Micro Economics

Does Google Have Too Much Money?

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For some time the blogosphere has made a ruckus over Google's growing power in the commercial Web. Such concerns probably would have arisen even if the world's developed economies were not in the midst of a painful macroeconomic nadir. In such dismal conditions, however, this extraordinary young firm's wealth makes it a natural target for envy and scrutiny. Many lawyers have begun sharpening their knives, looking for cases to bring.

I cannot help but think that I have seen this economic movie a few times already. This is not a sequel. It is a new cast, but a familiar plot. Only the ending seems up for a potential rewrite.

The concerns about Google Books are the most interesting. It is a new line of business, and the technical results could be pretty cool—namely, online access to any book ever published. The economics are not straightforward, however. Google is reportedly throwing $300 million dollars at the project. At this point, it is far from apparent how the company will ever generate enough revenue to recover its investment.

Is it a problem when a fabulously wealthy firm uses its money to explore grand new projects? If there is an economic problem, it is this: the firm has too much money.

When does it happen?

Before focusing on Google in particular, let's consider this topic with some generality. In every era, some high-tech firms have enjoyed more commercial success than others. This era it is Google and maybe Cisco. Last era it was Microsoft, Oracle, and Intel. Before that it was IBM.

Supersized profits are a remarkable economic outcome because they typically attract significant competition, imitation, and entrepreneurial entry. Hence, sustaining long-term commercial success is difficult. It is notable when a company achieves such success repeatedly.

Let me rephrase that last statement. In most markets, firms do not have enough money to survive an error or indulge (for long) in a strategically stupid direction. Competitive pressures make firms pay for their mistakes. But super-rich firms rarely pay as harshly. They can survive a few. Their wealth lets them invest in projects with long gestations. It also lets their managers ignore short-run market signals, or, at worse, hold onto an illusion longer.

Sometimes it works out for rich firms, and sometimes it does not.

The good stories have happy endings. In the late 1950s, for example, Thomas Watson Jr. inherited IBM from his father. The firm was already well run and rich. What did the younger Watson do first? He listened to his customers in a way his father had not. That gave him one great big audacious idea: a computing system with compatibility across a range of sizes. Thus was born the IBM System 360, the most lucrative product introduction ever.

IBM did not always match this early success, especially later, when it was very rich. For example, the 4300 series did not drive out Digital Equipment Corporation, as it was supposed to. And who can forget the PS/2 and token ring? These products looked out touch in the late 1980s, and caused IBM to throw lots of money down the drain.

Another rich firm, Microsoft, also has its list of exploratory successes and failures. Perhaps Encarta is as good an example as any. Encarta pushed sound and video compression into a new range of uses. The development process was disciplined. That product shook up the encyclopedia market in 1993 and for a long time thereafter. Microsoft sold many units and made a lot of money—until Wikipedia ate it for lunch.

More recently, Microsoft ventured into the mobile phone software business, as well as related areas, such as the Zune. Some of these products did okay, and others did not work out, but the experimenting was sensible, careful, and not a waste. Apple simply outdid them (and not for the first time). No shame in that.

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In the opposite direction, the bad stories at Microsoft are just horrid. For example, in the 1990s, the firm bet on MSN for far longer than was sensible. Microsoft also missed the commercial Web, only finding it after Bill changed his mind (in May 1995) about the ability of the commercial Web to undermine the profitability of existing Microsoft businesses. The firm spent the next few years beating the stuffing out of anybody who wanted to do things differently, setting back the commercial Web for years. What a legacy.

However, my favorite example of a waste of money is the XBox. Yes, I realize it's good for playing games, but that misses the point—namely, no stand-alone firm disciplined by venture capitalists would have made such an unprofitable business investment. Microsoft incurred eight to ten billion dollars in losses (there are various estimates) over many years so it could (today) operate a business that will never—can never—get much better than a bit above break even. Look, as a stand-alone business, XBox has lost more money than the combined losses of WebVan, Global Crossing, and Level3—the three biggest losing venture-backed investments of the dot-com era.

Back when Microsoft executives could have stopped the losses, they always responded to skeptical criticism by saying there were strategic benefits to developing XBox. Goodness, who spiked the Kool-Aid? Ten billion dollars would have bought back lots of stock earlier in the decade. Have Microsoft stockholders gotten 10 billion dollars worth of strategic benefits? Not even close. XBox has been an enormous and unnecessary waste of resources for Microsoft shareholders, and, in addition, it has destroyed wealth for Sony and Nintendo stockholders.

What to do, if anything?

Google is a recent entrant to this rich club. To be sure, Google's story differs in the details from those of IBM and Microsoft. At a broad level, however, there are many parallels. Google has been spending money on dozens of beta services; Google Books is just one of them.

Is Google Books a bad thing? By conventional economic reasoning, it depends on your perspective.

Commercial success on a grand scale usually involves technical proficiency mixed with a range of acute insights into how to translate technical knowledge into something valuable. I do not necessarily mean that a super-rich firm knows how to reach the technical frontier (although it might). Rather, the firm's managers know how to conduct business—keep costs lower than revenues, and aim all activities toward that accomplishment.

Google exemplifies this success. It knows how to perform search and promote a keyword-based auction, for example. The value of its offerings was not obvious initially, so the firm deserves some credit (and extra returns) for seeing the potential and developing it to near-perfection.

There is a related corollary that generates controversy. Once a firm's employees become proficient at making revenue well in excess of their costs, they tend to remain proficient until demand for their products dries up. That also usually means the firm's employees have figured out how to avoid losing their gains to imitators, at least for a while.

Why is that controversial? It is not sensible for economic policy to punish those who successfully translate technology into valuable goods and services. However, it might be sensible to limit the destructiveness of rich firms that can afford to ignore market signals or pursue illusions for too long. It is on such issues that most commentators divide.

One economic view of this topic—often called the "Chicago school" for its birth at the University of Chicago—stresses that fabulously wealthy firms got that way by being great at what they do, and usually better at it than others. Such a view considers this achievement to be rare, so adherents give large companies a pass on just about every activity.

An alternative economic view favors protecting competitive processes for future generations of entrepreneurs. This group worries about defensive market behavior from super-rich firms, which raises the costs of entry for others. It also worries about strong-willed executives holding on to illusions that hurt others around them.

These two sides split on whether Microsoft has had excessive control over distribution channels and default settings during the browser wars. One view wanted to give the company discretion, whereas the other thought Microsoft damaged competitive processes too much, reducing competitive variety in a setting where entry was rare.

As for Google Books, the worriers point out that Google has acquired too exclusive a relationship with publishers. Observers also disagree on the defaults for granting authors fairly broad opt-out rights, especially unrepresented ones. The Chicago view thinks the worriers are making a mountain out of molehill.

Going forward

I have no score card for who is right in the debate over Google Books, but I cannot shake the sense of déjà vu. One firm has too much money, and it is using it in adventurist ways. The plot line has a familiar outline. I wonder what sort of ending we will get this time?

Here are my two cents. Although I sympathized with the folks who thought Bill Gates used his discretion in damaging ways, when I look at Google Books I do not see the same destructiveness. It looks like a waste of money to me, but Sergey and Larry might just create a big business if they know something I do not, or they are just plain lucky.

My bottom line: Monitor, but give some discretion. What is the harm in letting them try?

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