

Microsoft's rise, fall owed to network externalities



Steve Ballmer's surprise announcement that he will be resigning as Microsoft's CEO has set off a huge flood of commentary. Being neither a tech geek nor a management guru, I can't add much on those fronts. I do, however, think I know a bit about economics, and I also read a lot of history. So the Ballmer announcement has me thinking about network externalities and Ibn Khaldun. And thinking about these things, I'd argue, can help ensure that we draw the right lessons from this particular corporate upheaval.

Paul Krugman

counts. Apple computers were better than PCs using Windows as their operating system. Yet the vast majority of desktop and laptop computers ran Windows. Why?

The answer, basically, is that everyone used Windows because everyone used Windows. If you had a Windows PC and wanted help, you could ask the guy in the next cubicle, or the tech people downstairs, and have a very good chance of getting the answer you needed. Software was designed to run on PCs; peripheral devices were designed to work with PCs.

That's network externalities in action, and it made Microsoft a monopolist.

The story of how that state of affairs arose is tangled, but I don't think it's too unfair to say Apple mistakenly believed ordinary buyers would value its superior quality as much as its own people did. So it charged premium prices, and by the time it realized how many people were choosing cheaper machines that weren't insanely great but did the job, Microsoft's dominance was locked in.

Now, any such discussion brings out the Apple faithful, who insist that anything Windows can do Apple can do better and that only idiots buy PCs. They may be right. But it doesn't matter, because there are many such idiots, myself included. And Windows still dominates the personal computer market.

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How could Microsoft have been so blind? Here's where Ibn Khaldun comes in. He was a 14th-century Islamic philosopher who basically invented what we would now call the social sciences. And one insight he had, based on the history of his native North Africa, was that there was a rhythm to the rise and fall of dynasties.

Desert tribesmen, he argued, always have more courage and social cohesion than settled, civilized folk, so every once in a while they will sweep in and conquer lands whose rulers have become corrupt and complacent. They create a new dynasty — and, over time, become corrupt and complacent themselves, ready to be overrun by a new set of barbarians.

I don't think it's much of a stretch to apply this story to Microsoft, a company that did so well with its operating-system monopoly that it lost focus, while Apple — still wandering in the wilderness after all those years — was alert to new opportunities. And so the barbarians swept in from the desert.

Sometimes, by the way, barbarians are invited in by a domestic faction seeking a shake-up. This may be what's happening at Yahoo: Marissa Mayer doesn't look much like a fierce Bedouin chieftain, but she's arguably filling the same functional role.

Anyway, the funny thing is that Apple's position in mobile devices now bears a strong resemblance to Microsoft's former position in operating systems. True, Apple produces high-quality products. But they are, by most accounts, little if any better than those of rivals, while selling at premium prices.

So why do people buy them? Network externalities: lots of other people use iPhones. Whatever, there are more apps for iOS than for other systems, so Apple becomes the safe and easy choice. Meet the new boss, same as the old boss.

Is there a policy moral here? Let me make at least a negative case: Even though Microsoft did not, in fact, end up taking over the world, those antitrust concerns weren't misplaced. Microsoft was a monopolist, it did extract a lot of monopoly rents, and it did inhibit innovation. Creative destruction means monopolies aren't forever; but it doesn't mean that they're harmless while they last. This was true for Microsoft yesterday, it may be true for Apple, or Google, or someone not yet on our radar, tomorrow.

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