

**“Agreed Use and Fair Use:
The Economic Effects of Fair Use and Other Copyright Exceptions”**

By

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Introduction

This paper reviews the merits of arguments being advanced to justify adoption of US style fair use exceptions to copyright law in countries that currently do not have it. Although we outline the background on global initiatives to introduce copyright exceptions, the focus of our analysis is on the Australian Law Reform Commissions' (ALRC) recent Discussion Paper, which has recommended adoption of broad fair use exceptions to copyright law Australia. This study can be seen as representative of the analysis promoting such reforms globally.

In this context the paper will also consider empirical studies relied on by the ALRC which have attempted to estimate the economic effects of what they call copyright exceptions industries (CEI) that rely on *exceptions* to copyright law¹. These studies in effect attempt to assert that *exceptions* to copyright law might make a larger economic contribution than copyright law itself. These studies are being promoted to the ALRC and in other copyright law reform processes as providing empirical economic analysis of the economic benefits of copyright exceptions like fair use. To that extent this paper seeks to assess their strengths and weaknesses and whether they are “fit for purpose”.

My general conclusion is that moves to extend copyright exceptions in response to the development of the digital economy are mistaken in that it will only serve to reduce incentives for the development of new creative works, which in turn is likely to reduce overall social welfare.² Rather I argue the development of the digital economy requires the opposite response – namely the strengthening of copyright and the limiting of exceptions. The reason why is that the Internet has served to reduce transaction costs. Transactions costs provide the basic rationale and define the economic scope for fair use exceptions. To the extent transactions costs are falling, the benefits of fair use also fall. The scope for fair use to contribute to innovation and economic growth is thus reduced. This necessitates a reduction in the extent of fair use laws rather than an extension.

Outline and Executive Summary

In the first section we outline the background on global initiatives to introduce broad fair use exceptions. In the second section we focus on the reasons identified by the Australian Law reform Commission (ALRC) justifying the proposal to introduce US style fair use exceptions. This boils down to a claim that US style fair use exceptions will allow a flexible response to the digital economy, and assist innovation, while imposing little or no cost on rights holders. As we shall see however rather than elaborate a coherent economic justification for reform itself, the ALRC instead largely just reviews submissions to its inquiry. To the extent the arguments identified by the ALRC appear to be a sample of the arguments used for such changes globally they are however worth reviewing.

In the third section we briefly attempt to fill the gap left by the ALRC discussion paper, and outline the appropriate objectives of any copyright law reform, and the received economic rationale for both copyright and copyright exceptions. We do this largely because the ALRC does not. It is however required to provide the framework and basis for our subsequent analysis of the case for reform.

In the fourth section we address the question: what has changed to necessitate the adoption of fair use exceptions now? Given existing laws appear to have met economic objectives in the past, what is the “new” problem the ALRC is trying to solve? The argument we review here is the ALRC claims that the development of the digital economy, and “a significant move from rule-directed legislation to

¹ The copyright-exceptions studies are summarised in Appendix I.

² This is similar to the likely effect of copyright piracy as noted by Brett Danaher, Michael D. Smith, Rahul Telang (2013) in “Piracy and Copyright Enforcement Mechanisms” “a strong economic argument can be made that reduced sales from piracy will, ceteris paribus, reduce incentives for the development of new creative works, and that reduced incentives are likely to reduce overall social welfare”. see <http://www.nber.org/chapters/c12945.pdf>

principles-based legislation in Australia” (p64 para 4.29) provide the triggers for reform. In this section we explore these arguments and conclude that the case is quite the opposite. First we note that the development of the digital economy in fact reduces the benefits of copyright exceptions and that their scope and role should therefore be reduced. Second we highlight that principled-based approaches to law and legislation are not new, and indeed predates the digital economy, and has been previously incorporated into earlier copyright law reviews and reforms.

In the fifth section we highlight the fact that the ALRC only considered two options for reform: to adopt either broad fair use exceptions or substantially broaden the current fair dealing exceptions. . It failed to review another key option for reform namely the removal of existing specific copyright exceptions that are not technology neutral *without* the introduction of the proposed US style fair use rule. We call this third reform option “agreed use”. We make the case that a proper economic analysis of this third option as a response to the digital economy would show that it would generate greater net benefits than the proposal advanced by the ALRC. In this regard then, the ALRC analysis is shown to be incomplete.

In the sixth section we explore the costs of the ALRC’s proposed fair use law. This is again necessary, as the ALRC does not explore the costs it may entail. We show these costs are twofold. First the short run direct costs and opportunity costs the proposed reforms entail. Second there are the larger and more significant dynamic or long run costs arising from the fact that the proposed reforms will lead to less investment in creative goods, and less innovation and economic growth over time as a result. This in turn will lead to a reduction in consumer welfare and social welfare more generally over time

In the seventh and eighth sections we review the evidence. First on the benefits of copyright law, and second on the benefits of copyright exceptions. This forms the greater part of the report.

In conclusion, and contrary to the ALRC discussion paper and the two unpublished economic reports that are relied upon by the ALRC, economic theory suggests that any weakening in the enforcement of copyright, through introduction of ill defined exceptions would have significant *negative* economic costs, and little or no benefit. Economic theory suggests that the advent and development of the digital economy far from expanding the role of copyright exceptions including fair use should trigger the reduction in the scope and extent of such exceptions. Finally in the new environment economic theory suggests that *if* there are flexible copyright ‘exceptions’ that would make a substantial contribution to Australia’s economic growth and innovation, with negligible downsides for rights holders, then in all likelihood they would have *already been agreed to in the market or may be expected to emerge over time through automated market based electronic payment systems*.

