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DEPARTMENT: MICRO ECONOMICS

Google and Apple Signed a Deal

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The pending federal case against Google echoes tropes found in prior antitrust cases. It partially ventures into familiar legal and economic territory. Prosecutors ask for the end of the exclusive deals Google has signed with many other market participants.

Look closely. The federal case is two cases wrapped into one. One set of exclusive deals, between Google and Apple, fundamentally differ from the others. The deal between two of the richest companies in the world raises its own set of questions. That is so even if all the other exclusive deals disappear.

Google pays Apple something like $12 billion a year. The payments are for making the Google search engine the default search engine on the iPhone, as well as making it the default search engine on other Apple products and services—i.e., Siri, Safari, and so on. I think the federal case about this particular deal contains considerable merit.

FEDERAL CASE

Google had signed many deals that make Google the default search engine. These deals extend to carriers, as well as to handset makers, some of whom are direct business partners with Android, which Google owns and guides. Some of these businesses—many distributors of phones, in particular—are indirect partners with Google, at most, but these deals affect them too. The prosecution seeks to end these arrangements because the prosecution believes they impede entry of potential rivals.

How does Google justify these deals? Many users never play with defaults, and have no idea how they work. Most users rarely reset them more than once with a new device. Google argues that its arrangements reduce hassles and frictions that many users would prefer to avoid.

0272-1732 © 2022 IEEE
Digital Object Identifier 10.1109/MM.2021.3129395
Date of current version 1 February 2022.

Google's view must be true for some users, but what holds for some may not hold for all. How many users and suppliers would alter the defaults if they were not paid to adhere to an exclusive arrangement? The prosecution argues that many would.

More to the point, the strategic gains to Google must extend beyond the revenue it gets from more participants in its auctions. A few other entrepreneurs have tried to develop search engines, and so have a couple of large firms. How many more would do so if the exclusive deals disappeared? Why would a VC fund any aspirations when the exclusive deals stand in the way of a substantial market foothold? In other words, the deal narrows the foothold that another potential entrant could have used to get started in search. The open question is whether it does so by a lot or a little.

IN THE PROSECUTOR'S VIEW, SOCIETY WOULD BE BETTER OFF IF GOOGLE HAD TO FACE THE CONSTANT THREAT OF NEW INNOVATIVE ALTERNATIVES.

The prosecution could argue that, absent the exclusive deals, Google would have to constantly compete to persuade users to set and reset the defaults. Google would have to use some of its cash to improve its product, invest in marketing and education, and find creative ways to satisfy the users who could have, or would have, played around with those defaults. Spending billions on such activity is expensive and risky. Paying others to not support any alternative is cheaper. In the prosecutor's view, society would be better off if Google had to face the constant threat of new innovative alternatives.

GOOGLE AND APPLE

On close inspection, Google's payments to Apple differ from its other deals. Most of Google's payments to Apple shape the iPhone. For the sake of brevity, I will

just focus there. It amounts to approximately $8 billion.

This deal influences more than 30% of search activity in the United States, and also controls the fastest growing segment of users. The prosecution says iPhone takes 60% of the market in the United States. Most commentators believe smartphones account for more than half of the time online today in the United States, and far more than half among the youngest user segments.

U.S. antitrust doctrine rarely ever allows one dominant firm to pay another to change a feature in a product. The exceptions typically involve massive anticipated consumer benefits, such as designing standardized plugs and sockets for all firms.

Google gets strategic benefits from Apple. The road Apple did not take comprises many steps not pursued. Were it unconstrained by contract, Apple could have informed users more transparently about their options beyond the defaults. Apple could have designed a process that made it easier to change defaults on search engines, or enabled experimentation from other services. Apple could have put effort into its contracts with carriers so that carriers inform users about the default when a purchase is made. As it does with its other services, Apple could send periodic reminders to users to try alternatives, or Apple could feature search engine alternatives on its online store as its own separate category, or advertise new options in its periodic emails to existing users. Apple now has $8 billion of reasons *not* to do any of the user-friendly actions, nor encourage users to try other search engines.

