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Microsoft

On April 3, 2000 Judge Thomas Penfield Jackson issued his conclusions of law regarding the *US vs Microsoft* case. In his ruling, which was largely favorable to the plaintiff, Judge Jackson stated that Microsoft had monopoly power and taken actions to crush attempts to challenge such monopoly power. On June 7, he also ordered a rather severe remedy: the breakup of Microsoft into two companies, one offering the Windows operating system and one offering other software products.[1]

Was this to be the end of a twenty-four-year success story?

Microsoft Corporation

Soon after dropping out of Harvard University, Bill Gates (with Paul Allen) founded Microsoft Corporation on April on 4, 1975 in Albuquerque, New Mexico. During its first few years, the company wrote a variety of software for Apple and other computer manufacturers. Microsoft's first real successful product was the Disk Operating System (DOS), which it purchased in 1981 from Seattle Computer Products and was used in IBMs newly developed personal computer. In November 1985 Microsoft released the first version of Windows, originally a graphical extension of MS-DOS. Windows 95, which was launched ten years later, sold more than a million copies in the first four days.

As of 2008, Microsoft employed a workforce of about 90,000 and grossed over $60 billion in sales.

Per-processor fees

Microsoft's legal problems in the US started as early as in 1991, when the Federal Trade Commission opened an inquiry into the software firm's actions in the PC operating system. Microsoft's MS-DOS operating system was then competing with other versions of DOS, most notably DRI-DOS, as well as other operating systems, such as the MacOS. Microsoft clearly dominated this market, but DRI-DOS's market share was increasing rapidly. In addition to its operating system (MS-DOS and then Windows), Microsoft also sold a variety of applications software, such as Word. Here the competition consisted of third-party applications software that ran on Microsoft's OS (e.g., Word Perfect).

Possibly reacting to competitor threats to its dominance, Microsoft engaged in a series of pricing strategies that were nothing less than brilliant. First, it forced original equipment manufacturers (that is, desktop computer makers such as Hewlett Packard or Compaq) to pay Microsoft a fee per computer processor sold *regardless* of whether such processor was shipped with MS-DOS or with any other operating system. Second, Microsoft pressed OEM's to purchase a bundle of products (tied sales) in a way that effectively disadvantaged third-party suppliers who could only offer one of the products offered by Microsoft.

The FTC investigation was about these allegedly anti-competitive practices. In 1993, the commissioners deadlocked in a 2-2 vote and closed the investigation. However, soon after the FTC stalemate the Department of Justice (DoJ) opened its own investigation. Differently from the FTC, the DOJ considered Microsoft's practices to be anticompetitive. As a result, Microsoft was forced to settle by signing a consent decree. In it, Microsoft agreed to end "per-processor" contracts with original equipment manufacturers (OEMs), although it was allowed to use unrestricted quantity discounts. Moreover, the software giant agreed not to tie other Microsoft products to the sale of Windows, though it remained free to integrate additional features into its operating system.

The 1995 consent decree was a fragile, unstable equilibrium. In particular, the distinction between a tie-in and a feature that is an integral part of the product was not clear. It was only a matter of time before a dispute arose regarding the decree's interpretation.

Browser wars: US v Microsoft

The mid-1990s were a period of rapid technology change. During the early 1990s, Microsoft's plain MS-DOS gradually gave way to the Windows operating system. Moreover, as the Internet expanded, the demand for web browsers increased. Netscape, one of the early entrants, dominated the browser market. Trailing Netscape by a few years, Microsoft introduced its own browser, the Internet Explorer (IE), which was bundled with Windows and thus offered at no extra charge.

In 1998, the first major legal case against Microsoft was brought about by various states as well as the Department of Justice. Among other things, the plaintiffs claimed that Microsoft had violated the 1995 consent decree. The decree's unprecise definition of tie-in become apparent: is IE an *added feature* of the Windows operating system, or is it a different product that Microsoft bundled with Windows?

