How Piracy Opens Doors for Windows

Bill Gates may not be entirely dismayed by software thieves. They seed the world market and make Microsoft a standard.

By Charles Piller, Times Staff Writer
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Microsoft Corp. estimates it lost about $14 billion last year to software piracy — and those may prove to be the most lucrative sales never made.

Although the world's largest software maker spends millions of dollars annually to combat illegal copying and distribution of its products, critics allege — and Microsoft acknowledges — that piracy sometimes helps the company establish itself in emerging markets and fend off threats from free open-source programs.

The gist of the beneficial piracy argument is that the retail price Microsoft charges for signature products such as Windows and Office — as much as $669, depending on the version — can rival the average annual household income in some developing countries. So the vast majority of those users opt for pirated versions.

The proliferation of pirated copies nevertheless establishes Microsoft products — particularly Windows and Office — as the software standard. As economies mature and flourish and people and companies begin buying legitimate versions, they usually buy Microsoft because most others already use it. It's called the network effect.

"The first dose is free," said Hal Varian, a professor of information management at UC Berkeley, facetiously comparing Microsoft's anti-piracy policy to street-corner marketing of illicit drugs. "Once you start using a product, you keep using it."

Even as the Internet makes global piracy easier than ever, Microsoft's revenue and profit have risen steadily. It earned $12 billion on $41.4 billion in revenue in calendar '05.

That record of success has led many experts and software companies to regard piracy as less of a problem than initially assumed or even part of a comprehensive strategy, said Eric Goldman, a law professor at Marquette University in Milwaukee and the former chief counsel of a Silicon Valley Internet firm.

"Is widespread piracy simply foregone revenue, a business model by accident or a business model by design?" he asked. "Maybe all three."

Of course, Microsoft executives prefer that people buy, but theft can build market share more quickly, as company co-founder and Chairman Bill Gates acknowledged in an unguarded moment in 1998.

"Although about 3 million computers get sold every year in China, people don't pay for the software. Someday they will, though," Gates told an audience at the University of Washington. "And as long as they're going to steal it, we want them to steal ours. They'll get sort of addicted, and then we'll somehow figure out how to collect sometime in the next decade."

That's exactly what has happened around the globe, according to the Business Software Alliance, a Microsoft-backed anti-piracy group. Even Vietnam, which at more...
than 90% has the highest piracy rate in the world, has improved from 100% in 1994. The No. 1 software firm in Vietnam: Microsoft.

Closer to the company's Redmond, Wash., headquarters, the decline of piracy in the United States has tracked Microsoft's rise. Stratospheric 25 years ago, the U.S. piracy rate dropped to 31% in 1994, then to 21% in 2004 — the lowest in the world.

Microsoft's public posture on piracy is one of zero tolerance.

"We're all working five days a week and getting paid for three," said Cori Hartje, the company's director of license compliance. "We do everything we can to stop piracy."

The company sues online auctioneers and computer makers that supply pirated products, including Windows, the operating system for more than 90% of the world's personal computers. It cooperates with law enforcement agencies to seize pirated discs and warns users around the globe that counterfeit programs may destabilize their systems.

The effort even prompted Islamic clerics in Saudi Arabia and Egypt to declare fatwas, or religious edicts, against software piracy.

Microsoft, like most other software companies, has experimented with technical tricks to prevent copying, such as discs that could be used only once and hardware "dongles" that had to be connected to the PC before a software program could run.

Legitimate users complained bitterly. Such methods caused software bugs and prevented customers from reinstalling programs when their computers malfunctioned, yet hackers quickly subverted each new attempt.

"Copy protection is a balancing act because it always reduces the value of your product," said Bruce Schneier, chief technical officer of Counterpane Internet Security Inc. "State-of-the-art copy protection makes your customers hate you."

By 1986, like most other software companies, Microsoft abandoned copy protection.

Now it attacks piracy with technical and legal carrots and sticks. In 2004, it launched the Windows Genuine Advantage program, which offers special features and updates for legal users. It also requires a product activation key — a string of letters and numbers the retail buyer of Windows or applications such as Word must enter to install the product on a computer.

Experts applauded the approach as thoughtful, given past problems with copy protection. But it does little to deter piracy, because thousands of activation keys — stolen or generated by software programs — can be found easily on the Web.

Microsoft's legal approach differs sharply with that of the music industry, which sues as if it were in the fight of its life, said John G. Palfrey Jr., director of the Berkman Center for Internet & Society at Harvard Law School.

"They put Napster out of business and sued Grokster to the Supreme Court," he said.

Unlike Microsoft, the music industry sees network effects from piracy. For little-known artists who have trouble getting airtime, piracy can be crucial to create buzz. But instead of generating revenue growth, pirated music generally replaces a CD purchase. In most countries, music revenue is falling.

In a loudly public campaign, music publishers have pressed more than 15,000 suits against individual pirates worldwide. Microsoft and the Business Software Alliance have rarely sued individuals, instead making claims against dozens of distributors and institutional users of illicit products.

More commonly, according to industry observers, Microsoft has cut pragmatic deals to convert institutional piracy into standard sales. Instead of suing, it asks organizations found to use illicit copies to replace them with licensed, paid versions. Microsoft wares become entrenched without competitive bidding, via piracy, and formal forgiveness cements the commercial relationship.

Microsoft declined to comment on how often it uses this approach.

Piracy also prevents free, open-source alternatives such as Linux from chipping away at Microsoft's monopolies, especially in developing nations.

China, for instance, promotes Red Flag Linux — a local, open-source competitor to Windows. As Gates concluded in 1998, piracy may be the only way Microsoft can stay in that market, embracing the opportunity to gradually convert pirates to payers. If Microsoft launched a draconian crackdown, UC Berkeley's Varian said, it would provoke the obvious reaction: "People would just switch to open source."
In China, pirated versions of Windows are easy to find on the street for 5 yuan, or about 62 cents. Why doesn’t Microsoft put the thieves out of business by giving away or deeply discounting local-language versions of its products? The strategy would offer network benefits while providing better data on users.

Consistent global pricing reduces confusion for multinational buyers, Hartje said.

Experts believe high prices encourage piracy but offer the company offsetting advantages. If Microsoft sold Windows for, say, $10, it would lose money on every copy because of manufacturing, distribution and support costs. At zero cost to Microsoft, piracy enhances network effects by getting Windows out to users who can’t or won’t pay, without undercutting normal prices.

"Microsoft benefits from piracy, then says, ‘If you think prices are high, blame the Chinese, because they are the thieves.’" said Ariel Katz, a law professor at the University of Toronto and an expert on the economics of piracy.

“They like us to feel guilty — to think that piracy is wrong and immoral. Economically, it’s not necessarily true, but it resonates with the public.”