

COMMENT ON
DEPARTMENT OF COMMERCE
INQUIRY ON COPYRIGHT POLICY, CREATIVITY, AND
INNOVATION IN THE INTERNET ECONOMY
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Digital Society is a 501(c)(3) non-profit organization devoted to the propositions that culture and commerce are inseparable, that the digital economy flourishes when people are free and rights are secure, and that free markets produce free people.

We bring this perspective to the [Notice of Inquiry on Copyright Policy, Creativity, and Innovation in the Internet Economy](#) issued on behalf of the Internet Policy Task Force on Oct. 5, 2010.

The NOI raises numerous topics, and requests specific information and data that can be produced by the stakeholders on the basis of their experience in the marketplace. Its broad purpose is to help the Task Force “analyze various approaches to meet [the] challenges” of “protecting online copyrighted works and . . . sustaining robust information flows,” bearing in mind “a dual public policy imperative – to combat online copyright infringement more effectively and to sustain innovative uses of information and information technology.”

The main point we want to make is that these two imperatives are complements, not contradictions, contrary to views of the opponents of effective copyright who march under the banner of the [Free Culture Movement](#) (FCM).

The FCM wants both to dilute property rights in the interests of an abstract “balance” between creators and customers, and to hobble effective enforcement of the rights that remain, Digital Society believes that the only viable approach to achieving both “public policy imperative[s]” is a policy based on three pillars:

Strong and well-defined property rights. Many attacks on copyright are based on misunderstandings of the law. For centuries, the common law has worked to define what should and should not be within the scope of copyright, and the rules are sensible, in that facts are excluded from protection, as are basic plotlines and similar expressions. (There is a strong echo of the patent law requirements of novelty, utility, and non-obviousness.) These assessments must adapt to changing technology, but the adjustments should be carefully done to promote clear and effective property rights, not to undermine them or add uncertainty.

Markets. It is a fundamental fact that creators want their works to be available to as broad a public as possible. The FCM assumption that creators want works to be scarce is not based on the real world. Given this incentive for dissemination, and given that no one can predict what business models and pricing points will work, it is crucial to allow free-wheeling, market-based experimentation and discovery. Problems will indeed arise, but these will be corrected over time, often over a surprisingly short time, as the market adapts.

Low transaction costs. Markets are also enhanced by low transaction costs. Many of the problems that have arisen in the context of copyright are due to the frictions and costs of transitioning from an old system of physical distribution to a new system based on the Internet. The tangle of criss-crossing and uncertain rights that characterizes intellectual property in the physical world raises transaction costs in the digital world. The answer is to allow new institutional structures and rules to develop that reduce transaction costs, not to eliminate or undermine copyright.

Within this framework, four particular arguments often made by the FCM, and which will probably be raised in this proceeding, deserve special comment. These can be capsulized in the phrases:

“Copyright creates an artificial scarcity”
“People won’t pay for content”
“You need to find new business models”
“We are in a new culture of sharing”

They are addressed in order.

“Copyright creates an artificial scarcity”

A stock argument of the Free Culture Movement is that those who favor intellectual property rights are trying to create an artificial scarcity, in that creative works can be distributed at a cost close to zero and that, therefore, the price should be zero.

This is an extension of a fallacy based on a misunderstanding of the role and limits of economic models. An axiom of Economics 101 is that “price should equal marginal cost.” However, this axiom is true only in the abstract world of classroom theory, in which information is free, capital is perfectly mobile, transaction costs are zero, investment is non-existent, and time does not exist. In this non-existent world, the axiom expresses a conclusion about achieving a static equilibrium.

In the real world, time does exist and the crucial considerations are dynamic rather than static. Investment is necessary, capital will not be committed in the absence of certainty that marginal-cost pricing will *not* be required, and both information and transactions carry real costs.

