Why The Government's Case Against Microsoft Never Held Water

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With the federal antitrust trial of Microsoft (Nasdaq: MSFT) winding down, it's time to take stock. What lessons have we learned, or what should we have learned, from the market events and intellectual discussion surrounding the case?

One is that the market moves so much faster than the government that antitrust suits are, at best, irrelevant. The government charged in the present suit that Microsoft, by bundling Internet Explorer with its Windows operating system, was hurting Netscape Communications' chances of success. The government's complaint mentioned Netscape exactly 39 times. Netscape's acquisition by America Online (NYSE: AOL), long before the trial has ended, makes that fear look silly. That AOL, the country's leading provider of Internet access, now owns Netscape should have assuaged the fears of anyone still worried about Microsoft's dominance of Web access.

RULINGS OF THE ROAD

The second lesson is that a ruling that limits Microsoft's actions would be bad for consumers. Two economists, Thomas Hazlett of the American Enterprise Institute and George Bittlingmayer of the University of California at Davis, have argued that if lawsuits against Microsoft are likely to make the PC industry more competitive, then in the few days following an announcement of such a suit, software companies that allegedly suffer from Microsoft's exclusionary tactics and computer makers that rely on Microsoft's software should both see their stock prices go up. By extension, an overall rise in the stocks of these other firms shortly after news of a suit would indicate an improvement in consumer well-being. Conversely, if lawsuits allow Microsoft to behave less competitively, stock prices of those same software and hardware companies should fall shortly after announcements of such lawsuits, indicating that the market has been rendered less competitive, and therefore harmful to consumer well-being.

To test this hypothesis, Mr. Hazlett and Mr. Bittlingmayer identified 54 events announced in the Wall Street Journal between 1991 and 1997 that were related to the various antitrust suits against Microsoft. They judged as positive the events that tended to help Microsoft's case (like the overruling of a progovernment decision). They classified as negative the events that hurt Microsoft. Not surprisingly, in the three days after these announcements, Microsoft's stock price rose following positive events and fell following negative ones. More interestingly, after positive events for the corporation, the stock prices of 159 other hardware and software companies rose by an average of 1.2 percent; after negative events, they fell by 0.6 percent. All results were statistically significant. The market was saying that suits against Microsoft hurt consumers.

There's also a lesson to be learned from the discussion of so-called network effects. Franklin Fisher, a professor at MIT and the Justice Department's chief economic witness, argued that the market dominance of Microsoft Windows was protected by the huge network of people using the operating system. Because new users want whatever OS is already in widest use, Mr. Fisher claimed, they have an incentive to buy Windows even if a superior technology becomes available.

TYPEWRITER'S BLOCK

Mr. Fisher's larger point was that the company with a head start in market competition becomes dominant, and that as a result, the best technology does not always emerge. The earlier technology, the argument goes, is protected from competition. Paul David, a Stanford economist, made this idea famous in a 1985 article about the QWERTY typewriter key configuration, which, he claimed, was inferior to one designed by August Dvorak. Yet, as two economists, Stan Liebowitz and Stephen Margolis, pointed out in a 1990 article -- and at length in their new book, Winners, Losers, and Microsoft (Independent Institute, $30) -- there was little basis for QWERTY's alleged inferiority. Mr. David had taken at face value the claims made for the Dvorak keyboard in a 1944 study by the U.S. Navy. Mr. Liebowitz and Mr. Margolis tracked down the study and found it deeply flawed; it was also, they noted, directed by none other than Mr. Dvorak. But many economists continued to use the QWERTY example for years after Mr. Liebowitz and Mr. Margolis's 1990 article.

Brian Arthur, an economist and one of the leading proponents of the idea that network effects lead to market failure, has argued that the supposedly inferior VHS video format won the battle with Beta because of network effects. However, Mr. Liebowitz and Mr. Margolis countered in their book that despite Beta's initial two-year advantage, VHS overtook it six months after being introduced to the U.S. market. If network effects are so powerful, then Beta should be dominant today.

TURNOVER ACHIEVER

The whole idea of inferior technology dominating for a long time is based neither on evidence nor, as Mr. Leibowitz and Mr. Margolis show, on good reasoning. What's really going on is the "creative destruction" that Joseph Schumpeter described in his 1942 classic, Capitalism, Socialism, and Democracy. Network effects do give firms temporary monopolies, but these monopolies are the reward for the development of superior technology. Nevertheless, another company can always come up with better technology that blows out the old monopoly.

That's what has happened with word processing software. The dominant software of the early '80s was WordStar, in the late '80s it was WordPerfect, and in the '90s it's Microsoft Word. If network effects create durable monopolies, then this article should have been composed with WordStar, which is virtually forgotten today.

The lesson for us economists -- a lesson that we were supposed to have learned in graduate school -- is to check the evidence before we reach sweeping conclusions.