The Global Copyright Exceptions Law Reform Movement

The US incorporated so called “fair use” exemptions into its Copyright Act in 1976.³ Under the US doctrine a use is “fair” considering the following tests:

1. the purpose and character of the use, including whether such use is of a commercial nature or is for non-profit educational purposes;
2. the nature of the copyrighted work;
3. the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
4. the effect of the use upon the potential market for or value of the copyrighted work.

³ 17 U.S.C § 107 (2006). The Copyright Act does not define fair use, nor does it contain definitive examples of particular fair uses. All that the Act offers by way of guidance is (1) an open list of examples “such as criticism comment and news reporting” which may or may not be fair use and (2) four general factors to be considered in applying fair use; and (3) since 1992 a minor clarification relating to the status of unpublished works

The US exemptions have never been seriously challenged under international copyright law, despite questions as to the consistency of the US fair use rule with the so-called three-step test incorporated into the 1967 Stockholm revision of the *Berne Convention*.⁴ While not challenged to date, the US exemptions have also not been widely adopted by other jurisdictions either.

Those countries that have introduced a US style exception for fair use, or extended fair dealing, include: The Philippines in 1998⁵, Singapore in 2006,⁶ Israel in 2007,⁷ and the Republic of Korea in 2012⁸

Recently other countries either have considered, or are currently considering extensions to copyright exceptions similar to the US exception. The common trigger surfacing in these reform exercises is the development of the so-called digital economy over the past 20 years. In the context of the evolving digital economy, the focus of analysis is often on the effect of copyright exceptions on transaction costs, and as a consequence innovation, and economic growth. This will form the focus of our analysis in this paper.

Having said that even after a long reform process, and pressure for copyright reform from the US, Canada rejected a US fair use style law with the introduction of its *Copyright Modernization Act*⁹ in 2012. The Act however does include an amendment to introduce some limited exceptions for user-generated content and specifically recognize fair dealing for educational purposes.

In the UK the Hargreaves Review¹⁰ in 2011 similarly rejected a US style fair use exception. Hargreaves commented specifically on fair use that the economic benefits of fair use

*'may sometimes have been overstated.'*¹¹

The Hargreaves Review did not support the proposition that the adoption of fair use would stimulate innovation. Instead it concluded that factors such as attitudes to business risk along with investor culture were more influential.¹² The Hargreaves Review also found that the economic benefits of a copyright regime would be better realised through specific copyright exceptions, rather than broad open standards:

The approach advocated here stops short of advocating the big once and for all fix of the UK promoting a Fair Use copyright exception to the EU, as recommended by Google and under examination by the Irish Government. We do so because we believe that the economic benefits of a more adaptive copyright regime are more likely to be attained in practice by

⁴ Berne Convention for the Protection of Literary and Artistic Works (Paris Act), opened for signature 24 July 1971, [1978] ATS 5 (entered into force on 15 December 1972).

⁵ Intellectual Property Code of the Philippines, Republic Act No. 8293, Section 185, enacted June 6, 1997, effective January 1, 1998.

⁶ 2006 Amendment to Copyright Act 1987 (Singapore) ss 35, 109 -clause III.35. Fair dealing in relation to works.

⁷ Copyright Act of 2007, Section 19.

⁸ 2012, the Korean Copyright Act article 35-3

⁹ Copyright Modernization Act, C-11 2012 (Canada). See further M Patterson, R McDonald, Fraser Milner Casgrain LLP, The Copyright Modernization Act: Canada's New Rights and Rules <www.lexology.com/library> at 22 March 2013.

¹⁰ I Hargreaves, Digital Opportunity: A Review of Intellectual Property and Growth (2011).

¹¹ I Hargreaves, Digital Opportunity: A Review of Intellectual Property and Growth (2011), [5.16].

¹² Ibid at [5.17].

*the approach recommended above and because there are genuine legal doubts about the viability of a US case law based legal mechanism in a European context.*¹³

The United Kingdom (UK) Government in response to the Hargreaves Review¹⁴ in 2011 has noted that in the context of the digital economy ‘the IP framework is falling behind and must adapt’¹⁵ and it has engaged in a number of reforms involving specific exceptions to copyright that apply in prescribed and limited circumstances.

As noted in Australia, a Copyright Inquiry by the Australian Law Reform Commission (ALRC) was announced in October 2011. The inquiry is into whether the exceptions and statutory licenses in the *Copyright Act 1968*, are adequate and appropriate in the digital environment. The Commission started its work in 2012. The first stage included the release of the Issues Paper, *Copyright and the Digital Economy* (ALRC IP 42), which generated 295 submissions. The ALRC has since released its Discussion Paper in June 2013, which reviews the submissions, and proposes Australia adopt a fair use exception. ALRC has called for submissions to inform the final stage of deliberations leading up to its final Report, which is to be provided to the Attorney General by the end of November 2013. This may then be followed by a review of copyright legislation in the Federal Parliament.

