



Just before the November 2020 election, the United States Department of Justice finally filed a lawsuit against the monster Google for anti-competitive behavior.<sup>1</sup> In this Commentary, I want to discuss some basic economic theories that we have at our disposal, “off



of these customers who will use **whatever** search engine we tell them to. They would even use Bing if we tell them to! Pay us even more or we will go to Microsoft.” This is not an idle threat. Microsoft has plenty of money to compete with Google.

So Apple can effectively bargain for the customers for an even larger subsidy from Google. And this is then passed onto customers through lower prices on iPhones.

This is a simplification of the problem; it’s a model. But it should give us pause about the lawsuit. If we are using a consumer welfare standard, how is this arrangement bad for consumers?

### **Exclusive Dealings**

The second main complaint brought by the DOJ centered around concerns that parts of Google’s agreements prohibited manufacturers from dealing with Google’s competitors. As the complaint states: “In many cases, the agreements relating to mobile devices go even further, expressly prohibiting (1) the preinstallation of any rival general search services, and (2) the setting of other defaults to rival general search engines. This means that Google is the only preset default search provider preinstalled on the device.”

Now, exclusive fBT0 g0.002 Tc 0.168 n (. T)-9 (hi)-2 9tinge34 (t)-2 (h4uT)-9 (hi)-2 9oe sond mlenes.{ve)4

than made up in the cost saving, we would recognize that decision was in the consumer interest. We do not want a variety that costs more than it is worth ... If Standard finds it worthwhile to purchase exclusivity ... the reason is not the barring of entry, but some more sensible goal, such as obtaining the special selling effort of the outlet.<sup>4</sup>

### **How Trade Promotions Could Harm Customers**

Since Bork's writing, many theoretical papers have shown exceptions to Bork's logic. There are times that the retailers' incentives are not aligned with the customers, and we need to take those possibilities seriously. The most common way to show the harm of these deals (or more commonly exclusivity deals) is to assume:

1. There are large, fixed costs so that a firm must acquire a sufficient number of customers in order to enter the market; and
2. An incumbent can lock in enough customers to prevent the entrant from reaching an efficient size.

Consumers can be locked-in because there is some fixed cost of changing suppliers or because of some coordination problems. If that's true, customers can be made worse off, on net, because the Google contracts reduce consumer choice.

To understand the logic, let's simplify the model to just search engines and searchers. Suppose there are two search engines (Google and Bing) and 10 searchers. However, to operate profitably, each search engine needs at least three searchers. If Google can entice eight searchers to use its product, Bing cannot operate profitably, even if Bing provides a better product. This holds even if everyone knows Bing would be a better product. The consumers are stuck in a coordination failure.

We should be skeptical of coordination failure models of inefficient outcomes. The problem with any story of coordination failures is that it is highly sensitive to the exact timing of the model. If Bing can preempt Google and offer customers an even better deal (the new entrant is better by assumption), then the coordination failure does not occur.

To argue that Bing could not execute a similar contract, the most common appeal is that the new entrant does not have the capital to pay upfront for these contracts, since it will only make money from its higher-quality search engine down the road. That makes sense until you remember that we are talking about Microsoft. I'm skeptical that capital is the real constraint. It seems much more likely that Google just has a more popular search engine.

The other problem with coordination failure arguments is that they are almost non-falsifiable. There is no way to tell, in the model, whether Google is used because of a coordination failure or whether it is used because it is a better product. If Google is a better product, then the outcome is efficient. The two outcomes are "observationally equivalent." Compare this to the standard theory of monopoly, where we can (in principle) establish an inefficiency if the price is greater than marginal cost. While it is difficult to measure marginal cost, it can be done.

There is a general economic idea in these models that we need to keep in mind. If Google takes an action that prevents Bing from reaching efficient size, this could lead to a technological externality – sometimes called a network effect – and so that action may hurt consumer welfare.

I'm not sure how seriously to take these network effects. If more searchers allow Bing to make a better product, then literally any action (competitive or not) by Google is a technological

---

<sup>4</sup> Bork, Robert H. *The Antitrust Paradox: A Policy at War with Itself*. New York: Basic Books, 1978. Print.

externality. Making a better product that takes away consumers from Bing lowers Bing's quality. That is, strictly speaking, an externality. Surely, that is not worthy of antitrust scrutiny simply because we find an externality.

And Bing also "takes away" searchers from Google, thus lowering Google's possible quality. With network effects, bigger is better and it may be efficient to have only one firm. Surely, that's not an argument we want to put forward as a serious antitrust analysis.

Put more generally, it is not enough to simply identify some externality and then have the antitrust authority come and try to sort matters out. For me to take the network effect argument seriously from an economic point of view, compared to a legal perspective, I would need to see a real restriction on consumer choice, not just an externality. One needs to argue that:

- 1.