

Taking a meat axe to Microsoft

August 14, 2002

By Thomas Hazlett

Investors have turned surly towards the architects of the crash in equities: duplicitous executives, clueless accountants, see-no-evil directors. But another set of players has escaped censure, despite triggering a reduction in market capitalisation perhaps larger than that inflicted in aggregate by WorldCom, Global Crossing and Enron.

On Friday March 31 2000 the Nasdaq index closed at 4572.83, about 10 per cent below its March 10 peak. Then, during the first weekend in April, the government won a major "victory" in US v. Microsoft. Settlement talks supervised by Judge Richard Posner collapsed, paving the way for Judge Thomas Penfield Jackson to pummel the software maker for violating antitrust law. In anticipation of the ruling, released after markets closed on Monday April 3, Microsoft shares plummeted 14.5 per cent in that day's trading - a shareholder loss of \$80bn. The bankruptcy of Enron cost stockholders much less.

Of course, antitrust law should punish the monopolist, and the whoosh of supra-competitive profits vanishing would be a welcome sound. But so would screams of joy from erstwhile victims of the vanquished monopolist. As luck would have it, those standing to benefit most from enhanced competition in operating system software are the scores of publicly-listed firms - such as Compaq and Dell (Microsoft's biggest customers), Intel and Cisco (producers of complementary products) - that populate the computing and networking sector. Their happiness is easy to quantify: just check stock prices.

Yet where capital gains were supposed to flow there was only carnage. The Nasdaq, a proxy for the computer sector, suffered its largest one-day loss to date on April 3 2000 - 349 points, or 7.64 per cent. Excluding Microsoft, \$370bn in shareholder wealth evaporated. Through to midday trading on Tuesday April 4 the Nasdaq declined an astonishing 20.2 per cent. The Department of Justice "win" was a bloodbath for investors.

This collateral damage offered far more than an illustration of destroying the village in order to save it. The sharp share value decline signalled investors' evaluation of the merits of the case. If the Windows monopoly was abusing consumers or stifling innovation, PC makers, chip manufacturers, peripheral suppliers, network providers and software application sellers see their markets shrink. Opening that stranglehold was both the theory of the Justice Department case and the logic of pro-consumer antitrust.

But US v. Microsoft, which has seen Judge Jackson's verdict largely overturned by an appeals court and which now languishes in skirmishing between state and federal antitrust prosecutors, has damaged the very interests it was ostensibly designed to protect. In research with George Bittlingmayer of the University of Kansas*, I discovered a regular pattern in the long series of US antitrust enforcement actions targeting Microsoft. Examining 54 breaking news stories concerning the investigation or prosecution of Microsoft from 1991 to 1997, we found that where Microsoft shares go so goes the computer sector (without Microsoft). On good news for antitrust enforcers, Microsoft loses significant value - but so do its partners and (surprisingly) even its rivals. And vice versa on bad news.

Financial investors, playing with their own resources, reject the proposition that antitrust regulators offer a software market cure superior to the disease. The reasons for this policy pessimism are not directly observed in share returns, but are not difficult to identify. The government's conception of competition in operating systems is incomplete, to understate, and its methods for combating monopoly brutish. Operating systems are ill-suited to the standard market share analysis most familiar to regulators.

Microsoft does ruthlessly pursue its market, but that aggressiveness is both an artifact of the product it provides and a key to the firm's spectacular success. By establishing a ubiquitous, seemingly inevitable platform, thousands of firms - including those producing complementary chips, boxes or networks - enjoy reduced market uncertainty. Millions of PC users join them, investing in compatible systems that further increase positive network effects. These results may theoretically be the outgrowth of anti-competitive actions, and surely do not achieve perfection. But market participants have consistently bet that an unregulated Microsoft will get closer to the optimum than the antitrust-enforcer alternative.

America's premier investor, Warren Buffett, was puzzled by the case. "I think we've got something that is working very well and I wouldn't want to tinker with it very much," he said in 2000. "I wouldn't want to take a meat axe to something that is pulling us along in a very important way." And Charlie Munger, Berkshire Hathaway's number two, openly questioned the policy approach to Microsoft. "Every business tries to turn this year's success into next year's greater success ... If it's a sin, then I hope all of Berkshire Hathaway's subsidiaries are sinners ... Someone whose salary is paid by US taxpayers is happy to dramatically weaken the one place where we're winning?"

The feedback loop for those who destroyed equity values has sometimes (though not often enough) performed with brutal efficiency, leaving wrongdoers penniless, disgraced or in prison. Policymakers and civil servants are, for the most part, immune from such sanction. But, at minimum, we ought to promote honest accounting in government regulation, as well as on corporate balance sheets. The benefits of US v. Microsoft should be tallied and compared to its cost. Investors have already told us what sign to place on the policy's net worth.

* *George Bittlingmayer and Thomas W. Hazlett, "DOS Kapital: Has Antitrust Action Against Microsoft Created Value in the Computer Industry?" Journal of Financial Economics (Mar 2000), 329-59; <http://www.manhattan-institute.org/hazlett/rahazl11.pdf>.*