This recent ALRC’s recommendation that Australia adopt a fair use exception thus contrasts starkly with the Canadian approach; the UK Hargreaves Review and the ongoing United Kingdom (UK) Government inquiry into reforms involving specific exceptions to copyright that apply in prescribed and limited circumstances. The fact two different review processes (Hargreaves and the ALRC) in similar common law jurisdictions have led to different conclusions (assuming the proposals put forward in the ALRC’s Discussion Paper will not be radically different to their Final Paper) perhaps reflects the scope for error created by lack of empirical evidence available. The ALRC Discussion Paper however seems to imply that the only reason Hargreaves did not recommend the change proposed by the ALRC was that it would conflict with EU law, commenting

4.14 The Hargreaves Review was specifically asked to investigate the benefits of a fair use exception and how these benefits might be achieved in the United Kingdom (UK).¹⁶ The Review expressed regret that it could not recommend that the UK promote a fair use exception to the European Union (EU)—‘*the big once and for all fix*’¹⁷—as it had been advised that there would be ‘significant difficulties’ in attempting to transpose US-style fair use into European law.¹⁸

The reference to “the big once and for all fix” cited by the ALRC here, in fact occurs in the Hargreaves report in the paragraph which we just quoted in full above. The full quote provided above moreover makes it very apparent that there was no expression of regret that difficulties from a European Law context prevented Hargreaves from recommending that the UK promote a fair use exception to the European Union. In fact, the above quote makes clear, the first reason given by

¹³ Professor Ian Hargreaves, *Digital Opportunity A review of Intellectual Property and Growth: An independent report by Ian Hargreaves* (May 2011), at 52. In the Gower Review of Intellectual Property: Proposed Changes to Copyright Exceptions, the UK government has earlier rejected moving to a fair use model, favouring instead a series of clearly-defined exceptions for particular circumstances due to risks that the open-ended model would not comply with the UK’s international obligations and the administrative burdens uncertain standards would impose on business, i.e. in practice.

¹⁴ I Hargreaves, *Digital Opportunity: A Review of Intellectual Property and Growth* (2011).

¹⁵ UK Government, *The Government Response to the Hargreaves Review of Intellectual Property and Growth* (2011), p2.

¹⁶ I Hargreaves, *Digital Opportunity: A Review of Intellectual Property and Growth* (2011), 101.

¹⁷ *Ibid*, 52.

¹⁸ *Ibid*, 46. Some scholars have challenged the view that a Member State of the EU cannot introduce flexible copyright norms. See, eg, B Hugenholtz and M Senftleben, *Fair Use in Europe: In Search of Flexibilities* (2011)

Hargreaves for not recommending a more adaptive copyright regime was that “the benefits of a more adaptive copyright regime are more likely to be attained in practice” by the alternative more narrow approach the Hargreaves review recommended [i.e. expanded fair dealing]. In technical economics or public policy terms this implies the more narrow approach recommended by the Hargreaves review was seen to be a more “cost effective” means of securing any benefits than the broader approach recommended by the ALRC.

No doubt Hargreaves noted there were *also* potential EU legal impediments to a more adaptive copyright regime in the UK. Hence the words “and because” used in the last sentence in the above full quote from Hargreaves. EU legal impediments thus provided a *second* reason not to adopt the approach. From the full quote it is clear however that even if EU legal impediments to a more adaptive approach didn’t exist, the first reason given by Hargreaves is sufficient reason not to pursue the more adaptive copyright regime recommended by ALRC. From the full quote it is clear the first reason Hargreaves gave for a more limited approach (i.e. that “benefits...are more likely to be attained in practice” using it) would be sufficient reason to support a more narrow approach from a public policy point of view - not only in the UK, but also Australia. This inconsistency between the Australian and UK reviews recommendations provides added motivation for our in depth assessment of the arguments used by the ALRC in support of its recommendations in later sections of this report.

In Ireland a review of copyright law began in 2012¹⁹ that is to examine the ‘optimum’ copyright law for Ireland, including consideration of whether a fair use doctrine would be appropriate in the Irish/EU context. The report date has been extended in light of the large number of submissions received in response to a discussion paper.

The European Commission in January 2013 further announced seven new priorities for the European Digital Economy and Society. One of these steps is to ensure the EU copyright framework ‘remains fit for purpose in the digital context’.²⁰ Among the proposals are new EU Directives concerning activities of collecting societies in order to facilitate introduction of new business models that enhance online distribution of music.

Finally in the US in April 2013, the US House of Representatives announced ‘a comprehensive review of US copyright law’.²¹

In the context of these ongoing review and reform processes, decision makers are being forced to rely on a relatively small number of academic papers on the economic effects of fair use.²² To enhance the standards of evidence aimed at informing policy makers, a number of these jurisdictions have issued guidelines to set an acceptable standard for reports and commissioned work. The Hargreaves Review addressed the issue of sub-standard research papers²³ which resulted in the UK IPO issuing a "Good Evidence for Policy" guideline²⁴ which included a standard that research should be peer reviewed. The importance of obtaining objective and peer reviewed evidence as a basis for copyright

¹⁹ Copyright Review Committee (Ireland), Copyright and Innovation: A Consultation Paper (2012).

²⁰ European Commission, Orientation Debate on Content in the Digital Economy (2012).

²¹ US House of Representatives, Committee on the Judiciary, ‘Chairman Goodlatte Announces Comprehensive Review of Copyright Law’ (Press Release, April 24, 2013).

