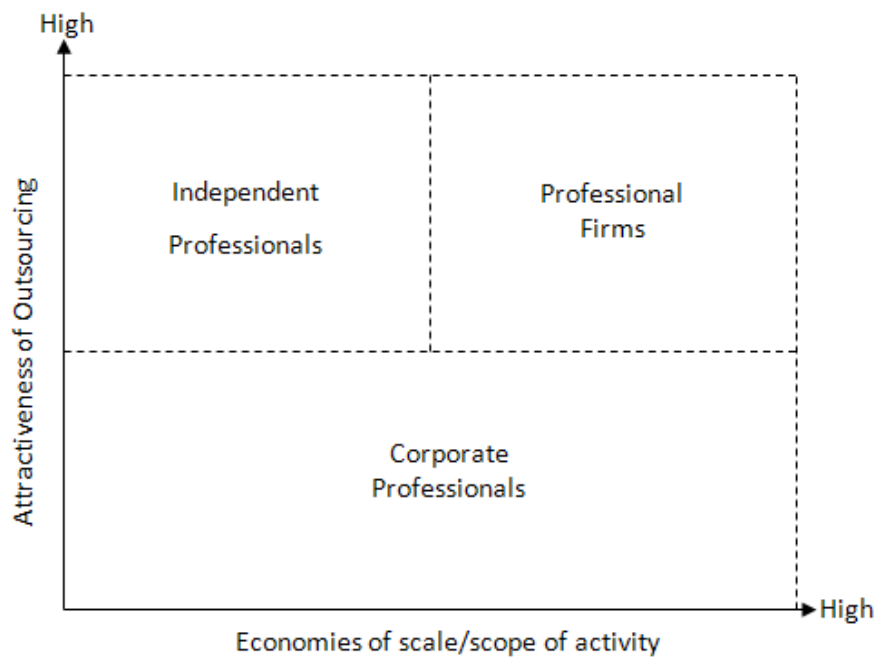


Source: Jacobides (2006)

In Figure 2 this process is depicted. Firstly, due to technological advancements and other economic and social changes, the distribution of capabilities and resources changes. This implies that specialization, or unbundling along the value chain, potentially leads to improved production. To accommodate specialization methods and techniques (e.g. data interchange formats) are developed to trade (2). When these transaction costs decrease the gains from trade further stimulate the development of specialized assets (forces (3) and (4)).

In this dynamic model the push towards disintegration is driven by heterogeneity of knowledge bases along the value chain. This creates the birth of a new industry. Gradually an accepted system of interfaces between economic actors emerges and the industry architecture becomes stable. According to Jacobides, Knudsen and Augier (2006) the industry architecture that emerges, is defined by the interfaces of those firms that initially hold superior capabilities. Once this industry architecture is established, it is very hard to change.

Figure 3: Outsourcing to freelancers and economies of scale & scope



The theory of Jacobides explains the recent trend towards disintegration, but the theory only partly explains the growth of freelancing, as an organization can outsource to a freelancer, but also to a large professional organization. This is because these theories do not pay any attention to economies of scale and scope in the knowledge economy. And it is here where the economies of scale and scope become important. Figure 3 shows that outsourcing to independent professionals is important in industries where economies of scale and scope are less important. In the creative service oriented knowledge economy, the economies of scale and scope are much

less important than in the large scale industrial era due to technological advancements and the individual nature of service, creativity and innovation.

Seeing all the evidence and theories above, one can distillate four reasons for freelance growth when one looks at the above theories of organizational boundaries. Firstly, the arrival of the internet has lead to **lower transaction costs**. It is nowadays possible to search, find and hire genuine experts everywhere in the world to a fraction of the costs before the internet era. It is much easier for organizations to rely on the market mechanism and establish a true networked organization than in the pre-internet age. Anderson's long tail effect is not only applicable to products and services, but certainly also to freelancers. Secondly, the **increased level of (process) standardization** across organizations since the 1980s, due to business process redesign, technology advancements and outsourcing, has decreased the importance of firm specific knowledge in favor of industry and task specific knowledge. Gibbons and Waldman (2004, 2006) focus on the effects of the increase of task-specific human capital versus firm-specific human capital. In such a world, utilization of human capital is optimized when a worker switches between firms to maximize professional skills. Thirdly, the ongoing **miniaturization of technical solutions** has increased the power of individuals along the value chain. Activities which always had to be performed by large teams with significant capital are nowadays performed by a single individual. This decomposition of the resource distribution makes outsourcing of specialized tasks more interesting. This argument is in line with several other authors (Thurow, 2003), who argue that in the last decennia the advantage has moved from large corporations to small firms because information technologies have reduced the importance of scale economies. Fourthly, Matusik and Hill (1998) show that a firm can dynamically increase its competitive position by using freelancers in their core. Using freelancers increases innovation and flexibility of a firm. Freelancers are therefore especially useful for firms which operate in **innovative and competitive knowledge environments**, such as: media and technology firms.

Then there are a number of trends that are perhaps not causing the growth of freelancing, but are supporting forces. Firstly, the age wave is increasing the war for talent, making it less risky for individuals to start a career as an independent professional. Secondly, globalization has led to an acceleration of the share of the knowledge economy in Western countries as more and more large scale industries are outsourced to countries with cheaper labor costs. Thirdly, the labor protection rules in the traditional labor market together with the increased share of personnel costs in the knowledge economy, are making freelancing more attractive.

Conclusions of Chapter 2:

1. Freelancing is a growing phenomenon in the Netherlands and most other Western economies.
2. The primary reasons for the growth in freelancing are:
 - a. Lower transaction cost of searching, finding and hiring true professionals due to the arrival of the internet;
 - b. Increased standardization of business processes and technology solutions, which increased the importance of professional and industry knowledge over firm knowledge;
 - c. Miniaturization of technology solutions has given the individual much more power;
 - d. Arrival of the knowledge economy with his emphasize on creativity, innovation and flexibility. Freelancing is the preferred method of contracting in a creative economy, where innovation and flexibility are crucial.
3. There are a number of trends that are not causing the growth of freelancing, but are supporting it. Firstly, the age wave is increasing the war for talent, making it less risky for individuals to start a career as an independent professional. Secondly, globalization has led to an acceleration of the share of the knowledge economy. Thirdly, the labor protection rules in the traditional labor market, together with the increased share of personnel costs in the knowledge economy, are making freelancing relatively more attractive.
4. All drivers behind freelance growth are structural. Jacobides model of disintegration suggests that slowly but steadily, more and more sectors in the knowledge economy will be governed by hybrid freelance markets instead of traditional large scale firms.