In quest of profits: legal and ethical implications facing Microsoft

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Abstract *Despite its wide acceptance in economics, the fundamental tenet of the theory of the firm is not without its critics. Questions related to the nature and role of the firm, its objectives, responsibilities and behavior have fueled much of the recent debate. Today, firms are being evaluated and scrutinized not merely on their economic performance, but also by the ethical standards they uphold. The case brought against Microsoft is an example of the tangled web that characterizes the economic, legal and ethical dimensions of business operations. This paper shows that as an economic entity, Microsoft employed strategies that were consistent with its long-run objective of profit maximization. In so doing, however, Microsoft violated anti-trust laws and was charged with illegal conduct. Despite the court ruling, economic and legal justifications continue to be a subject of debate amongst the different entities involved in this case. More so when ethical implications are considered, consensus becomes even harder to reach due to the subjective nature of the judgement.*

Introduction: the legal case against Microsoft

The actions that Microsoft are accused of are not unique. Issues dealing with monopoly, tying agreements, and exclusive dealings have been raised and argued in this case as well as several other precedents. In this case specifically, the Department of Justice (DOJ) claimed that Microsoft implemented numerous illegal practices to preserve its monopoly power in the operating systems market. Furthermore, the government stated that Microsoft's monopoly was not kept by competitive advantage, but rather that it was preserved by the erection of entry barriers.

To test the validity of these claims, the approach taken in this paper relies on economic definitions and measurements. The allegations made by the DOJ are first presented and are then followed by a rebuttle from Microsoft.

The first issue deals with the determination of whether Microsoft did indeed possess monopoly power in the market. Based on the standard characteristics of a monopoly market, the discussion to follow shows that:

- Microsoft controlled the market;
- barriers to entry existed such that competition was prevented;
- it was a price maker; and
- there were no close substitutes for its products.

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First, so as to determine wether Microsoft did indeed control the market, data were collected and analyzed for a seven-year period. The results showed that although Microsoft did not capture the entire market share, it had for the past seven years controlled over 90 per cent of the sales (*Government Exhibits* v. *Microsoft*, 1999) .

Second, with regard to entry barriers, it has been argued that the very high costs of developing alternate operating systems served as entry barriers that prevented competitors from penetrating the market. Microsoft responded to this claim by citing the success of Linux, thereby maintaining that the entry barriers were not as high as the government originally claimed. It is worth noting, however, that Linux's success should be measured in terms of its ability to have survived, and not in terms of posing any competitive challenge to Microsoft. Despite the support of the entire industry, Linux has to date a market share that falls below 5 per cent, which would lead one to believe that Microsoft's assumption of openness is not very convincing.

Third, with respect to Microsoft's ability to set market prices, the DOJ provided testimony that confirmed Microsoft's power of setting prices. The evidence presented by the DOJ in support of its claim was challenged by Microsoft on the premise that in its industry one deal can totally alter the competitive landscape.

Last, a monopolist by definition supplies a product to which there are no close substitutes in the entire market. To assess the validity of this condition, consensus must first be reached on the definition of what constitutes the market. According to the Department of Justice, the market, is defined as being that of Intel-based computers. The proposed definition has been argued by Microsoft as being too narrow, and that it needs to be expanded to include all platforms for running software. By broadening the definition to include substitute products such as Apple, Microsoft could dismiss the accusation made by the DOJ of regarding it as a monopolist.

To ascertain whether alternatives or substitutes for Intel-based systems exist, the cross-price elasticity of demand is evaluated. A positive coefficient for the cross-price elasticity would imply that the two products are substitutes. The larger the value of the coefficient, the larger is the degree of substitution between the two products. A value of zero would mean that the two products are unrelated, and as such would not be regarded as pertaining to the same market. When tested empirically, it was found that the cross-price elasticity between Intel-based systems and Apple was zero, thereby supporting the proposed definition by the DOJ, and confirming that Microsoft faces no competition in the market (Fisher, 1999).