In this real world, the axiom that price “should” equal marginal cost is nonsense, not just irrelevant but destructive. Any real-world business forced to price at marginal cost is on the way to bankruptcy as it cannibalizes its capital. A large portion of the business literature (as contrasted with that of economics) is focused on the question of how businesses must find a way to *avoid* marginal cost pricing if they are to succeed.

For discussion of the marginal cost issue and its limitations, and for further references to such basic thinkers as Ronald Coase and Lester Telser, see:

William Baumol, [Regulation Misled by Misread Theory](#), AEI Monograph, March 2006 (marginal cost and price discrimination).

Solveig Singleton, [Is Cheaper Always Better? Misusing the Concept of Marginal Cost in Policy Discussions](#), CLI White Paper, July 24, 2008 (intellectual property).

Competitive Enterprise Institute, [Declining Marginal Cost Industries in the Global Information Age](#) (Workshop), May 6/7, 2004 (general papers & discussion).

James V. DeLong, [Marginalized](#), TCS Daily, July 29, 2003 (competition policy).

For intellectual property, the problems created by focusing on marginal cost are obscured by the nature of the transition from physical to virtual distribution of creative works.

Society has a huge stockpile of creations that were produced under old rules about their protection and distribution, and the availability of this stockpile hides the nature of the long-term problem.

These existing works can indeed be distributed at close to zero marginal cost. Based on static economic efficiency, an economist might argue that this is the correct result. (Of course, this breaks faith with the creators, who acted on the belief that they would be paid for distribution, and whose ability to derive compensation is destroyed, but we are talking economics here, not law or morals.)

However, a rule allowing for distribution at zero cost is a one-time deal. It destroys the incentive for future creativity, because future creators now know that their investment cannot be recaptured through the sale of their works.

An analogy would be if the government looked at the existing stock of automobiles and decided that the cars could be distributed at zero cost, since they already exist, and that whoever wants to drive them off the lot gets them. In static terms, the argument is impeccable, but in terms of maintaining an auto industry over time, it is absurd.¹

The FCM is in cahoots with some powerful corporate interests in promoting the “price should equal marginal cost” fallacy. Advertisers and search engines want to maximize eyeballs and reduce the costs of the content that lures in the viewers. From their point of view, a cost of zero for content could not be improved upon. Indeed, the larger the volume of zero-cost content, the more valuable becomes the search engine function of sorting it out, and the less the costs of advertising as well.

The advertising and search industries have no responsibility and little interest in protecting the dynamism of the content industry – they can be confident that something will turn up in the future, even if it is suboptimal in quality, that people will need to search for it, watch it, and listen to it, and that advertising can be attached. The promotion of high-quality content is low on their list of priorities.

¹ Another point made by the FCM is that intellectual property is non-rivalrous in the sense that many people can use a creation at the same time, unlike a physical good, the use of which must be rationed. This argument is true, and has important implications for analyzing the role of property rights and the price system in allocating a limited resource, but it is not relevant to problem of incentive effects. For more discussion, see J.V. DeLong, [Defending Intellectual Property](#), in [Copy Fights: The Future of Intellectual Property in the Information Age](#), Cato Institute, 2002.

“People won’t pay for content”

Another stock argument of the Free Culture Movement is that people will rebel against paying for content, and therefore that all efforts to enforce intellectual property rights are doomed.

The disproof of this is that people *do* pay for content. They pay hefty monthly fees for connections to TV providers, and to Netflix and Hulu, they spend millions of dollars on gadgets that provide access to content and on the telecom connectivity necessary to get it, they buy expensive concert tickets, they subscribe to pay TV channels and buy movie tickets.

Naturally, most people, faced with choice of free or pay, will choose free. But the public is adult enough to know that free lunches don’t exist, and it will adapt to reasonable systems.

Of course, the “reasonable” is important. A fatal error of the music business was its slowness in developing methods of digital distribution. One can argue over the cause -- was it due to the difficulties created by a nightmarish complexity of rights or to an “[Innovator’s Dilemma](#)”-style reluctance to embrace a disruptive technology -- but the result was that the public could see the possibilities of greatly reduced costs and improved access while the industry was stuck in its CD-based model.

