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## Befuddled by "Internet Time": The Government's Pointless Lawsuit Against Microsoft

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The antitrust case *United States v. Microsoft* was filed in May 1998 and went to trial last October in Judge Thomas Penfield Jackson's federal district court in Washington, D.C. On June 24, the final witness left the stand. The parties now have thirty days to file proposed "findings of fact," on which Judge Jackson will base his decision, expected late this fall.

The Department of Justice charged that Bill Gate's computer empire had attempted to "defeat" its competitor Netscape by, among other tactics, forcing Internet service providers to distribute Microsoft's Internet-surfing software, or browser, to customers, "foreclosing" competitors. The government's complaint singled out just two Internet service providers for signing exclusive deals to use Microsoft browsers—America Online (AOL) and its subsidiary CompuServe.

Now, just over a year since the complaint was filed, the landscape has altered dramatically. AOL owns Netscape and has established a formal alliance with another computer powerhouse, Sun Microsystems. Together, the two firms are valued at \$170 billion and control 43 percent of Internet and online access in the United States. Microsoft's campaign to "defeat Netscape" does not appear to be going so well.

Except in Jackson's courtroom. There and only there, the dazzling incompetence of Microsoft counsel and the flamboyant irrelevance of the government's case loom larger than market realities. The very heart of the charge against Microsoft is that its monopolistic activities will financially asphyxiate Netscape by denying it market share. Yet now that Netscape has been adopted by wealthy parents (AOL) and is the favorite of a rich uncle (Sun), Justice Department lawyers insist that "the AOL-Netscape transaction isn't relevant to the key issues in the trial."

In a funny way, they are right. While crucial events zip past at Internet speed, the government is trying a case on the theory that it knows precisely what technology would win out in the marketplace if only Microsoft would sit back and let others do their thing. Not only is the government's picture of the computer industry obsolete, but its assumptions about competition are wildly unrealistic. Useful competitors—firms that bring better products to consumers at lower prices—do not produce those social benefits by sitting back and casually ceding market share to rivals. In prosecuting what it breathlessly calls Microsoft's "jihad" against Netscape, the government has fallen into the

classic antitrust trap of confusing the health of a particular competitor with the health of the market as a whole.

The government's case against Microsoft treats as a smoking gun the evidence that Microsoft considered Netscape (and Sun's Java programming language) a genuine threat worthy of countering. Thus, the government highlights Microsoft vice president Paul Maritz's boast to industry executives, "We are going to cut off [Netscape's] air supply. Everything they're selling, we're going to give away for free."

But the dynamics of the situation belie the charge of predatory conduct. Netscape's browser, Navigator, became the most popular software application in history, landing on 38 million computers in just 18 months, thanks to its free distribution on machines running Microsoft's Windows operating system. Naturally, Microsoft countered. It spent hundreds of millions to improve its own browser, Internet Explorer, and distribute it free even when Netscape foolishly got grabby and stuck a \$ 49 price tag on Navigator. This is just the way Adam Smith drew it up on the chalkboard.

Firms thrive on issuing death threats to rivals. Netscape itself incorporated Java—to create what the government claims is the best bet for ending the Windows "monopoly"—in a bold bid to quash Bill Gates's world. The brash Marc Andreessen, then vice president of technology at Netscape, taunted the "Beast from Redmond" (Washington, where Microsoft is based) and drew instant support from the formidable "anybody but Microsoft" crowd. Michael Cusumano and David Yoffie write in their fascinating book *Competing on Internet Time: Lessons from Netscape and Its Battle with Microsoft* that "As early as September 1995, [Andreessen] claimed that the combination of Java and a Netscape browser would relegate the operating system to its original role as an unimportant collection of 'slightly buggy device drivers.'" In other words, death to Microsoft Windows.

Netscape had reason to think big. In its initial foray into the marketplace, it had taken on a product with near-100 percent market share—Mosaic, the browser Andreessen had helped create at the University of Illinois in 1993—and reduced it to ashes. This devastation was according to plan: Netscape had pointedly code-named its product "Mozilla"—Mosaic killer. This was in the spirit of Apple's challenge to Windows 95 (developed under the name "Chicago")—a new operating system developed under the code name "Capone." For that matter, it was in the generic spirit of "creative destruction" that rules Silicon Valley. A recent book about the computer business is entitled *Unleashing the Killer App: Digital Strategies for Market Dominance*, the "killer app" (short for application) being the new product that buries the old.

