

Antitrust regulators must listen to reason

By Thomas W. Hazlett

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When Apple's iTunes rocked our planet with its 2003 blast-off, it triggered near-instantaneous iPod adoption by a generation of audio thrill-seekers and revived the company that delivered us into the age of the personal computer.

The innovation has achieved the ultimate imprimatur of success: antitrust regulators are descending. France has passed legislation that could force Apple's iTunes to play on devices other than Apple's iPods. While the law allows Apple to retain iTunes exclusivity if it gains copyright permission, this escape hatch could prove treacherous. Record companies want to renegotiate their iTunes deals upwards, and regulation sends its own signal. "We are the first in the world to do this," crowed Renaud Donnedieu de Vabres, French culture minister. Norway, Denmark and Sweden are poised to follow.

The competition policy bureaucrats squeeze Apple's achievement into this box: they sell a product that is so popular it is dominant; this market power is then exploited by excluding rivals from using its software (iTunes) to build competitive mousetraps (iPods). By untying the two products, via regulation, market rivalry will be unleashed and consumers will be better off.

The theory disregards how this smash hit was created. Bundling pods and tunes was the business model that Apple chose to execute its innovation. The consumer's reward has been musical, lyrical and sensational. The producer's reward is antitrust enforcement. Worse, regulators ignore what is efficient, as testified to by the most ruthless of Apple's rivals. Microsoft has been flailing at the iTunes market since it launched, providing software for iPod competitors such as Sony and Samsung. The platform is open to independent device makers near and far – just the type of market structure that makes regulators feel warm and fuzzy.

Yet customers have given it scarcely a listen. In spite of the firms involved, which dwarf Apple, the latter accounts for 77 per cent of the \$4bn in US digital player sales. Voting with their money, customers prefer Apple's package. Were Apple to truly exploit its customers, its market would be ripe for an upstart. Microsoft is, let us put this calmly, a well-equipped upstart. Their counter iPod offerings – giving customers a choice of hardware – should rock.

Microsoft will now shift gears. Impatient with independent manufacturers' digital play devices that keep losing to the venerable iPod, Microsoft will make its own – complete with wireless download functionality as yet unavailable to iPodsters. May the best dominance-seeking corporate behemoth win.

Microsoft's desperate course correction delivers a verdict on the efficiency of rival business models. Apple produced a better mousetrap there, too. But policymakers appear star-struck, unable to see this evidence nor to spot new rivals on the horizon. Amazon is set to introduce a music player that it will subsidise to embed with customers, while the cellular carriers, already cashing \$6bn annual cheques for ringtones, are swarming the iPod space.

European regulators are increasingly pointing their revved-up antitrust sceptre at US firms. In a forthcoming paper in the *Economic Journal*, Nihat Aktas, Eric de Bodd and Richard Roll show that EU authorities tend to block mergers where competition to European firms, as revealed by stock market movements, is most likely. The iPod presents an inviting target.

Recall the muck that the iPod-iTunes solution oozed out of. File sharing services such as Kazaa were downloaded by the millions, yet as Jack Goldsmith and Tim Wu detail in *Who Controls the Internet?* (Oxford, 2006),

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this resulted in chaos. Not only were copyrights routinely appropriated, “Kazaa users were weeding through a junkyard of corrupt files, deliberate fakes and efforts to advertise pornography sites that made the P2P experience a major chore”.

The French law aims to disrupt a process that was enhancing the wealth of nations. From the rubble of file sharing, with its *Pirates of the Caribbean* business model and its “junkyard” user experience, emerged a spiffy iTunes marketplace where songs and their listeners embrace, 99 cents a hug. The format brought artists together with users, ending their conflict and forming a virtuous circle of co-operation. A rival field of dreams is now being built by the Microsofts, Sonys, Dells, Amazons and T-Mobiles, stomachs growling and each eager to devour a little Apple. Antitrust regulators should stand back and let Apple feast or be eaten.

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James Boyle: Prometheus bound



Tom Hazlett’s article is a characteristically lucid account of the dangers of antitrust intervention in high tech markets. The story he tells is worthy of a Greek tragedy. Seeing a temporary ability of a company to exclude others from a market, the bumbling regulators step in, leaving destruction in their wake.

The chorus tells us the regulators have failed to realise they are meddling with two deities: the god of dynamic innovation, and the god of market dynamism.