The most unfortunate result of this interlude was that the “content should be free” mantra gained serious traction, egged on by the FCM, and we are still suffering from this. And, as noted earlier, there was an immense stockpile of existing material that could be cannibalized, so incentives for continuing production were regarded as irrelevant.

The long-term result is not in the interests of music fans, and the Free Culture Movement errs most grievously in pretending that consumers are somehow well-served by illicit appropriation. As Digital Society Fellow James DeLong argued in an [amicus brief in *Grokster*](#), the problem is the familiar one of Prisoner’s Dilemma:

Consumers know perfectly well that unauthorized downloading decreases incentives for creativity, but they have a collective action problem, of the type known as Prisoner’s Dilemma.⁸ They know that their collective course of conduct is ruinous in the long term, to the creation of product and to the development of legitimate Internet distribution channels, but no single consumer can stop the tide.⁹ An individual who stops participating loses access to the material while other consumers continue to obtain it. In the end, the individual’s refusal to participate will have trivial impact on the availability of content in the future, so the non-participant will have sacrificed without result. Thus, while each participant knows that the current course of joint conduct is folly, each has a strong incentive to continue to take while the taking is good.

Indeed, the situation becomes a particularly egregious case of a commons problem. If a commons is going to be destroyed, then each individual has an accentuated incentive to grab as much as he or she can as quickly as possible before the destruction is complete, and the downward spiral accelerates.

Clearly, consumers' willingness as individuals to seize the opportunity offered by Grokster to loot the music commons is not an indication of what they would perceive as their real long-term interest. Consumers' true interest is in finding a mechanism for solving the Prisoner's Dilemma problem, a mechanism by which each consumer agrees to forego unauthorized downloading in exchange for a similar commitment from others.

In this framework, the question becomes, "what legal rules will prevent business entities from exploiting the short-term incentives of the situation and will enable consumers to pursue their long-term collective interest?"

FOOTNOTES:

⁸ For readable discussions of this concept, see William Poundstone, *Prisoner's Dilemma* (1992), Robert Axelrod, *The Evolution of Cooperation* (1984), and James D. Miller, *Game Theory at Work* (2003). There is a minor dispute over nomenclature, since some purists think the name "Prisoner's Dilemma" should be applied quite narrowly. This brief follows Poundstone, Axelrod, and Miller in using the term more generally, as a shorthand for the large class of situations in which short-term incentives of each individual render it difficult for the individuals *en masse* to maximize their utility. As Axelrod says:

Prisoner's Dilemma [is used] as the conceptual foundation for models of important social processes. Richardson's model of the arms race is based on an interaction which is essentially a Prisoner's Dilemma Oligopolistic competition can also be modeled as a Prisoner's Dilemma The ubiquitous problems of collective action to produce a public good are analyzable as Prisoner's Dilemmas with many players Even vote trading has been modeled as a Prisoner's Dilemma In fact, many of the best-developed models of important political, social, and economic processes have Prisoner's Dilemma as their foundation. (References omitted.) Axelrod, *supra*, at 28.

The distinction can also be embodied in the terms "constitutional interest" and "action interest"; the constitutional interest is what the individual sees as being in the best interest in the group as a whole while action interest is his interest in a particular situation. See Viktor Vanberg & James M. Buchanan, "Rational Choice and Moral Order," in 10 *Analyse & Kritik* 138 (1988).

⁹ A lively empirical debate exists over the impact of the unauthorized downloading services on sales of CDs. This literature is not cited here because it is profoundly uninteresting. While dual distribution channels will exist for some time, and the interaction of P2P with the sale of physical CDs will be complex and sometimes beneficial, the future of the business is in changing music into bits and sending it out over wires and wireless. The crucial issue in this case is the impact of Grokster and similar companies on the development of legitimate channels in this space, not on its impact on a declining business model.