Not trivially, the prosecution's complaint does not discuss potential search engine providers. Apple could have been considered one of them. After all, it employs some of the best programmers in the world, and it possesses the internal financing to undertake big projects. The deal with Google gives Apple financial reasons not to even have preliminary conversations.

To be sure, building a new search engine for the web would be an expensive project to attempt, and perhaps Apple has chosen not to pursue it as a rational business decision. This is an uncomfortable conclusion for Google. Either it is feasible and Google has discouraged a direct competitor with contracts, or one of the richest and most competent firms in the world does not see the sense in aspiring to build a search engine, confirming that Google's monopoly is nearly unassailable.

Antitrust lawyers summarize this type of arrangement by giving it the euphemistic label "cozy." Two CEOs became friendlier and "cozier" after sitting down to a dinner and making a deal. To be sure, Antitrust economists who despise these types of deals use more blunt terms. They allege that one monopoly shares monetary gains with another who helped foreclose the potential entrants.

GOOGLE'S BEST DEFENSE

Google has two lines of defense. It can talk about Apple's prices. It also can use a wildcard comprising legal technicalities.

The first option might be effective because most judges hesitate to interfere with price reductions, even in a cozy arrangement. The deal transfers to Apple some of the monetary gains Google gets from the advertising on iPhones, which, in turn, might motivate Apple to decrease the price of an iPhone.

HISTORY TEACHES A BITTER LESSON ABOUT FEDERAL ANTITRUST TRIALS. PROSECUTORS (TYPICALLY) ARGUE THAT SELF-INTEREST INTERFERED WITH ETHICAL JUDGMENT. LIKE IT OR NOT, THIS COURTROOM TACTIC SHOULD REAR ITS UGLY HEAD AGAIN WHEN GOOGLE'S CASE GOES TO TRIAL.

A skeptic also might expect Apple to act like every other large firm on the planet, and keep most of the money for its stockholders and employees, not translating the cash into price reductions for users. That argument leans on many studies that have found such patterns in other markets. In settings where firms have pricing power, as Apple does, many studies show that the lions' share tends not to go users.

If this generality holds in this case, it would be remarkable if prices decline enough for users to see a modest price decline, at best, on a product where prices exceed $500 a phone. A judge who removed this price decline is not taking a big action.

Now let's turn to the legal wildcards. Most of these excite legal experts, and may appear to most readers as legal technicalities. All of them arise from the ways in which modern antitrust doctrine has not adjusted to the business practices at modern software platforms.

To avoid a lengthy explanation, I will recognize the wild card exists, and briefly outline where it might be useful. All the wildcards arise from legal rules for platforms, which encourage the defense to look at all sides of platform competition. A recent (heavily criticized) Supreme Court ruling directs judges to do that.

For example, though Google presently splits the lion's share of online advertising market with Facebook, it is well known that Amazon recently has begun to grow advertising on its platform. Apple also has been taking steps to become more active in advertising (largely at Facebook's expense, so far).

A competent defense attorney would argue that the pressure is enough to undo any distortion coming from exclusive deals. A bold defense attorney might go further, and try to use the legal inconsistencies to sweep out the deal with Apple as part of a broad argument.

PUBLIC RELATIONS

History teaches a bitter lesson about federal antitrust trials. Prosecutors (typically) argue that self-interest interfered with ethical judgment. Like it or not, this courtroom tactic should rear its ugly head again when Google's case goes to trial.

That contains the potential to become a massive public relations disaster. For example, any prosecutor with a flair for sarcasm will highlight how far Google's actions strayed from the firm's earliest ideal slogans, such as "Don't be Evil." The Internet will adopt memes and Twitter will circulate savage ridicule.

Apple also shares some of the risks of the antitrust case because it is party to this deal. It would be reasonable for the CEO of Apple, Tim Cook, to prefer to avoid the anticipated costs, express some version of a publicly acceptable *mea culpa*, and ask Google to settle before trial.

Would Google's CEO, Sundar Pichai, and its founders, Larry Page and Sergey Brin, be willing to settle this lawsuit in order to avoid embarrassment? I have no idea, but I speculate not. Unless all of them have become steeped in antitrust history, they do not fully appreciate the downsides of going to trial.

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