(Both of whom, I am guessing, have spiffy costumes.) Dynamic innovation is involved because the profits companies like Apple can derive from integration of hardware, software and service, are the lure that drives innovation in the first place. Take away that lure and you disrupt future creativity. Market dynamism is involved because these profits are temporary. As the profits get larger, more and more competitors gather, hoping to crush the winner and take the spoils. Eventually, the market will commoditise the service, and the innovators will move on somewhere else. The chorus is there to warn human beings of the hubris they display when they tinker with forces they scarcely understand. French legislature, meet Oedipus.

There are two problems with this story. The chorus might well be right; the plot they describe does sometimes apply to high tech markets. But when? About that we are less sure. In some cases, we fear that “network effects” and “lock in” will allow a dominant player to prevent entire lines of technological innovation at a key moment in its development. I would say that the first wave of antitrust litigation against Microsoft benefited consumers by causing Microsoft to pull in its horns a little, long enough to allow venture capitalists again to fund companies that might compete with it. In other cases, we worry that strategic behavior will lead to gridlock, as competitors with potentially complementary monopolies hold out, blocking a new technology which requires cooperation. The development of powered flight is a classic instance. In the case of Apple, I tend to think Hazlett might be right. But always?

The second problem is that those who are enamoured of Hazlett’s story often forget that hubristic regulators have already tampered before the curtain ever rises on his story. Most high tech markets rest on legal monopolies called copyrights, patents and trademarks, regulators are hard at work expanding these. As I have noted before, many of those who mock the bumbling antitrust regulators in Hazlett’s play, inexplicably think the intellectual property regulators are different. Their interventions are seen as deft, precise, attended by favorable auguries. Are they demi-gods? Having been to the World Intellectual Property Organisation, I have to say, I saw little evidence of divine parentage.

Lets go back to Apple. As I pointed out [earlier](#), Apple has come very close to

suggesting that competition with it is illegal because new intellectual property rights such as those created by the European Copyright Directive and the Digital Millennium Copyright Act, (DMCA) make it illegal to make interoperable software services. Other companies have gone further and brought suit. We can only hope the courts continue to reject them. Will business method patents, and legally backed technological protection measures undercut Hazlett's markets before they ever get started? We do not know. But I would advise audiences to remember that his drama is the second in a trilogy. If you want to see a greater threat to creativity, I'd recommend the first in the series – Prometheus Bound, a classic tale of how we lock up innovation, and punish those who would spread it to the world. In the old days, the gods imposed the restrictions; the penalty for telling the world the secret of fire was an eagle tearing out your liver. Today the restrictions are imposed by less-than-divine regulators; the penalty is a DMCA lawsuit, or a business method patent case. Nevertheless, the plot and perhaps even the feelings of the victim are remarkably similar.

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Richard A. Epstein: Competition Law in Two Easy Steps



As someone whose technical sophistication lies some where between the stone age and pharaohs, I cannot talk about the joys of the iPods that my grown children use with such abandon. But I do have some general comment on the antitrust mentality in Europe, which in my view poses a real threat to innovation across the globe.

Recall, here and everywhere else, that the competition law works along two separate tracks that rarely meet. The first of these tracks seeks to control collusive behavior between competitors that restrict output and raise prices. There are lots of wrong turns that can take place along this road, but at least one has some sense as to why we start down that journey in the first place. There is some social gain that justifies the restriction, regardless of the products and services sold in the underlying market.

The second form of competition policy deals with vertical arrangements, and goes under the heading of monopolisation and market dominance in both the EC and US. The problem here is that no one can find a strong and clear theory which explains why the various vertical practices attacked on these grounds create social losses, let alone losses so great as to offset the real administrative costs that come from enforcing a ban against these arrangements, such as the tie-ins that Hazlett addresses.

Indeed the theoretical arguments cut in exactly the opposite direction. Most practices that are targeted for a dominant firm, as when Apple links iPods with iTunes are practices that are freely allowed by nondominant firms. Those firms choose their business models with efficiency objectives in mind. When the law says that the dominant firm can't play by those rules, it imposes two costs. It blocks efficiency by the key industry player, and it distorts the competitive balance between in at other firms. And for what?

Hazlett notes the real improvement in consumer welfare that the iPod revolution has wrought. And Microsoft and other players are working to improve that model with their own next generation of products. It doesn't matter that France in this case is using statute law to achieve an competitions objective, the situation is every bit as dangerous in forcing sharing through the basic competition law. It may sound innocuous to force Apple to allow iTunes to be played on devices made by other manufacturers. But in even this amounts to an implicit transfer of technology, without license or compensation, from one firm to its competitors. The bottom line is the usual set of distortions from any mandated cross-industry transfers, in which the innovating firm gets too little return and its followers get too much. And in these markets, you get what you pay for - more imitation and less innovation.

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