Are all corporate countermeasures fair, or do some tactics punish consumers by pushing prices higher? Doesn't legitimate competition sometimes entail firms' extinguishing rivals and thereby injuring customers? Clearly, determining where honest rivalry ends and anti-competitive predation begins can be a tricky business. Fortunately, we know from another case what a real smoking-gun memo looks like, and the Department of Justice has nothing close in the Microsoft case. Ironically, we also know that the government's

own economic expert in the Microsoft case thinks even a real smoking-gun memo reveals absolutely nothing.

While testifying for the defense in the 1994 case of *Leza Coleman, et al. v. Sacramento Cable Television*, MIT economist Franklin Fisher was asked to interpret the behavior of officials of Sacramento Cable Television who projected their losses from lowering their prices in response to competition. The company, which enjoyed a monopoly position, had already slashed its prices and given away free cable and even TV sets in the neighborhoods where it faced competition from two upstart rivals. It eliminated the first rival, then quickly raised its prices in the area where they had competed, and next embarked on a campaign to defeat the second, better-capitalized opponent, Pac West.

The key memo, dated January 25, 1988, from Richard Davis, CEO of Sacramento Cable Television, bemoaned the problem of "revenue exposure" (price cuts due to competition) and estimated the dollar loss if the second competitor got a foothold in the market: \$ 16,560,000 over 30 months. The memo concluded, "Taking Pac West out of the picture early has significant value."

Smell the smoke? The California court found against Sacramento—but Fisher disagreed: "As regards the behavior of SCT," he testified, "it seems to me that their behavior was, in fact, competitive behavior and ought not to be characterized as anti-competitive." He argued, "Companies should not be compelled to hold a price umbrella over inefficient competitors. They're also not compelled to be stupid and not notice when the inefficient competitor goes out of business."

In the Sacramento case, Fisher advanced a simple behavioral rule: Identify actions as profit-maximizing—and therefore legal—so long as the price charged exceeds the marginal cost. Said Fisher, "A company takes an action. It is profit maximizing on its own bottom. It may also have the effect of destroying or eliminating competition. In that case, you found documents in which the company says, 'Yes, we are going to destroy or eliminate competition.' That strikes me as irrelevant."

Now, however, in the Microsoft case, Fisher is an expert witness for the prosecution. Unable to recognize clear anti-competitive behavior back in 1994, he now errs in the opposite direction and sees predation where there is none. This level of confusion is a tip-off as to the true merit of what Robert Bork has called the Justice Department's "rock solid case." Bizarrely, Microsoft counsel attempted to introduce Dr. Fisher's previous contradictory writings and testimony only after he had left the witness stand—when Judge Jackson appropriately deemed them inadmissible.

Microsoft's best defense may be simply to read back to the court the government's original complaint, with its ambitious predictions, now laughably outdated. The complaint centers on the government's contention that Java would offer performance competitive with—or superior to—Microsoft's Windows. But even the Java cheerleaders at Netscape who originally sold this theory to Justice have changed their tune. "Javagator is dead," said Andreesen in July 1998, as reported in *Internet Time*. "My joke is that a

Java Navigator will have a lot of good attributes: It's slower. It will crash more and have fewer features. So you can do fewer things. It will simplify your life."

But that's okay—there's a brand new competitor to Windows that the government didn't even contemplate: Linux. This "open" operating system, whose code is posted for any user or company to install and customize, is exploding in growth. It is now running 8 million computers worldwide. Early 1999 saw announcements by IBM, Hewlett Packard, Compaq, and other major computer makers that they will offer Linux as an alternative to Windows. It is clear today that the government's central prediction—that Java was the one and only competitor to Windows—was dead wrong.

But the complaint's supporting predictions were off target as well. For instance, the complaint charged that Microsoft's monopolization of the market was aided and abetted by exclusive deals with Internet content providers, and it named three such partners-in-crime: Disney, Hollywood Online, and CBS SportsLine. Earth to Justice: Does a cross-promotional deal with Hollywood Online "tip" the market? Hollywood Online does not even rank among the Top 15 News and Entertainment Web sites, while Disney and CBS SportsLine make it all the way to Nos. 12 and 13. Sadly for Microsoft and the Justice Department's forecasters, the four most popular sites are AOL News Channel, AOL Entertainment Channel, AOL Computing Channel, and AOL Sports Channel.