²² As we shall see later, it is notable that the ALRC only cites two unpublished and non-peer reviewed economic papers in support of their recommendation that Australia adopt broad fair use exception proposals namely: R Ghafele and B Gibert, The Economic Value of Fair Use in Copyright Law: Counterfactual Impact Analysis of Fair Use Policy On Private Copying Technology and Copyright Markets in Singapore (2012) and the Lateral Economics Report, Excepting the Future: Internet Intermediary Activities and the Case for Flexible Copyright Exceptions and Extended Safe Harbour Provisions (2012). Google was moreover involved in commissioning both of these reports, either directly (in the case of Ghafele and Gibert) or indirectly (in the case of the Lateral Economics report) through the Australian Digital Alliance.

²³ Hargreaves, Digital Opportunity: A Review of Intellectual Property and Growth (2011) – pages 18-19

²⁴ <http://www.ipso.gov.uk/consult-2011-copyright-evidence.pdf>

reform has also been recognised in the US, where the US National Research Council recently issued a report outlining how research should inform copyright policy.

In order to assess the merits of the arguments for fair use, we will focus on the analysis presented most recently in the ALRC report, and the economic papers the ALRC cites as the basis or as authority for its recommended proposals and conclusions.

Australian Law Reform Commission Proposals

The ALRC outlines its case for its proposed fair use exception in chapter four of its Discussion Paper. The ALRC however does not derive its recommendation from a closely argued, coherent theoretical or empirical analysis. Of particular concern is the failure to articulate a detailed economic analysis of the impact of the proposed reform. The chapter begins with a discussion of what is fair use and a summary of other reviews that have considered fair use. But then all the ALRC does in chapter four is summarise the views expressed in submissions under three sections entitled

- The changed environment (from page 64)
- Arguments in favour of fair use for Australia (from page 65)
- Arguments against fair use in Australia (from page 71)

The table below summarises the main points discussed under each of these sections

The changed environment (p64 para 4.29ff)	Arguments in favour of fair use for Australia (p65 para 4.34ff)	Arguments against fair use in Australia (p71 para 4.57ff)
<ul style="list-style-type: none"> • The most important change is the development of the digital economy. • There has also been a significant move from rule-directed legislation to principles-based legislation in Australia (p64 para 4.29) 	<ul style="list-style-type: none"> • provides flexibility to respond to changing conditions as it is principles-based and technology neutral; • assists innovation; • restores balance to the copyright system; and • assists with meeting consumer expectations. 	<ul style="list-style-type: none"> • is unnecessary and no case is made out for it; • would create uncertainty and expense; • originated in a different legal environment; and • may not comply with the three-step test.

Having summarised submissions made to it both for and against the fair use proposal, the ALRC then simply states its conclusion in a section entitled the “ALRC’s proposals for reform” (page 71 para 4.92ff) in which to quote “the ALRC proposes that the Copyright Act should be amended to provide a broad, flexible exception for fair use” Para 4.4. This section is in effect where the ALRC might be expected to clearly summarise its “rationale for reform”. In this section however the ALRC just simply states its conclusion at the outset rather than derive it, namely that:

4.92 The ALRC has considered the various arguments made for and against the enactment of a fair use exception in Australia and concludes that fair use:

- *is suitable for the digital economy and will assist innovation;*
- *provides a flexible standard;*
- *is coherent and predictable;*

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- *is suitable for the Australian environment; and*
- *is consistent with the three-step test.*

How the ALRC derives these conclusions is not clear. Simply summarizing arguments from the submissions both for and against fair use in this way does not constitute articulation of a clear rationale for reform. It is not clear what weight the ALRC attached to the relevant arguments of those making submissions and why. The ALRC thus does not derive the conclusions outlined using a coherent theoretical argument, or scientific evidence, nor more fundamentally a clearly articulated set of objectives. We turn to the question of objectives in the next section. Despite the difficulty therefore discerning a clear and coherent statement of the ALRC's logic for reform, in this section we attempt to outline and summarise what the ALRC has claimed.

In the subsection to chapter four entitled "*ALRC's proposals for reform*" (page 71 para 4.92ff) the ALRC makes a number of key claims about the effects of its proposed US style fair use exceptions regime that we will first now try to collate, so we can later make them a focus of our review. In particular there is a key statement at paragraph 4.93 in chapter four that

4.93 The ALRC considers that fair use would provide flexibility to respond to changing conditions and would assist innovation. These arguments outlined earlier are not repeated here.

The first sentence in 4.93 then suggests a core twofold rationale for reform which the ALRC seems to emphasise namely that it would:

- First "provide flexibility to respond to changing conditions" – "the flexibility rationale" and
- Second assist innovation – "the innovation rationale"

We will call these the ALRC's flexibility and innovation rationales for reform and make them a focus of our analysis later. These are both arguments raised in submissions and discussed earlier in chapter 4 under the section "Case for reform" as highlighted in the table above.

On the flexibility rationale the two main reasons cited for the claim that fair use "provides flexibility to respond to changing conditions" which the ALRC identified in its summary of submissions highlighted in the table above are that it is

- principles-based and
- technology neutral.

The ALRC goes on to elaborate this in paragraph 4.93 that

In the ALRC's view, a fair use regime will:

- *employ technology neutral legislative drafting;*
- *assist predictability in application;*
- *minimise unnecessary obstacles to an efficient market; and*
- *reduce transaction costs.*

It would seem the first two points clearly relate to the flexibility rationale. The last two could relate to both the flexibility and innovation rationales.

