



Policy Brief

Stanford Institute for Economic Policy Research

The Microsoft Case: Implications for Competition and Innovation

The Microsoft antitrust case raises the issue of appropriate anti-trust enforcement in a highly innovative and rapidly changing industry. Critics often think that enforcement must be anti-innovation, but the reality is the opposite. Microsoft inhibited the widespread distribution and adoption of innovative technologies in order to maintain its monopoly position in operating systems. Microsoft's Windows monopoly was legal, and it was not challenged by the government. A number of new technologies from the Internet, however, threatened Microsoft. If other firms succeeded in commercializing those technologies, and if the technologies remained under the strategic control of those other firms, the resulting vertically disintegrated industry structure would weaken Microsoft's position dramatically. To make matters worse for Microsoft, it was unable to defeat those new threats by competition on the merits. Microsoft dealt with this as a business problem, breaking the law to inhibit the widespread competitive distribution of the threatening technologies. The economic consequences are severe, as Microsoft's actions deprive computer buyers of the choices brought by the Internet and interfere with mass-market distribution of valuable innovative technologies.

Monopolies like that of Windows don't end easily, but they can and do end. To compete with or displace Windows, a new operating system would need to get over a difficult chicken-and-egg hump. Users buy Windows not just for its features but also because it has the richest mix of applications. Applications authors write for Windows not only because it is a capable development platform, but also because it has the largest installed base of users. This "applications barrier to entry" is substantial. An entrant would need to induce both many users and many applications to switch, a difficult or impossible task in ordinary times.

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The late 1990s were not an ordinary time: the commercialization of the Internet was a thunderclap, leading to new classes of network-centric applications and to new users, many at home rather than at work. Microsoft correctly assessed that the innovations brought by the Internet were good for its customers. But those same new ideas were dangerous to the company's monopoly position, undermining Microsoft by bringing better and cheaper alternatives to its operating system. Structurally, what Microsoft feared was vertical disintegration, knowing that a powerful technology like the browser controlled by another firm would restore the competitive situation it had seen earlier in the PC industry.

Microsoft responded with both legal and illegal actions. They made their own browser and their own version of Java, improved them, and priced them low. All that was legal – and none of it worked to stop the competitive threats. Microsoft over and over concluded that they could not win the battle for control of the PC—Internet interface only by those lawful strategies. To preserve their position, they added a mix of strategies that are clearly illegal. It tried to bribe or bully Netscape not to offer a competitive threat. Netscape refused. Annoyed that important complimentors such as applications developers, Internet access providers, and Apple chose Netscape's browser or Sun's Java as better for their customers, Microsoft bribed some of these third parties and used its monopoly power to compel others to choose the Microsoft variants.

Steadily, Microsoft increased the limitations on PC manufacturers. At first Microsoft mandated distribution and prominent display of its browser. It then banned PC innovations that made it easier for customers to choose and use Netscape. Customers continued to choose the better and more popular product, however, and Microsoft despaired of ways to get them to switch. It responded by making it harder and harder for its customers to choose a browser on the merits, ultimately tying the browser so tightly to the operating system as to make it a “jolting experience” to use Netscape's product. Trampling over the screams of protest from their immediate customers, the PC manufacturers, Microsoft forced its ultimate customers, end users, to take the product they didn't want and made it hard for them to choose the product they did want.

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Microsoft was not found guilty of “competing too hard” nor were its actions harmless to consumers. Customer-harming and customer-choice-preventing actions to block commercialization of a new and useful technology in order to preserve a longstanding monopoly are and should be highly illegal. This is the central point of the Sherman Act, and a centerpiece among the drivers of American economic success. The old winner gets to enjoy his natural advantages, such as his huge installed base, but the new challenger gets the opportunity to bid for business on the merits of his product or technology. Ultimately, the market chooses and consumers reap the benefit of competition and innovation. Microsoft, unable to win by invention or by effective execution, abused its position to prevent competition on the merits.

Microsoft didn't stop with attacks on the browser and Java, but has a persistent pattern of failure to compete on the merits. A number of other innovative technologies from a variety of companies, notably multimedia technologies, would have had the chance to attract demand based on their technical merit except for Microsoft's antitrust violations. Microsoft was found guilty of illegally interfering with distribution of so many technologies it found competitively inconvenient that the District Court found

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a “corporate practice” of blocking distribution of such technologies. This practice continues today. Mr. Gates, for example, finds use of non-Microsoft technologies for communications between cell phones and the web to be competitively inconvenient, and

has directed his team to use the same kind of anticompetitive shenanigans to prevent it. Similar tactics are being launched to prevent effective competition from server-based computing. The hallmarks of all these attacks are the same. Microsoft cannot bear external control of general-purpose software technologies. But it lacks the ability to provide best or near-best technologies in all

the new technical areas made commercially feasible by the Internet. Solely to preserve its position, and disdainful of the harm to its customers, it plans to win by breaking the law, not by innovating or executing.

What should a government dedicated to market solutions do when confronted with this situation? Negotiate at every stage, but then what? Many observers, including me, have argued that the government should not break up Microsoft just because it thinks a different industry structure is better. That is not the motivation for the current breakup: had Microsoft not violated the law, we would now have an independent browser company, not control of both the PC operating system and the browser by the same firm. The remedy entered by the District Court last June would split Microsoft into applications and operating systems companies, restoring the more competitive vertically disintegrated industry structure Microsoft sought to prevent. (It is too late in the technological history to restore a standalone browser company.) The applications company and the operating system company will each serve as a sponsor of entry into the other's market, a pattern of competition well established in the history of the PC as highly valuable for consumers. Each is a potential distribution partner for innovative technologies, likely ending the pattern of suppression of innovation.

The early part of the new century is, once again, not an ordinary time. A number of innovative technologies are emerging, ones important enough that buyers of computers will get real opportunities to choose real change – that is, if existing dominant firms like Microsoft don't unlawfully interfere with the choice. There is an opportunity for market forces to work, and the vertical disintegration put in place by this remedy will permit them to work. The remedy permits, but does not compel, the emergence of competition in the operating system and browser markets, and permits, but does not compel, the marketplace to choose new, open, Internet-based foundations for the future of computing. Microsoft is reduced to arguing, as did AT&T before it, that the best way to get innovation is to have one firm plan and coordinate it. The irony of antitrust: private firms in favor of central planning, while the government stands in for market forces. ■

Though I served as Chief Economist of the Antitrust Division until June and continue to consult with them, this Policy Brief is my view as a private scholar, not the official position of the Division.

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