Timothy Bersnahan, chief economist of the DOJ Antitrust Division during the Microsoft case, argued that

> OEMs were contractually required to carry Internet Explorer and display it prominently, even when consumers overwhelmingly preferred Netscape and when OEMs protested that there were substantial costs (confusion, support calls, etc.) of distributing the product consumers didn't want next to the product they did ... OEMs could not afford not to distribute Microsoft Windows and survive commercially, so this was clear use of existing monopoly power to prevent a competitive threat.[2]

According to Bresnahan, OEMs were not the only targets of Microsoft's tactics:

> Firms that made PC applications software ("ISVs") were contractually required to make IE the default browser used by their software and to make Microsoft Java the default Java (if their software used a browser or Java) ... Why did ISVs accept? The requirement was a condition of the "First Wave" contracts that permitted ISVs to learn about new versions of Windows in the lengthy testing and coordinating period before the versions were commercially released. Timely access to that information was a commercial necessity to anyone writing end-user oriented software, so they agreed. Through these ISV requirements,

> Microsoft successfully denied Netscape and Sun the opportunity to make valuable contractual and collaborative relationships with software developers that would have led to improved Internet software applications.[2]

Microsoft's defense was that IE was a feature, a functionality, of the Windows operating system, and as such should be encouraged, not discouraged. For example economists Stephen E. Margolis and Stan Liebowitz argued that

> Progress in software inevitably involves increased functionality. A legal rule against adding functions to software products would impede progress in the software industry.[3]

In his testimony for the plaintiffs, economist Frank Fisher also referred to Microsoft's "predatory pricing and distribution of its browser."[4] To this, Margolis and Liebowitz respond by arguing that

> Economists are generally skeptical of claims that price cuts or other actions have predatory intent because they have determined, both in theory and in practice, that predatory campaigns are unlikely to have profitable endings ... Predation drains the predator while imposing uncertain burdens on the prey.
>
> Another problem with predation is that almost any action that a firm takes to become more attractive to consumers can be alleged to be predatory ... In the most elementary case, a price cut or product improvement will damage the prospects for some competitor. It bears noting that most of the alleged cases of predation have been demonstrated to be false.[3]

A related point of contention — in fact, a central point in the case — centered on whether Microsoft did or did not have monopoly power. The issue is important because many practices — tied sales, for example — which may be considered anticompetitive when practiced by a firm with market power are unlikely to raise objections when practiced by a competitive firm. Frank Fisher argued that

> Microsoft possesses monopoly power in the market for operating systems for Intel-compatible desktop personal computers. There are no reasonable substitutes for Microsoft's Windows operating systems for Intel-compatible desktop PCs. Operating systems for non-Intel-based computers are not a reasonable substitute for Microsoft's Windows operating system.

Responding to accusations that Microsoft used illegal tactics to drive out competitors, the defense's leading economist Richard Schmalensee asked:

> So, what is the evidence this "monopolist" cashed in by charging more for Windows? On average, computer makers pay about $65 for Windows 98 — far less than they paid for DOS, Microsoft's operating system of the 1980s, after you factor in the extra software consumers had to buy to get even a portion of the features Windows offers today. Some monopoly.
>
> By my calculations, a real monopolist — one who extracted the last dollar of profit from consumers — would charge hundreds of dollars more for the software that runs modern PCs.[5]

Trial, appeal and settlement

The Microsoft trial, which took place on an accelerated schedule, lasted from October 1998 until June 1999. In November 1999, Judge Jackson issued his "findings of fact," which were rather favorable to the government's case. He also recommended that the parties attempt to reach a settlement. On April 1, 2000, settlement talks broke down. Two days later, Judge Jackson issued his "conclusions of law," again siding with the plaintiff; and in June 2000, he issued a series of remedies, among which the split of Microsoft into two companies (dealing with operating system and applications, respectively).[1]

Microsoft appealed and was granted a stay on these remedies until the appeal was heard. The government proposed that the Supreme Court hear the case immediately, but the Supreme Court refused to do so. Instead, the DC Court of Appeals took on the case. Although the findings of fact by the lower court were upheld, the Court of Appeals overturned Judge Jackson's rulings against Microsoft. This decision was a considerable loss for the plaintiffs but especially for Judge Jackson, who was accused of unethical conduct when giving a media interview about the litigation process. The case was remanded to the lower Courts and Judge Colleen Kollar-Kotelly was chosen to find a more appropriate remedy.

During his 2000 campaign, George W Bush disclosed his stance on antitrust by stating that he would only pursue price fixing antitrust cases. In fact, the new DOJ was far more pro-business than the Clinton administration's. In September 2001, the DOJ announced that it was no longer seeking Microsoft's breakup. Two months later it reached an agreement with Microsoft, which was accepted by Judge Kollar-Kotelly on November 1, 2002. Among other things, the settlement agreement required Microsoft to share its application programming interfaces with third-party suppliers. However, it did not prevent Microsoft from bundling applications software with the Windows OS.