The original filing went on to explain that the most imminent threat of Microsoft's monopoly was not a new operating system, rather it was its Internet and Web browsers. The Web browsers threaten not to overtake the operating system, but to make it less important. Microsoft's monopoly would

be challenged, and very likely ended, and the operating system could be reduced to a commodity.

Microsoft was not oblivious of the impending threat from the browsers containing it. In May of 1995, Microsoft tried to divide the market illegally with Netscape so that Microsoft and Netscape would not compete. When Netscape refused, Microsoft purposely started to create barriers for Netscape and other browsers to compete. Microsoft launched a "*jihad*" to win the "browser war" (Klein, 1998).

Economic objectives: means vs. ends

As a business entity, Microsoft identified its objectives and devised effective measures to achieve them. As such, its behavior from an economic perspective is deemed rational. The objective or end is to maximize its long-run profits to which it deployed several means. In order to continue exercising market power, Microsoft allegedly pursued strategies that stifled, if not eliminated, competition. Business practices such as predatory conduct, product bundling, and exclusive dealings have been exercised in an effort to ensure market dominance that would help it realize its long-run objective.

Predatory conduct

Predatory behavior is conduct that is profitable by driving competition out of the market or deterring potential competitors. The three conditions of predatory conduct are:

(1) the post-predatory profits outweigh the costs of the predatory conduct;

(2) there is no other more profitable strategy, such as a merger, to achieve the same result; and

(3) the firm must be able to block entry into a market.

Microsoft gave away its product and Windows desktop space in order to drive out its rival Netscape. Although in the short run the consumer may enjoy low prices, once the competition is eliminated prices escalate, and the dominant firm would exercise full control of the market.

Product bundling

The tying of two products is a very common practice. In some cases the tying can increase efficiency, while in others the tying can have anti-competitive results. The effects of the tie-in that must be considered are:

- benefits to the consumer;
- the relationship between the two goods; and
- the degree of competition in each market.

Microsoft understood that giving away its Internet Explorer for free was not enough to take over the browser market. It used its monopoly in operating

systems to leverage its browser. By bundling its Internet Explorer with the Windows operating system, it was effectively giving away the browser for free, and as such was violating Section I of the Sherman Anti-trust Act. In the words of Microsoft's group vice president in charge of the platforms group:

> We [Microsoft] are going to cut off the air supply. Everything they're [Netscape] selling, we're going to give away free (Klein, 1998).

In response to the above allegation, Microsoft noted that product bundling raised the level of efficiency which in turn benefited the consumer. Microsoft maintained that the bundling of products saves the consumer time, installation charges, and prevents complications, all of which render the product more attractive to the consumer.

Exclusive dealing

Exclusive dealing is exemplified where a manufacturer requires a distributor to provide only its product to customers. The exclusive dealing can effectively close the market to competitors and potential competitors and, as such, can be shown to have great anti-competitive effects (*Government Exhibits* vs. *Microsoft*, 1999). Microsoft's actions were solely to protect its monopoly in operating systems, and to monopolize the browser market. The success of its actions is evidenced by the rapidly increasing share in the browser market which was largely due to its monopoly in the operating systems. Microsoft's exclusive agreements with Internet service providers, Internet communication providers, and original equipment manufacturers were in violation of Section II of the Sherman Anti-trust Act. Microsoft justified its exclusive dealings by arguing that it did so in order to eliminate the free-rider effect.

The behavior described above demonstrates how questionable practices can be challenged in courts, and how the judiciary system plays a prominent role in determining the boundaries of acceptable conduct. In the following section , the analysis shows that although it is necessary for individual entities to adhere to legal regulations, this condition falls short of being both a necessary and sufficient qualifier for ethical behavior.

Welfare implications

It would be hard to dispute the fact that Microsoft is a dominant firm in the industry, and that the market in which it operates has a limited degree of competition. Based on this premise, the dominant firm model is used to analyze the welfare and ethical implications of its behavior.

