In 1997, in one of the most ambitious anti-trust actions of the 20th century, the United States Department of Justice and the Attorneys General of 19 States sued Microsoft. Just as they had with John D. Rockefeller’s Standard Oil and American Telephone & Telegraph (AT&T), the government’s lawyers launched an all-out assault on the nation’s most valuable company.
THE REAL LOSERS IN THE MICROSOFT ANTI-TRUST CASE

By Nicholas Economides

The government’s crusade against Microsoft and the world’s richest man could end up costing customers and the computer industry dearly.

Aside from inviting unwelcome comparisons between Microsoft founder Bill Gates and John D. Rockefeller — the richest men of their respective epochs — the Microsoft case has captured a great deal of attention. And when Microsoft refused to settle, the case went to a lengthy and closely watched trial, with an all-star witness list that included Gates himself as well as other computer industry luminaries.

U.S. vs. Microsoft raised serious issues. The government had charged Microsoft with a range of abuses, including the alleged monopolization of the market for operating systems (“OS”) for personal computers by Windows, anti-competitive bundling of Internet Explorer with Windows, and various other exclusionary and anti-competitive acts against competitors and buyers.

In December 1999, U.S. District Court Judge Thomas Penfield Jackson issued a far-reaching “findings of fact” that found for the plaintiffs in almost all the allegations. (The judge’s findings of law, expected by the end of March, will most likely rule the same way.) Jackson found, among other things, that:

➤ Microsoft has a monopoly in the PC operating systems market where it enjoys a large and stable market share;
➤ Microsoft used its monopoly power in the PC operating systems market and harmed competitors;
➤ Microsoft hobbled the innovation process;
➤ Various Microsoft contracts had anti-competitive implications;
➤ Microsoft actions harmed consumers.

These findings by no means signaled the end of the case. But they provide important guidance for the ultimate outcome, which will define the value of Microsoft and the computer industry’s rules of competition for years to come.

What next? Given Judge Jackson’s across-the-board siding with the plaintiffs, a negotiated settlement seems extremely unlikely in the short run, even though Judge Richard Posner, a prominent antitrust scholar, was appointed as a mediator. For any settlement would be based on Jackson’s “findings of fact,” which would make Microsoft unlikely to settle. Instead, the company will probably exhaust all appeal possibilities and try to settle the case after the Presidential election.

Microsoft has already suffered substantial fallout from the process, however. The company has essentially foreclosed making any aggressive moves while the case continues. So even as America Online (AOL) agreed to buy Time Warner, and as companies in a range of industries continued to strike alliances and merge, Microsoft has largely been forced to stay on the sidelines.

Microsoft’s future will be very bleak if the Department of Justice prevails and breaks it up. Three break-up plans have been proposed. In the first, Microsoft would be divided along lines of business into three companies: one for operating systems (Windows 98, NT, and 2000), one for Internet applications (Internet Explorer), and one for other applications (MS-Office, MS-Money, etc.). The second plan would separate Microsoft into three “identical” parts,
with each part acquiring the source code of all the programs the company presently sells and one-third of all employees. These prospective entities have been dubbed “Baby Bills.” The third plan is a combination of the previous two: First Microsoft would be divided into three companies according to the type of program produced, and then the operating systems company would be broken into three parts, thus creating five Baby Bills.

Microsoft views the breakup attempt as a very serious threat. Steve Ballmer, Microsoft’s new chief executive officer, noted at his appointment ceremony that a break-up “would be utterly irresponsible.” Such a move would undoubtedly cause great inconvenience and challenges to Ballmer and his colleagues. But would it have a similarly negative effect on Microsoft’s customers and shareholders? The answer: Yes.

First, consumers have directly benefited from the free distribution of Internet Explorer and the bundling of Internet Explorer with Windows – two tactics that Judge Jackson identified as key anti-competitive actions. When Microsoft started seriously competing with Netscape in the Internet browser market, Netscape – essentially the sole provider – charged non-academic users $40-$50 to download the program. Microsoft, by contrast, gave its Internet browser away.

Today, with at least 40 million browsers installed in the United States, the actions of Microsoft created a direct benefit of $1.6 to $2 billion to American consumers. And since Microsoft’s actions intensified competition, which in turn produced higher quality browsers, they provided further value.