The ALRC later reiterates its claim that its “fair use” exceptions proposal in its Discussion Paper will contribute to flexibility when it claims they will

- “enhance adjustment to the digital environment” (Para 4.94)

Turning to the contribution fair use might to innovation the ALRC claims it will

- “foster an entrepreneurial culture which contributes to productivity (para 4.97) and
- “assist in making Australia a more attractive market for technology investment and innovation. (para 4.98)

Finally the ALRC tends to downplay any negative impact from a US style fair use exception on copyright-holders in its rationale sub-section to chapter. It does however cite reports sponsored by the Australian Digital Alliance and Google in its rationale subsection noting

4.100 Some stakeholders submitted that fair use would not necessarily cause economic harm to rights holders, citing economic studies.²⁵ Further, Google remarked that many companies are both owners and users of copyright materials and submitted that:

The idea that fair use somehow reduces copyright owners’ rights is belied by the regular practice of large US media companies applying fair use in their every day commercial decisions.²⁶

On this basis the ALRC concludes

4.101 The ALRC considers that the introduction of a broad, flexible exception for fair use into Australian law should allow flexible and fair mediation between the interests of owners and users in the digital environment.

In what follows then we will review the apparent ALRC arguments on the following three key issues identified so far namely

- 1) **Flexibility & the Digital Economy:** Including the ALRC claims that “*Fair use provides flexibility to respond to changing conditions*” where “*the most important change is the development of the digital economy*” and in particular that fair use will
 - a. “enhance adjustment to the digital environment” (Para 4.94) as it is
 - i. *principles-based* and
 - ii. *technology neutral*” or will “*employ technology neutral legislative drafting*” and
 - b. As a consequence it will
 - i. “*assist predictability in application*”;

²⁵ citing Copyright Advisory Group—Schools, Submission 231 citing R Ghafele and B Gibert, *The Economic Value of Fair Use in Copyright Law: Counterfactual Impact Analysis of Fair Use Policy On Private Copying Technology and Copyright Markets in Singapore* (2012), prepared for Google; Google, Submission 217 citing Lateral Economics, *Excepting the Future: Internet Intermediary Activities and the Case for Flexible Copyright Exceptions and Extended Safe Harbour Provisions* (2012), prepared for the Australian Digital Alliance.

²⁶ Google, Submission 217.

- ii. *minimise unnecessary obstacles to an efficient market; and*
- iii. *reduce transaction costs*

- 2) **Innovation, Productivity, Investment and Economic Growth:** Including the ALRC claims that Fair use “Assists Innovation” and that it would
 - a. *“foster an entrepreneurial culture which contributes to productivity (para 4.97) and*
 - b. *“assist in making Australia a more attractive market for technology investment and innovation. (para 4.98)*
- 3) **Harms to Rights holders:** Including the ALRC claims that fair use will “not necessarily cause economic harm to rights holders”

Finally it is noteworthy that the ALRC makes reference to only two economic papers, neither of which were published nor peer –reviewed, to support its key economic assumptions (Para 4.100)²⁷ namely:

- Lateral Economics²⁸, *Excepting the Future: Internet Intermediary Activities and the Case for Flexible Copyright Exceptions and Extended Safe Harbour Provisions (2012)*, commissioned by the Australian Digital Alliance²⁹ (cited by Google, Submission 217)
- R Ghafele and B Gibert, *The Economic Value of Fair Use in Copyright Law: Counterfactual Impact Analysis of Fair Use Policy On Private Copying Technology and Copyright Markets in Singapore (2012)*, commissioned by Google (cited by Google, Submission 217)

For this reason at the end of this report we turn to review both these papers in detail, both of which we show to be fundamentally flawed.

Besides the above economic papers the ALRC also cites:

- PricewaterhouseCoopers, *“The Start-up Economy: How to Support Start-Ups and Accelerate Australian Innovation” (2013)* commissioned by Google (cited by Google, Submission 217)
- A submission co-authored by Burrell, Hudson, Handler and Weatherall³⁰ in support of fair use.

Objectives, and the Economic Analysis of Copyright law, and Copyright Exceptions

Flexibility and innovation are not objectives. They might (or might not) contribute to more fundamental social objectives, but that requires analysis. Flexible rather than strict enforcement of the criminal law for example might fail to deter criminals. Similarly innovation by criminals might increase crime. It is important first of all then to clarify objectives by which outcomes from fair use laws will be judged. No doubt fair use will have consequences, whether it makes the world better depends on ones objectives or criteria for evaluating the outcomes.

²⁷ See ALRC Discussion Paper in section 4 at para 4.100 p 80, and footnote 184

²⁸ The author of the Lateral Economics report, Nicholas Gruen, is a Board Member of the Australian Digital Alliance and a member of the 25 person ALRC Advisory Committee.

²⁹ Google is a Board Member of the Australian Digital Alliance. Four Board Members of the Australian Digital Alliance are also members of the 25 person ALRC Advisory Committee.

³⁰ The submission is the equal third most cited submission in the Discussion Paper. The co-author, K. Weatherall is a member of the 25 person ALRC Advisory Committee.

Given the ALRC does not clearly elaborate its criteria or objectives it is useful to pause for a moment in this section to clarify the basis on which this paper will evaluate the ALRC's arguments. We then briefly review how received economic analysis evaluates the consequences of first of copyright law, and second copyright exceptions, relative to these objectives, before proceeding to the rest of the paper.