According to this model, the market is two tiered, consisting of a dominant price-setting firm, and smaller price-taking firms, referred to as the competitive fringe. Two scenarios are examined based on whether entry by new firms is possible or not. If entry is restricted, both the dominant and competitive fringe firms are able to enjoy economic profits. If, however, entry by new firms is possible, then the competitive fringe will realize no more than normal profits,

while the dominant firm will only be able to sustain its economic profits by maintaining a cost advantage.

The outcomes for both the competitive fringe and the dominant firm are shown in Figure 1. In Figure 1(a), the competitive fringe firms face a standard supply and demand curve for their product which determines their price P_f. The market share captured by the competitive fringe firms reduces the demand faced by the dominant firm, leaving it with the residual demand DR.

Faced with the residual demand (DR), the dominant firm maximizes its profits by selecting its price P_d at the point of intersection of marginal revenue MR and marginal cost MC. The price of the dominant firm P_d is above that of the fringe P_f but is lower than what the price would have been had it operated as a monopolist in this market. If the dominant firm had no competitive fringe firms to share the market with, it would face the entire market demand curve DD, and as a monopolist would charge an even higher price. The existence of competition, albeit far from perfect, constrains the activity of the dominant firm, and provides the consumer with a lower price.

Applying this model to our case, Microsoft would be regarded as the dominant firm, while the competitive fringe would include firms such as IBM and its OS/2, Unix, and Apple. If barriers are assumed to exist preventing entry by new competitors, then economic profits would be possible for all firms in the market. However, if entry barriers are easy to overcome, then by penetrating the market, competitors would erode the economic profits enjoyed by the existing firms. In such a situation the dominant firm will only be able to maintain its profits through a cost advantage.

Regardless of the assumptions made about new entry in the market, the dominant firm model allows us to draw several welfare implications. First, with respect to the welfare of the society as a whole, both consumers and producers suffer a deadweight loss equal to the sum of area 1 and 2 shown in Figure 2. This loss in welfare is attributed to the pricing of the imperfectly competitive market. Area 1 in Figure 2 represents the loss in consumer surplus, while area 2 represents the loss in producer surplus.

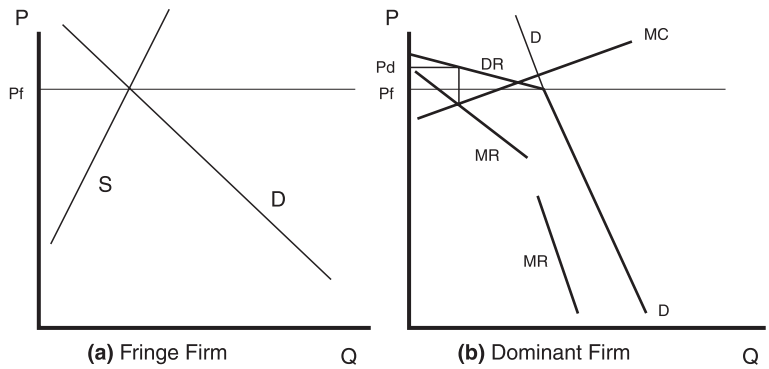

Figure 1.
Competitive fringe and dominant firm model

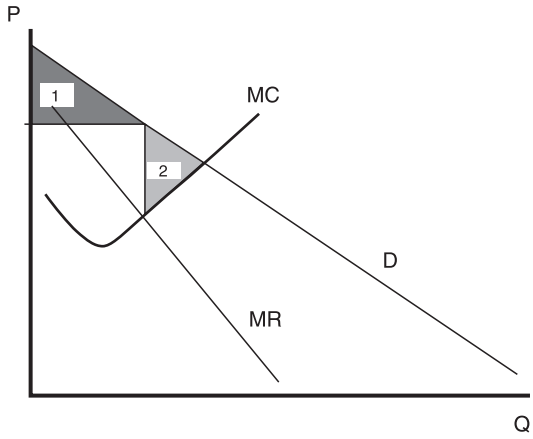

Figure 2.
Welfare implications in a monopoly market

From the firm's perspective, the potential for monopoly profits serves as an incentive to be innovative and to identify cost reduction methods. To preserve this incentive, patents are granted to reward companies for their innovation. However, once a monopoly is established, it will have little if any incentive to innovate in the market.