In a post-mortem of the US case, economist Carl Shapiro, who served as an expert witness on behalf of the states (and was appointed chief economist at the Antitrust Division in 2009) stated that

> In my view, the Justice Department dropped the ball during the remedy phase of the case. Perhaps the change in leadership at the Antitrust Division had a major impact on how the Division handled the case during the remedy phase.[6]

The European Union (ongoing) saga

In parallel with the US, the European Union (EU) — more specifically the European Commission's DG Comp — has had a legal spat with Microsoft for years. This was partly the result of complaints by Microsoft's competitors, partly the EC's initiative. The allegations included the practice of per-processor fees, the bundling of Windows Media Player with Windows, and the refusal to share inter-operability information required for third parties to write software to run on Windows.

In March 2004, the EU ordered Microsoft to divulge server information to third-party software writers; and to offer a version of Windows (which came to be called Windows XP N) that did *not* include the Windows Media Player in it. Finally, the US software firm was ordered to pay €497 million ($794 million), at the time the largest fine ever handed out by the EC.[7]

Microsoft complied with the EU and offered the MediaPlayer-less version of Windnows, for which, not surprisingly, there was little demand. The appeal of the EC's 2004 decision was rendered fruitless when, in 17 September 2007, the European Court of Justice ruled in favor of the EC. A month later, the US company announced that it would no longer appeal the decision.

Microsoft's prospects did not improve when, in November 2004, Neelie Kroes was appointed the European Commissioner for Competition. The new commissioner, a professed believer in open standards and open source software, continued and stepped up the pressure on Microsoft, both in terms of remedies and in terms of fines. For example, in February 2008, Microsoft was fined an additional €899 million (US$1.44 billion) for failure to comply with the March 2004 antitrust decision.

Meanwhile, the issue of bundling IE with windows was brought back to life in January 2009 when the EC stated that "Microsoft's tying of Internet Explorer to the Windows operating system harms competition between web browsers, undermines product innovation and ultimately reduces consumer choice." This was clearly reminiscent of 1998 US case, with one important difference: since then, Mozlia's Firefox, partly backed by giant Google, had gradually eaten up IE's market share. To prevent the anti-competitive effects of tying IE with Windows, the Commission proposed that Microsoft offered Windows with a menu that allows the buyer to choose which web browser it wants to use. In July 2009, Microsoft declared that it would comply with the EC's proposed remedy.

Epilogue

On June 2, 1999, the *Washington Post* and the *New York Times* ran a full-page ad paid by the Independent Institute. It was titled "An Open Letter to President Clinton From 240 Economists On Antitrust Protectionism" and stated that

> Consumers did not ask for these antitrust actions [by the US against Microsoft] — rival business firms did. Consumers of high technology have enjoyed falling prices, expanding outputs, and a breathtaking array of new products and innovations ... Increasingly, however, some firms have sought to handicap their rivals by turning to government for protection. Many of these cases are based on speculation about some vaguely specified consumer harm in some unspecified future, and many of the proposed interventions will weaken successful US firms and impede their competitiveness abroad.

Consumers did not initiate litigation against Microsoft. But was consumer welfare maximized with a concentrated market structure and the rate of innovation that flowed from it? Ralph Nader, the well-known consumer advocate, didn't think so:

> Microsoft has rarely been the innovator ... Excel, the Microsoft spreadsheet, is an imitation of Lotus 123, which was in turn an imitation of VisiCalc ... Microsoft Word was introduced into the market long after several other popular word processors. Microsoft's Power Point imitated programs such as Harvard Graphics or Freelance, and Microsoft used acquisitions to buy itself into the relational database market ... While Microsoft was typically late for the dance, it rarely left empty-handed. Today, Microsoft so completely dominates each

> of these markets that few venture capitalists would even consider funding new programs that would seek to dislodge it. Microsoft is not only successful, it seems unbeatable in the PC applications markets.[8]

Will the real consumer please stand up and state his case? In most markets, consumers to do by voting with their dollar. What makes Microsoft a special case is that, through a combination of market power and network effects ("I use Windows not so much because I like it but because everyone else uses it"), the consumer may not necessarily get the best deal.

Whether or not this is the case continues to be a matter of great controversy, even among economists (or especially among economists):

> On the issue of innovation, economists' opinions are split on whether monopoly or competition would create more innovation. Economists' opinions are also split on whether vertically integrated or independent companies create more innovation.[1]

It's no wonder, therefore, that regulators and antitrust authorities have a hard time deciding on the right policy toward Microsoft.

Endnotes

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4. Direct Testimony of Franklin M. Fisher in *US v. Microsoft*.
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