Objectives

Two objectives dominate economic analysis of public policy. The first is economic efficiency, the second distributive justice or equity. On the one hand the economic efficiency goal seeks to grow the economic pie, on the other; distributive justice seeks to divide it fairly.

The ALRC explicitly identifies efficiency as one of its concerns, where it claims that

“In the ALRC's view, a fair use regime will:.....minimise unnecessary obstacles to an efficient market; (para 4.93) and

Equity or fairness is also clearly in play given the way the ALRC describes its reform as involving “fair use”. Is fair use an apt description however? The ALRC's proposed reforms are clearly not proposing “agreed use”. Agreed use however could be called both fair and efficient. It would permit only efficient change, as it would ensure no one could be made worse off. It would also seem to ensure fairness, at least fairness of process. The fair use exception proposed by the ALRC however does not require agreement of the parties. Instead it clearly involves a taking, or abrogation of the rights of copyright holders. Why might this be fair? In what way is it efficient? How is it to be justified?

The ALRC does not really go into any depth in its analysis of the objectives by which it evaluates its proposal. It is for example not sufficient for ALRC to justify a “flexible copyright regime” by claiming there will be benefits, (for example that it might “assist innovation”) while ignoring whether there will be costs for example to copyright holders. This is for two reasons

The first reason as noted is efficiency. From an economic point of view, to justify reform *benefits must exceed the costs*. Thus any and all costs associated with the proposed flexible copyright regime needs to be identified and measured, which ALRC does not do. As we shall see below such costs are likely to be significant. Such costs also include more than the amount by which rights holders' revenue is reduced. It also includes the dynamic social and economic costs from less creative content over time.³¹ The costs also clearly include more than the issues identified by the ALRC in its section entitled the case against reform (see table above).

The second reason why simply citing benefits from reforms is not a sufficient justification is equity. Even if benefits exceed costs, the claims made by the ALRC do not necessarily justify reform as one could clearly face a distributional problem. Unless some part of the benefits from greater innovation (if in fact greater innovation occurs) was paid to rights holders to compensate for the “costs” of the reduction in their revenue there will be a redistribution of wealth.

The problem with not addressing the distributional issues at the heart of reforms is that reforms with serious distributional effects both exacerbate uncertainty, and encourage unproductive lobbying and

³¹ See the discussion of welfare effects and copyright enforcement in “Piracy and Copyright Enforcement Mechanisms by Brett Danaher, Michael D. Smith, Rahul Telang (2013) <http://www.nber.org/papers/w19150>

rent-seeking for redistributive gains in the future. The reform of rights systems thus creates costs in itself as it encourages efforts by people to get reforms in their favour.

So one needs to explain not only why benefits might exceed costs, but also assess what will happen in terms of distribution and why any particular redistribution should be favoured if at all.

The Received Economic Rationale for Copyright

The mainstream economics view is that the enforcement of copyright law (not exceptions to it) has significant economic benefits. This is based on the role of copyright in counteracting so called “free riding” on the investments of creators. Clearly the ability to freely copy another person’s creation without their permission encourages those who may benefit from it to *free-ride* on the creators effort and copy the work without paying for it. This undermines the ability of a creator or inventor to earn a living through voluntary exchange or sale. The creator or inventor cannot compete with freely distributed copies of their own work, even though other industries may indirectly benefit through advertising revenues as a result of increased ‘eye-balls’ to search indexes and other platforms. By limiting the reward of creators and inventors, free riding weakens their incentive and ability to create in the first instance, and is therefore likely to lead to less creative and inventive work over time. Copyright law is a mechanism for changing incentives and reducing the adverse consequences of free riding for creativity in the digital economy including music, film, e-Books, software, video and other digital creations.

The general mainstream economics view that the enforcement of intellectual property rights including copyright has significant economic benefits by counteracting free riding has been around for at least 250 years. In 1762, Adam Smith, the acknowledged founder of modern economics, commented on both copyright and patents that, “these two privileges can do no harm and may do some good” (Smith, 1762 p83). The support of leading mainstream economists for copyright protection continued through time. Jeremy Bentham writing in the early 19th century clarified that copyright solves the so called *free rider* problem which can lead to the underproduction of creative works.³² (Bentham, 1843) John Stuart Mill in 1848 concurred with Smith and Bentham in his Principles of Economics (Stuart Mill, 1848 Bk V, Ch.X paragraph 25) noting exclusive rights to creators and inventors was better than any real world alternatives. (Stuart Mill, 1848 Bk V, Ch.X §4 p563). Sidgwick (1887), another famous economist of the late 19th century, shared the view of Smith, Bentham, and Mill that copyright created benefits, and no harm.³³ (Sidgwick, 1887, p 434) The same was true of John Bates Clark, the famous American economist of the early 20th century.³⁴ (Clark, 1907, p360).

