

The PayPal Wars

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Unzipped is an excellent movie about fashion designer Isaac Mizrahi as he plans his fall 1994 designs. Im not into fashion: except for special occasions, I wear blue jeans and track shoes. The reason I like the movie so much is that its about a man who is passionate about his business, who conveys that passion, and who bets his company every year on whether hes got the fashions right. I thought someone could make just as exciting a movie about the information technology industry -- at the time, I was the regular economics columnist for Red Herring -- or even the steel industry. So far as I know, that still hasnt been done well. But now there is a book that passionately tells the story of one business in the information technology industry: Eric Jacksons The PayPal Wars.

Its rare that a business book is a page turner, but The PayPal Wars is: I read the whole book on one cross-country flight. We get to see the humble beginnings of PayPal, the small Silicon Valley company that was about to revolutionize the business of small financial transactions over the Internet. We see how it managed to switch from a strategy that yielded monthly losses only worsened by higher volume to a strategy of charging enough for its services to actually have the prospect of making money, a rare feat indeed for a completely Web-based company. We learn how it dealt with the various attempts eBay made to hamper it in favor of its own in-house financial settlement system. We also find out how a few government officials almost succeeded in killing PayPal with vaguely defined laws that they threatened to interpret in an extreme way.

Jackson, a 1998 Stanford economics graduate, joined the firm Confinity (shortly to be renamed PayPal) in 1999 and, within 15 months, was promoted to director of product marketing. Throughout, the firm was small enough that Jackson could follow fairly closely the major turning points and challenges. And there were challenges galore. Just when theyd beat back one competitive threat from eBay, eBay came up with another. Or if wasnt eBay, it was Eliot

Spitzer, the notorious attorney general of New York, who subpoenaed information regarding PayPal's use in on-line gambling.

As an economics professor at a business school, I am probably expected to believe that anything to be learned about business can be learned at a business school. One of my retired colleagues, fellow economist Patrick Parker, who had been CEO of a Fortune 500 company, disabused me of that notion long ago. The real challenge of running a business, Pat told me, is that you're trying to manage a stream of revenues and a stream of costs, where both are uncertain, you want to make revenues exceed costs, bad decisions can kill you, and you've got to decide quickly. Business schools don't teach much about how to do that.

It was this fact that motivated my co-author and former student, Charley Hooper, and me to write *Making Great Decisions in Business and Life*, which gives guidance on some basic principles that, once integrated, help one make good decisions quickly, including the decision about how much time to spend on a decision.

But enough of the sales pitch for our book; back to Jackson's book. *The PayPal Wars* shows just how apt Pat Parker's characterization of the business world is. One move that almost sunk the firm was its decision, made at 3:00 a.m., to renege on its policy of never charging fees to non-businesses. Fortunately, PayPal was able to get feedback quickly, and it was the kind of organization that paid attention to feedback. As Jackson writes, All hell promptly broke loose. Many customers complained on message boards, pointing out that the fees would push them into old-fashioned checks and money orders. Within 24 hours, management reversed its decision, disguising it as a clarification. (In *Making Great Decisions in Business and Life*, Hooper and I show why PayPal would have generated even more good will by being completely honest and admitting that the company blew it.) It's on such stories that *The PayPal Wars* shines. We see the quick decisions they make and how creative they are in responding quickly to the challenges, especially the challenges from competitors and from eBay.

At one point, for example, eBay sneakily tried to channel its users into its own on-line financial system, Billpoint, without the users knowing. Anyone who had ever used Billpoint was so channeled. The result: an instant increase in Billpoints market share and a decrease in PayPals. Jackson quickly crafted a warning to PayPal users, telling them that to get back to using PayPal on eBay, they needed to end their Billpoint accounts. The only way to end a Billpoint account was to contact eBay directly, and, of course, eBay didnt operate phone-based customer service. Jackson had a simple but inspired idea. He worked his way through the eBay directory until he found the telephone number of a skeletal customer service support crew. Then he e-mailed this relatively secret phone number to PayPal users, hoping they would flood eBay with calls. The strategy worked and eBay backed off.

This strategy was also more ethical than a strategy that PayPal considered but rejected, namely, using the legal system to go after eBay the way some of Microsofts competitors had done. Jackson argues, correctly, that the legal strategy probably wouldnt have worked in time to save PayPal. I was disappointed, though, that he didnt even mention that theres something unethical about suing your competitors just because they are playing hardball with their dominant position. Jackson writes that eBay tried to coerce our shared customers into abandoning PayPal. No it didnt. Coercion means the use of force. EBays actions, though nasty, were peaceful. Interestingly, even one of my favorite, and among the most clear-thinking economists, Milton Friedman, makes the same mistake in his classic book, *Capitalism and Freedom*. Friedman argues that monopolies, even those that are granted no government privilege, inhibit effective freedom by denying individuals alternatives to the particular exchange. But freedom means simply the right to buy from or sell to any willing seller or buyer. A monopolist that doesnt depend on government power for its monopoly denies no ones freedom. Nor did Jackson note the irony in considering suing eBay and, at the same time, complaining about government regulation.

Fortunately, Jackson is clear-minded enough to see the problem with government more generally. His description of the arcane rules revolving around Initial Public Offerings (IPOs) is hilariously on target. The process takes at least three or four months, he writes, long enough for a companys

bankers, lawyers, and accountants to learn enough about its business so they can describe it to other bankers, lawyers, and accountants. Even though one legal journalist made inaccurate statements about PayPal's business model during the pre-IPO quiet period, SEC regulations prevented PayPal employees from responding.

And that's just one example of absurd everyday regulations that people in the business world are used to. PayPal, because it was a new model, had run-ins with the attorney general of Louisiana, who threatened to ban PayPal unless it obtained a license to be a money transmitter. After PayPal's lawyers met with Louisiana state officials, the government rescinded its threatened ban. A regulator from Louisiana's Office of Financial Institutions stated, "We're trying not to be unreasonably hard on those folks. Our goal is to get all of those licensed that are required to be licensed." Jackson comments wryly, "If imposing an outright embargo prior to a company's IPO with no provocation and without prior warning isn't considered unreasonably hard, one can only wonder what these people would call playing hardball. Indeed. Jackson points out that one of the ominous signs in American business is just how easy it is for innocent, apparently law-abiding people to run into swinging legal doors."

I like to end a book review of such a positive book on a positive note. One of my favorite parts is Jackson's story of the day the IPO took place at an initial price of \$13 and the market quickly bid it up to \$18. His innocent delight is infectious, and I cheered for him and his co-owners who had worked so hard to create value for the American public and who celebrated their harvest of some of that value. It reminded me of Sam Johnson's famous saying, "Man is never so innocently employed as when he is honestly making money."