The second welfare implication is related to the predatory conduct which Microsoft is accused of practicing. Although in the short run consumers may enjoy the artificial low prices, in the long run they will suffer by having to pay the higher monopoly prices and will have no product choice. In the short-run consumers gain by having a free Web browser provided to them. Internet Explorer is free when bundled with Windows, with no time costs incurred to download the browser from the Internet. However, the long-term costs are high. First, if Microsoft was to monopolize the browser market, the price of Internet Explorer would be higher than the competitive price. Second, since Microsoft's Internet Explorer and Netscape's Navigator are not homogenous products, the consumer will be left with no product choice. Lastly, if the programming language Java did make the operating system into a commodity, it would cause a decline in the price of operating systems. Thus, the consumer loses by not having the possibility of lower prices in operating systems. For Microsoft, the forgone short-term profits associated with its low prices outweigh the long-term potential profits it would enjoy if it were to succeed in securing its market dominance.

Ethical evaluation

When evaluating actions and outcomes from an ethical standpoint, one must acknowledge from the outset that the issues presented are controversial and are likely to raise more questions than provide answers. The lack of consensus when drawing ethical implications stems from two sources:

(1) the choice of the perspective adopted when rendering the evaluation; and

(2) the disagreement surrounding the definitions that guide the relationships.

Ethical views attempt to determine whether an action is right or wrong and, depending on the approach taken, the response may be very different. In business, the two basic moral philosophies that apply are:

(1) teleology; and

(2) deontology.

Teleology assesses the moral worth of an act by evaluating its outcome, and is referred to as consequentialism. Deontology, on the other hand, focuses on intentions rather than consequences (Ferrell *et al.*, 2000).

The two most popular views of the teleology philosophy are egoism and utilitarianism. Egoism defines acceptable actions as those that maximize the self-interest of the individual entity. Utilitarianism seeks to maximize total utility by identifying the course of action that will lead to the greatest good for the greatest number. One formulation of utilitarianism is derived by evaluating preferences, which is the basis of marginal analysis in neoclassical economics. A second approach to utilitarianism is cost-benefit analysis (Boatright, 1999).

Deontology focuses on the rights of individuals and on the intentions rather than on the outcomes of behavior. Fundamental to this theory is the notion that individuals must be given equal respect. Rule deontologists believe that ethical behavior must conform to general moral principles, and that there are things that we must not do, even to maximize utility. Of the philosophers that were greatly influenced by this view is Immanuel Kant, who developed the theory of the "categorical imperative" which holds that individuals should "act as if the maxim of thy action were to become by thy will a universal law of nature" (Ferrell *et al.*, 2000). Act deontologists, on the other hand, hold that ethical and moral judgements should be based on actions. Accordingly, act deontologists factor in the particular circumstances surrounding an act and give that precedence over any rule (Ferrell *et al.*, 2000).

In economics, ethics is described as a rational practical activity which includes a reflective and self-critical decision-making process. As a code of conduct, ethics supports or criticizes moral judgements individuals make by providing reasons. Defined as the science of choice, economics recognizes that scarcity and opportunity cost are associated with the decision-making process. As such, economic agents are assumed to act rationally, seeking to maximize the outcomes of their decisions. Rational behavior implies consistency between the stated objectives and the actions or inactions taken to achieve them. Economics explains and guides the behavior of the entity if it were to act rationally.

This paper relies on the teleological view which focuses on outcomes rather than on intentions. Teleology reduces the degree of subjectivity by relying

on more concrete forms of measurements and evaluations. Although moral judgements are supposed to be impersonal, impartial, and to a certain degree universal, it is recognized that the decision-making process is to a large extent shaped by the moral philosophy one adopts.