In the early 20th century a concern was expressed with the potential monopoly costs of copyright and patent (Plant 1934a,1934b). But this view confused property rights with monopoly rights. As Nobel winning economist Ronald Coase noted about his old teacher Plants views

“Today his discussion seems some what incomplete”

In more recent times, the significant benefits from intellectual property rights including copyright, has been articulated through the work of a number of influential economists, including Nobel Prize

³² “But that which one man has invented, all the world can imitate. Without the assistance of the laws, the inventor would almost always be driven out of the market by his rival, who finding himself, without any expense, in possession of a discovery which has cost the inventor much time and expense, would be able to deprive him of all his deserved advantages, by selling at a lower price.” See Jeremy Bentham [1843] Chapter III “Of Wealth”

³³ Commenting “.so far as at least as protection is limited to the results which persons other than the author protected could not conceivably have produced by independent effort – as mainly the case with copyright” Sidgwick 1887 p434

³⁴ Clark commenting that the exclusive rights offered the creator can cause no harm as:“the man is allowed to have an exclusive control of something which otherwise might not, and often would not have come into existence at all. ”Clark (1907 p360

winning economists. The work of Kenneth J Arrow, writing on the economic nature of invention and creativity as a process³⁵ (Arrow, 1962), George J Stigler writing on the economic nature of information (Stigler, 1961) and Ronald Coase writing on the role of law and property rights in the economic system, (Coase, 1960) contributed to the appreciation of the important economic role of intellectual property rights (including copyright, patents and trademarks). This culminated in the work of Harold Demsetz, (Demsetz, H. 1967, 1969, 1970), which was advanced in later applied work on copyright law, including that of William Landes and Richard Posner (Landes & Posner, 1989). Together this work established a coherent and integrated view of the economics of intellectual property rights. Economic historian and Nobel laureate Douglas North has further elaborated the important general role property rights play in economic growth and development through their effect in limiting the free rider problem (North 1981)

A key feature of the new economic analysis of copyright law is its comparative institutional analysis, or its focus on the role, or costs *and* benefits of such personal property rights, compared to any alternative solutions.³⁶ (Barker, 1996). Ultimately, it is the efficiency, or economic consequences of copyright in one form, compared to the efficiency, or economic consequences of feasible alternatives means of promoting creative and inventive activity that is at issue. In this regard if one compares the economic consequences of letting free-riders have the right to copy creative works, versus allocating the right to creators, one finds there will be less creative output under the “free rider” regime. Copyright serves to alleviate scarcity by creating property rights, thereby facilitating investment and exchange, and overcoming the so-called *free-rider* problem.

It serves to promote innovation, creative and inventive activity. Without the enforcement of laws allocating property rights and supporting contracts, *free-riders* will rule, theft of creative output will prevail, and investment, exchange and cooperation will suffer to the detriment of the cultural, economic and social development of society. In the same way as farmers gave up investing in their land when their property rights to the harvest were not protected from marauding Vikings, (North 1981) so too with creative investments. Copyright law in this way does not involve a trade off or exacerbate scarcity as some suggest,³⁷ but rather alleviates it, bringing forth more and new information and creative goods to meet the expanding demand for them.³⁸

The Received Economic Rationale For Exceptions

Given the above economic analysis or standard theory of copyright why have fair use rather than rely on agreed use? The received economic theory of the efficiency of fair use focuses on the impact of transaction costs in potentially preventing the negotiation of agreed uses between copyright owners and users. Transactions costs of course exist under any rule, and indeed it is transaction costs that underlie the free rider problem justifying copyright in the first instance. Thus it is not transaction costs per se that justify exceptions, transaction costs primarily justify copyright, not exceptions to copyright.

The economic rationale if any for exceptions is limited to a special set of conditions. That is where the value of a potential “agreed use” is lower than the transaction costs or the costs of coming to agreement about that use. In which case the parties are not likely to establish an agreed use. To rely on

³⁵ Arrow noted “In the absence of special legal protection, the owner cannot, however, simply sell information on the open market.” The solution Arrow pointed to was simple. “With suitable legal measures, information may become an appropriable commodity”. Arrow (1962 p615)

³⁶ For a detailed elaboration of the comparative institutional method see Barker 1996.

³⁷ For example see Lemley M.A (2005) p 1055 who comments “Intellectual property, then, is not a response to allocative distortions resulting from scarcity, as real property law is. Rather, it is a conscious decision to create scarcity in a type of good in which it is ordinarily absent”, see also footnoted references therein, including Lessig L. 2005.

³⁸ See Landes and Posner (2003) at 374 who argue that “information is a scarce good, just like land.”

agreed use only, would lead to situations where use is not agreed because the transactions costs of coming to agreement exceed the benefits of the agreement.

This is said to provide a transaction costs theory of fair use³⁹, which posits that the fair use defence should protect only those uses for which a socially beneficial transfer of rights would not occur absent a finding of fair use. Thus the fair use defence will fail if the courts are persuaded that the alleged infringer could have obtained a license to use the work through the open market.

For a long time both common law case law, and statutory law have thus provided for exceptions to copyright. As outlined the economic rationale for these exceptions has been that it might serve to “reduce transaction costs”, and “minimise unnecessary obstacles to an efficient market”. Points the ALRC claims for its fair use exception - but without explaining the reasons why. A gap the foregoing tries to remedy.

Problem Definition – What then has changed? – The Effects of the Digital Economy

Given the existing legal arrangements include exceptions, and that current law has presumably been judged to contribute better to social objectives than the ALRC’s alternative in the past, the question then is what has now changed to necessitate the adoption of fair use exceptions? What is the “new” problem we are trying to solve?