In the context of this NOI, it is worth repeating the point made in the brief: "The question [for the IPTF is] 'what legal rules will prevent business entities from exploiting the short-term incentives of the situation and will enable consumers to pursue their long-term collective interest?' "

"You need to find new business models"

Another argument of the FCM is that content producers simply need to find new business models to replace the property-based models of the past. Touring, selling merchandise, advertising, and

patronage are often mentioned, but these suggestions are never accompanied by financial spreadsheets that show how they would work.

The argument that alternatives to property-based models are adequate is mistaken. Yes, there are different business models, but they should be complements rather than substitutes, and a healthy market allows producers to select among models and combine different sources of revenue so as to produce optimal levels of satisfaction for consumers and maximum opportunities for themselves.

In particular, ad-based and direct payment models are basically different businesses. In an ad model, the content disseminator is selling the audience to the advertiser. It uses the content as bait to collect eyeballs or ears, and the audience then becomes the product. Broadcast television was a prime example, and the combination of the limited number of stations combined with the need to collect the largest possible number of eyeballs to sell to mass marketers created a lowest-common-denominator programming philosophy that was called, during the time when it dominated, “the vast wasteland.”

Television content improved enormously with the rise of cable and pay-TV, which allowed viewers to pay directly for baskets of programming and fostered the creation of high-quality niches.

In a direct payment model, customers can express their preferences in content without intermediation. The differences between this and an ad-based model can be dramatic. For example, suppose 100,000 people want to watch a television production of a play. If each is worth only 10 cents to an advertiser, then the total possible revenue to the producer is only \$10,000 and the play is unlikely to appear. If each is willing to pay \$1, the economics are better, and at \$10 per viewer the production almost certainly becomes worthwhile.

Rather obviously, it would make no sense to tell drama lovers that they do not need to be able to pay for their preferences because an ad-supported model is available. Indeed, over 40 years ago the Supreme Court of California held that the difference in revenue models is so significant that a state initiative banning pay television violated the First Amendment to the U.S. Constitution. [Weaver v. Jordan](#), 64 Cal.2d 235, *cert. denied*, 385 U.S. 844 (1966).

Other alternatives to the direct sale of intellectual content have their own problems. A recent article in the *Economist* (Oct. 9, 2010, pp. 101-03) (proprietary), pointed to the increase in revenues from concerts and to the reversal whereby music is given away as bait to sell merchandise. It also discusses the rise of streaming digital and the fact that revenues from this source are rising. The tone is fairly sunny.

Near the end of the piece, however, some realities intrude. The concert revenues are going primarily to big, well-known, and aging acts. They come disproportionately from the older segment of the audience, which is less connected on the Internet. Most importantly, the young artists – the seed corn of creativity – are getting suffocated. The piece cites one young singer/song-writer as saying that “File-sharing was fine for long-in-the-tooth bands that ‘do sell

out arena tours’ But for new acts is a calamity. As revenues dry up, record companies are becoming unwilling to invest in young artists, apart from those who have built an audience”

Furthermore, says the article, the situation is worsening. The old acts are doing well because they appeal to the older generation that is not into file sharing. But younger fans are into file sharing, so they take from the younger artists.

These developments do not mean that there will not be stars – there will be – but it skews the possibilities. Like television in the pre-pay days, there will be mass-appeal acts that can fill a succession of large stadiums, but the artists who appeal to niche tastes will have a difficult time. To go back to the theater analogy, there will be no way for those who want to pay for a high quality production to express their preferences in the marketplace.

This concert-based model forfeits one of the best things about the Internet – its capacity to create niche markets that are unlimited in geographic scope. If content can be distributed digitally for a fee, then a few thousand fans among the world’s billions can sustain a creator. If the only creators who can survive are those who can fill stadiums in every city, then the structure of the business will look quite different.

Two arguments are sometimes made in support of the proposition that unauthorized sharing is not really damaging the market for content.

First, it is said that while overall music industry revenues are down, the revenues that go directly to artists are actually increasing.