Second, consumers have directly benefited from the relatively low price of Windows. Microsoft’s operating system, for which computer manufacturers pay $40-$60 per copy, is cheap compared to the historical and current prices of other operating systems. For example, in the late 1980s, IBM sold OS/2 (which ran many fewer applications than Windows) for hundreds of dollars. Some Linux packages – essentially add-ons to the free Linux source code – currently sell for $150, and run far fewer applications than Windows does. These price discrepancies highlight a huge contradiction in the government’s case and in the judge’s findings of fact. If Microsoft were a true malevolent monopoly, it would charge far more for Windows than it does. The annual consumer benefits from Windows’ relatively low price may be many billions of dollars.

In arguing for a break-up, some Microsoft critics point to the successful 1982 break-up of AT&T. The company was divided into the long-distance company (AT&T) and seven regional operating companies, each of which remained a regulated local telecommunications monopoly. The destruction of AT&T’s long-distance monopoly encouraged competition, which brought sharply lower prices and immense consumer benefits.

However, there are a number of key differences between the two companies and their competitive situations. And these differences make it very likely that a Microsoft breakup, besides harming Microsoft, would harm consumers and the computer industry.

In 1981, AT&T was a 100-year-old company with many layers of management. For historical reasons, the local phone companies within the old AT&T, such as New York Telephone, were managed separately from the “long lines” division. Thus, it was not difficult to separate the divisions since they functioned on many
levels as separate companies. And AT&T’s rigid management structure and abundance of managers helped it avoid managerial problems in the break-up.

By contrast, Microsoft is a young, entrepreneurial company run by very few top executives (about 20), and its divisions are very fluid. While this has made Microsoft one of the most efficient and successful companies around, it also means that a break-up would pose significant managerial problems and severely reduce the company’s flexibility.

Second, the industries are different. Telecommunications companies are regulated as public utilities. In the 1930s, all phone companies were forced by the government to interconnect so that anyone could place a call to anyone else. The companies emerging from the AT&T breakup were guaranteed to stay interconnected.

By contrast, it is almost certain that each of the Baby Bills, within a few months after a Microsoft break-up into three identical parts, would begin producing its own “improved” version of Windows. Each would likely be incompatible with the Windows of the other two baby Bills. Some software vendors would write programs that would be compatible with each version of Windows, while others undoubtedly would not. This would inevitably reduce the range of software that would be compatible with consumers’ computers.

Emerging incompatibilities would also hurt shareholders, since the combined value of the resulting Baby Bills will be smaller than that of the original Microsoft. The situation would also be a nightmare for corporate IT departments until, in a few years, one of the three Microsofts becomes the dominant platform.

Three alternatives to a far-reaching breakup have been proposed. And they may offer a set of more reasonable alternatives.

One is auctioning the Windows source code. Given the present stock market value of Microsoft, Windows source code may be worth as much as $200 billion. No company can bid that much cash in an auction. (Practically speaking, only a handful of foreign governments could.) This implies that the source code of Windows will be sold forcibly at a small fraction of its worth, and that would severely reduce the value of shareholders’ equity. Auctioning the Windows code would not only effectively confiscate Microsoft’s intellectual property, it would also seriously reduce the incentive for innovation. Moreover, source code evolves. Over time, different firms will add and alter the Windows code. Soon, incompatibilities will arise, with all the negative consequences described earlier.

A second solution would be to force Microsoft to disclose the so-called “APIs” (lines of software code that define interfaces between applications) that permit it to include Internet Explorer in the operating system. Microsoft routinely discloses APIs that hook applications to the operating system and allow for interoperability. Currently, it does not disclose the APIs that tie together parts of the Windows operating system, which includes Internet Explorer. If Microsoft were to disclose the APIs that hook Internet Explorer to other parts of the operating system, Netscape (or any other browser) could get the same interoperability with Windows.

A third solution – and in my mind, the best – would be to consider imposing various restrictions on the contracts that Microsoft can write with sellers of complementary goods and with competitors. This is a likely remedy that is easy to tailor according to the violation.

This remedy, combined with forcing Microsoft to disclose certain APIs, should be sufficient to guarantee that Microsoft will be precluded from taking anti-competitive actions. At the same time, it preserves the managerial and other benefits that have made Microsoft one of the most successful and profitable companies ever.

Regardless of the final outcome, the effects of U.S. vs. Microsoft are likely to be felt for a long time. A far-reaching break-up would likely impose the dark shadow of radical antitrust intervention on the whole computer industry. And if the Justice Department wins big on Microsoft, anti-trust suits against AOL, Yahoo, and other pioneers of the New Economy will not be far behind.

For more information, see the “Economics of Networks” Internet site at http://www.stern.nyu.edu/networks.

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