Evaluating the ethical conduct of Microsoft from an "egoistic" approach, one would have to conclude that as a business entity it saught to maximize its self-interest, and in so doing its behavior was both ethically and economically justifiable. From a "utilitarian" perspective, following the neoclassical marginal analysis view, the firm is regarded as a profit-maximizing unit whose sole responsibility is to serve its corporate objective. Milton Friedman, a strong proponent of this view, argues that economics is not so much interested in how this objective is achieved so long as the rules of the game are obeyed. He clarifies his position by noting that these rules should include "open and free competition without deception or fraud" (Friedman, 1962). Friedman holds that managerial decisions should only serve the interest of the corporation and that the social responsibility of business is to increase profits (Friedman, 1970).

Challengers of this view hold that the corporation should serve the interests of a broader set of constituents which includes stakeholders and not just shareholders They also point out that if the corporation would abide by Friedman's "rules of the game" they would have to comply to regulatory, legal, and social constraints and not just promote their selfish, narrowly defined objective (Boatwright, 1999). This later view contends that the corporation is not the private property of the stockholders, rather they regard the corporation as a public institution sanctioned by the state in order to achieve some social good (Allen, 1992).

An alternate evaluation of utilitarianism is cost-benefit analysis. Identified as the basic problem, scarcity dictates that choices have to be made and that optimal choices would imply an efficient allocation of the scarce resources. By definition, allocative efficiency means maximizing the ratio of benefits to costs resulting from the choices made. Both economics and ethics recognize that any responsible use of resources would have to be, to some extent, concerned with efficiency (Buchanan, 1998).

Cost-benefit analysis is, however, not value free. The approach, although claimed to be a scientific procedure, suffers from a number of drawbacks. First, is the question of whose perspective we are adopting when computing the costs and benefits. Second, some benefits and costs are hard to quantify. Third, when conducting the evaluation we are doing so at a given point in time, whereas costs and benefits of a decision accrue over time. Lastly, cost-benefit analysis says nothing about their distribution. Despite these shortcomings, cost-benefit analysis as a method continues to be used in both economics and ethics.

Based on the utilitarian approach, ethical considerations are found to be broader than economic interests. Ethics may require individuals to evaluate the impact of their actions on the welfare of the society. Such actions may oppose

their own self-interest. If so, fundamental differences between the two approaches may lead some to believe that they are irreconcilable.

Several attempts to reconcile economics and ethics have been made dating as far back as the eighteenth century to the work of DeMandeville (1714), and Adam Smith (1776). Both showed that the market mechanism, if allowed to operate freely, would translate individual self-interest into societal wellbeing. DeMandeville argued that market institutions translated "private vices" into "public virtues". Adam Smith argued that perfect competition enhanced the welfare of a nation by yielding efficient and optimal outcomes to all the market participants.

The proposed ethics of economics is based on the outcomes of the perfectly competitive market. It holds that the market, through free operation, will yield pareto optimal results that are morally admirable, without having an explicit need for ethics. This view, however, does not discuss the issue of equity or distribution, it merely refers to allocation efficiency, ignoring externalities (Buchanan, 1998).

Concluding remarks

Economics affirms that market efficiency depends on competitiveness. Anti-competitive behavior is discouraged: if not for the sake of undermining efficiency, it is out of fear of prosecution for violations of anti-trust law. The legal battle which resulted in a court ruling ordering the breakup of Microsoft into two separate companies was based on that very principle. The breakup into two companies, one selling the Windows operating system and one selling the Windows applications system, aims at creating a more competitive climate by increasing Microsoft's vulnerability.

Microsoft opposed the decision, arguing that the breakup would hurt the company's employees, shareholders, business partners, and consumers throughout the world. It plans to appeal the ruling that favored the government by attacking the validity of the two central claims to this case: product bundeling, and exclusionary contracts.

One thing is certain in the case of Microsoft, the dispute will likely be ongoing and costly in terms of time, energy, and resources. What is less certain, however, is whether the resulting divestiture produces substantial innovations and competition. Although for the individual entity being moral is a cost, knowing that others will practice moral restraints may prove to be of greater benefit. For if a market is to function well, it is in the interest of the whole to know that all participants adhere to some basic moral principle.

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