Homework 1: Part 2. Analysis of the Microsoft Case

I. Alleged harm from Microsoft's monopoly

The case put forth by the U.S. Department of Justice against Microsoft was based on violations of Sections 1 and 2 of the Sherman Act. The government claimed that Microsoft committed six anticompetitive actions to "preserve and increase barriers to entry into the personal computer operating system market" (Fisher and Rubinfeld, 3). First, Microsoft bundled its Internet Explorer browser to the Windows operating system, and thus required the original equipment manufacturers (OEMs) to distribute Internet Explorer (IE). Consequently, Microsoft limited the threat of Netscape as a competitor. Second, Microsoft utilized its leverage to prevent its competitors from being able to reach consumers through efficient and less costly channels. Third, Microsoft demanded that OEMs not remove IE or substitute another internet browser. Fourth, Microsoft insisted that companies of online services, internet service providers, and internet content providers not deal with Netscape, in effect "foreclosing" market access from Netscape. Fifth, Microsoft provided IE as part of its operating system for free, and in some cases paid companies to take the browser. Finally, Microsoft responded to the potential threat of Java by "polluting" it so that its applications would have to with Windows.

From these alleged actions, Fisher and Rubin identified four major areas of harm to consumers. First, Microsoft prevented OEMs from offering consumers a browserless version of Windows, thereby failing to satisfy consumer demand for such a product. Fisher and Rubin argue that this unfulfilled demand was not only inefficient, but also created costs to the consumers in the form of "confusion and frustration," time and effort involved in installing a new browser, and the disadvantage of a reduced memory on PCs and thus degraded system performance. They also contend that the unavailability of a browser-less Windows increased technical support costs for customers.

Next, Fisher and Rubin argued anticompetitive practices hindered innovation. Microsoft's actions against its competitors deprived consumers of software innovation, since the innovations had not been allowed to reach the marketplace because of barriers. Also, Microsoft harmed consumers indirectly by distorting competition, and reducing incentive for innovation to overcome the applications barrier to entry and Microsoft's advantage through network effects. The sum effect of stifled innovation is the deterring of investment in technologies and businesses that exhibit the potential to threaten Microsoft. "As a result, consumers have a limited range of software products from which to choose, and that limited choice reduce consumer welfare"

(Fisher and Rubin, 42). The reduced competition also believed to lead to lower quality products and higher prices.

Additionally, the lack of competition may reduce efficiency in the market. Microsoft, as the chief firm of the market, would have less incentive to innovate and reduce costs. In fact, the possibility that monopoly firms are less efficient because of their market power is the core of the X-inefficiency theory. The direct results of the lack of competition and innovation are higher prices for the consumers, less available products for selection, and diminished product quality. While it may not be possible to show the amount of the inefficiency (deadweight loss) that occurs because a product is not as good as it could be had it been developed in a market with greater competition, the logic of the argument indicates that Microsoft's actions did indeed harm consumers. The amount of harm could be higher than measurable.

II. Analysis of the government's case of alleged harm

While the government provided evidence to show Microsoft's anticompetitive actions, the case to demonstrate harm to the consumers as a result of these anticompetitive actions seems less persuasive. Without establishing this connection, the government could not make the case that Microsoft's effort to preserve its market power actually harmed consumers. The government was successful, however, in dispelling Microsoft's argument that its actions benefited consumers. As Gilbert and Katz pointed out, the short run benefit from receiving IE at a low or nonexistent cost to consumers was a hollow gain, since Microsoft's retaining of significant market share of operating systems would allow it to sell Windows at a higher price.

The first argument of harm put forth by the government that Microsoft failed to satisfy consumer demand and created costs to consumers who sought alternate browsers was, to me on a personal level, fairly persuasive. Although antitrust cases do not usually involve customer testimonials, there are plenty of people, myself included, who have spent time and effort installing new internet browsers and undoing the damage from using IE, which is particularly suspectible to adware and bugs.

Secondly, the arguments of lost innovation theoretically entail harmful to consumers, but were not supported by substantial, concrete evidence. As the theory goes, since firms are rational actors, reduced incentives to compete against Microsoft dissuades potential companies from entering the market and investing in research. With a smaller amount of research, product development would be reduced. In the long run, consumers will suffer from this lack of competition and the lack of product development by paying higher prices and receiving products of lesser quality. However, this argument was not convincingly demonstrated since it would be hard to predict what will happen with technological change. As for the X-Inefficiency argument, the theory of the argument directly contradicts the assumption that monopolists maximize profits and little empirical evidence supports this contention.

Overall, arguments of the detrimental effects of anticompetitive behavior on innovation and efficiency are unpersuasive. As Gilbert and Katz argued, the link between the degree of competition and the degree of innovation is complex, and it is difficult to demonstrate that anticompetitive practices led to reduced innovation. Even more challenging is to show the link between innovation and welfare. The government's case did not sufficiently demonstrate

III. Remedies proposed by Judge Thomas Penfield Jackson

Judge Jackson found Microsoft guilty of violating the Sherman Act in that it "illegally sustained the applications barrier to the entry of operating system competitors." Three remedial options were proposed. All would reduce anticompetitive behavior and thus lessen the efficiency loss and harm to consumers. However, all three also would create costs and, potentially, inefficiency. In the first plan, Microsoft's conduct would be restricted in its dealing with other companies and imposing contracts. While this option would enhance competition by prohibiting anticompetitive behavior on the part of Microsoft, therefore reducing the disincentive for other companies to innovate and compete, this option would require continued government oversight. Also, it may create a situation susceptible to manipulation by Microsoft's competitors. Critics of this proposal also pointed out the disincentives on Microsoft by curbing its ability to compete in the market. A second proposal entailed the splitting of Microsoft into two identical companies, which would separately develop and sell the operating system and the applications. This proposal had the advantage of not requiring continued government monitoring and could enhance competition and create incentives for the two newly-created companies to make the operating system and applications more widely compatible with other products. The incentive for innovation and the advantage in increased systems compatibility would benefit consumers. However, this proposal would require the defining and distinguishing of operating system business and application business. Given the rapid changes in technology, it may be impossible to maintain clear distinctions between what constitutes an operating system and what is an application. A third proposal would split Microsoft into three smaller companies of applications and operating systems. In this scenario of "Baby Bills," a structural reorganization would invigorate competition by reducing the market share of any one firm. Again, this remedy would enhance incentive to compete and innovate. Still, such a reorganization of a massive company likely would be accompanied by high costs and would impose an inefficient market structure.