Assuming this to be true, the point is a good one, to an extent. If revenues are down because of increases in efficiency, such as the substitution of digital distribution for imprinting bits on plastic disks and shipping them by truck, the decline in revenues is a good thing, and probably temporary, because lower prices will lead to increases in demand.

However, artists are not the only people in the system who add value. A healthy content-industry ecosystem involves not just artistic creation but also:

- Finance
- Talent spotting & development
- Marketing & market testing
- Distribution
- IP protection

If the decline in revenues means that these functions are being starved, then the industry is cannibalizing its “sunk capital” from the past, and – as noted in connection with the problems of young artists – is eating its seed corn. So if a higher percentage is going to artists because other functions are being reduced, and not because of efficiency gains, then the change is not healthy.

Second, the argument is made that file sharing is a search procedure that enables people to discover content of which they would otherwise be ignorant, and thus, perhaps, purchase it.

Again, this point is good to an extent. Search and discovery is an important part of any market. However, content producers are perfectly aware of the need for search and discovery, and they are the ones who should be able to decide how to incorporate it into their strategies. The free sample existed long before the Internet, but no one draws the conclusion that this entitles a customer to grab any product off the drugstore shelves that he has not theretofore used. In fact, content producers are experimenting with many methods of making their works available for trial.

“We are in a new culture of sharing”

Another argument of the FCM against intellectual property and its protection is that works should be available for use by “the community” which will then produce additional creative works. This view easily morphs into the argument that there is no such thing as an individual creative product; since nothing is produced *ex nihilo*, all creations actually products of the culture, and any assertion of individual ownership is presumptuous.

Again, there is a core of truth to these contentions. Content does build on other content in synergistic ways, and determining what element of a creation is new and thus deserving of protection can be difficult. And, again, this is not a new issue, since it has been the basic stuff of copyright and patent law since the inception of those fields. To say that a novel does not deserve copyright protection because it relies on the efforts of all who developed the English language, or all who developed fiction as an art form, is a non-sequitur. Dominion is never claimed over the language or the form; only over the author’s original contribution.

There are circumstances in which open systems and sharing are very productive. In academia, for example, creators are supported by salaries rather than by selling their products. One can argue that avoiding the transaction costs inherent in an intellectual property regime leaves everyone freer to produce substance. Indeed, every large corporation is a kind of commons – Google and Microsoft rely on intellectual property, but it belongs not to the individual creators within the company but to the corporate collective.

However, the claims for the productivity of non-property based peer production are easily overstated. Two of the major examples trotted out repeatedly are the Linux operating system and Wikipedia, but neither will bear the weight that the FCM wants to put on it.

Linux has always depended on large subsidies from major technology companies, which want to maintain a standardized version of the classic Unix operating system, and which want to make the operating system into a commodity so they can capture more of the value of the stack for hardware and services. Programmers of Linux are highly skilled and well paid professionals, not amateurs who flip burgers by day and write programs by night.

Nor is Wikipedia a persuasive example. While it is produced by amateurs for free, little of the important basic content is original. Wikipedia will not accept entries that cannot sourced to existing written material, which means that it is an example of the use of the existing stock of material which is available at zero cost, a pastiche of existing reference works. This does not denigrate its utility, which is often high, but dependence on the pre-existing stockpile of creative

goods is not a road to the future. To the extent that it makes it impossible for future producers of content to monetize their effort, such dependence is road block to the future.

There is nothing wrong with the culture of sharing, or with making creations available at no charge. The Internet's blogosphere is full of publications that do this, including Digital Society, because they have other purposes to be served and can most effectively fulfill their mission by making work available at no charge. But this should be at the option of the producer of the work, not a Procrustean bed enforced by the abstractions of FCM academics.

Nor should the advocates of sharing be able to enforce their ethic on the commercial world by demanding that the fruits of that mode of production be made available to them for free. The FCMers do not claim a right to free computers, or connectivity, or rent, or heat – there is no reason why they should not also pay to support production of the input that is most important to their work -- intellectual creations.