The complaint raised the specter of Microsoft as gatekeeper, controlling access to the Internet: "The Internet browser market is itself a substantial source of monopoly profits to any company that might achieve a durable dominant position and be able to charge monopoly prices for the efficient use of the Internet or the web." But with the explosion of Web sites, e-commerce, online subscribership, dial-up Internet access (now included—*for free! Ready the indictment!*—with cheap new computers from vendors like Gateway), and even pay-to-surf deals, the toll-free Internet is thriving.

Which leads to the government's most spectacularly errant prediction: that Microsoft was suppressing investment in the Net. From Janet Reno's lips to your ears: "Microsoft's conduct adversely affects innovation [by] impairing the incentive of Microsoft's competitors and potential competitors to undertake research and development, because they know that Microsoft will be able to limit the rewards from any resulting innovation; impairing the ability of Microsoft's competitors and potential competitors to obtain financing for research and development."

Who can't get financing for what are now called "these speculative dot-com deals"? What Wall Streeters now tout as "the incredible Internet IPO market" was triggered by Netscape's August 1995 initial public offering—then the most successful in U.S. financial history. Learned financial advisers today complain of the "glut" of Internet-related deals; the *Economist* cries that "venture capitalists in Silicon Valley have more money than they know what to do with." Don't these fledgling start-ups and risk-taking investors understand that Microsoft will only crush them?

One year ago the Department of Justice sped into court knowing its greatest foe was not Microsoft, but time. The case would become obsolete and ridiculous unless it moved quickly—it might even meet the same fate as *United States v. IBM*, the government's ill-conceived antitrust suit against IBM that dragged on for 13 years before it was simply dropped in 1982.

For all its haste, Justice is still too late. As the case enters its second year, the government's original complaint is ancient history, and there is only one thing left for it to accomplish. As Michael Cusumano and David Yoffie write, "The Department of Justice's action could have a material impact on Netscape. Even though Navigator remained free, . . . a favorable ruling in the government's case might make it easier for Netscape to charge for enhanced versions of the browser in the future."

Maybe there is something to be said for higher prices and corporate welfare. Indeed, the best line in the government's complaint is, ominously, "But Mr. Gates did not stop at free distribution [of Internet Explorer]." Certainly, however, there is much to be said for letting the computer titans fight to the death. AOL now owns Netscape, and the targets of Microsoft's allegedly predatory campaign are valued at three times what Microsoft's "monopoly" was worth when it launched its "jihad" in mid 1995. Consumers have gained enormously from the browser war. Robust competition is fueling rocket launches in the Internet IPO market, where scores of upstart rivals are challenging the old-line pillars of American commerce.

But the drama and folly on both sides of this case should not obscure its broader impact. *United States v. Microsoft* is not simply a boxing match between well-intentioned government officials and a single, incredibly successful firm. It's a brawl that includes Orrin Hatch (the Republican senator from Utah and water carrier for arch Microsoft rival and Utah constituent Novell), the 19 state attorneys general who joined the federal antitrust suit, and ProComp, the pressure group formed around Microsoft competitors Oracle, Sun, Netscape, and Sybase—photogenic potential candidate-endorsers in the great presidential swing state of California. Says Sun's CEO, Scott McNealy, "I think the government is doing all the right things. Government has to come in and discipline [Microsoft] until the rest of the world catches up."

Attacking industry pacesetters to win the plaudits of rival billionaires may result in some considerable ugliness for markets and consumers. The federal government's investigation of Microsoft has been going on virtually nonstop since 1990. In a study of the stock market effects of this long-running episode (forthcoming in the *Journal of Financial Economics*), we found that Wall Street discounted computer shares on antitrust news. In other words, the very companies that would benefit from greater efficiency in software markets lost value when Washington weighed in, supposedly to bring about just such efficiency. This perverse effect is strong evidence that rational investors don't like the government's case. More important, it suggests that billions of investment dollars—and valuable products for millions of consumers – are lost when financial markets fear the economic uncertainty that comes with speculative government litigation.

What's the Justice Department to do? Simply suck it up. Drop the case and let the Internet gold rush mine cyber-capitalism's mother lode.