It is notable that the issue of fair use style exceptions has been considered and rejected a number of times before in Australia. In 1996–98 by the Copyright Law Reform Commission (CLRC) at the onset of the internet or digital economy. Then in 2000 by the Ergas Committee, and in 2005–06 by the AGD. In addition as noted US style fair use rules were considered and rejected only recently in Canada after a long reform process resulting in the Copyright Modernization Act⁴⁰ in 2012.⁴¹ The Hargreaves Review⁴² in the UK in 2011 also rejected a US style fair use exception, noting specifically on fair use that the economic benefits of fair use:

‘may sometimes have been overstated.’⁴³

This context immediately poses the questions: so what has changed in Australia? and what makes it different to Canada and the UK? such that fair use is now suddenly a good idea for Australia, where it wasn’t seen to be in the past, and where it has been rejected recently by the UK and Canada?

The ALRC considers that two developments in recent years provide support of Australia introducing fair use.

³⁹ Sometimes inappropriately referred to as a “market failure” theory of fair use. Market failure theories however tend to compare real world markets with a fictional, idealistic or notional idea of a “perfect market”, or a market which has zero transactions costs. Compared to such fictional markets with zero transaction costs of course most markets will fail. This “fictional failure” however cannot be used to justify fair use rules, as fair use may fail for the same reason (i.e. transaction costs). Thus under a fair use rule, uses which are not in fact fair may occur, simply because the transactions costs of properly administering the law prevent perfect law enforcement. Ultimately one needs to develop a comparative institutional theory of fair use rules that incorporates transactions costs, and therefore both market and legal failure relative to perfect markets and perfect laws.

⁴⁰ Copyright Modernization Act, C-11 2012 (Canada). See further M Patterson, R McDonald, Fraser Milner Casgrain LLP, The Copyright Modernization Act: Canada’s New Rights and Rules <www.lexology.com/library/> at 22 March 2013.

⁴¹ The Canadian Act does however include an amendment on user-generated content and specifically permits fair dealing for educational purposes

⁴² I Hargreaves, Digital Opportunity: A Review of Intellectual Property and Growth (2011).

⁴³ I Hargreaves, Digital Opportunity: A Review of Intellectual Property and Growth (2011), [5.16].

4.29 The most important change is the development of the *digital economy*. There has been a noticeable degree of change with respect to digital technology, including increasing convergence of media and platforms. There has also been a significant move from rule-directed legislation to *principles-based legislation* in Australia.⁴⁴

Both these claimed rationales for change (i.e. the development of the digital economic and principles-based legislation) however appear to be incorrect or at least hard to make out.

First the digital economy predates the last two copyright reviews and provided a similar context. Indeed the recent evolution of the digital economy has long been predicted, at least in terms of direction, dating back at least to the “dot-com” crash of the late 1990’s. Indeed it has seemed slow to unfold. Second and more importantly, as we shall argue below, the primary impacts of the growth and evolution of the digital economy is to

- a) lower transactions costs by enabling low cost communication and exchange between copyright holders and potential users; and
- b) increase the value in use of copyright to users.

These effects in turn fundamentally weaken the underlying rationale for fair use exceptions of any kind. Given the spread of the internet has lowered and continues to lower transaction costs, fair use is of less relevance today than it was before, and increasingly so.⁴⁵

As noted earlier the fair use defence should protect only those uses for which a socially beneficial transfer of rights would not occur absent a finding of fair use. This means that it should apply only where transaction costs exceed the net benefits of agreement. Given transactions costs have fallen with the internet the scope for agreed use has expanded and the scope of fair use should be more limited. Copyright protection should be enhanced with the advent of the internet and development of the digital economy - not reduced as proposed by the ALRC. The ALRC case that the digital economy provides a trigger for reform, or a relevant problem definition quite simply fails.

Second the move to a “principles based approach to law and legislation” claimed by the ALRC has been around a long time in Australia - since the Hawke Keating reforms of the 1980’s and 1990’s. One only needs refer to the Competition Principles agreement in 1996 arising from the so called Hilmer reforms of competition law and utility regulation to highlight that a principles based approach to law and legislation predates major developments of the digital economy - and all three of the copyright reviews. Again the ALRC case for reform or problem definition fails.

The Policy Alternatives

The ALRC discussion document only really considers two proposals to respond to the evolution of the digital economy: i) to adopt either broad fair use exceptions or ii) to substantially broaden the current fair dealing exceptions. The problem is that this analysis is incomplete. The obvious alternative third and fourth options are: iii) to continue with the “status quo” and maintain the current ‘fair dealing’ or iv) to increase copyright protection, by eliminating the exceptions that the ALRC criticises as not technology neutral or principled based – but *without* introducing the fair use exception proposed by the ALRC. Let us call this last or fourth option an “agreed use” law reform option. This option would respond to the fact the internet has reduced transactions costs and reduced the role for fair use copyright exceptions – and expanded the role for agreed use copyright enforcement.

⁴⁴ ALRC Discussion Paper page 64

⁴⁵ In several recent US cases, courts have accepted evidence of lost licensing revenues as an indication of harm to the market for the copyrighted work

The analysis of these options could proceed in stages. First the costs and benefits of removing the existing or “status quo” specific exceptions which the ALRC itself criticises could be evaluated. Given the internet has increased the scope for “agreed use”, it seems likely that over time the benefits from abolishing a number of the current specific exceptions to copyright would exceed the costs. Particularly those exceptions which are the subject of criticism by the ALRC for not being technology neutral. Removing exceptions that are not technology neutral would create technology neutrality.

Copyright law suitably strengthened for the digital age, with fewer exceptions, and greater reliance on agreed use would arguably create the basis for a better functioning market in creative content resulting in more consumer choice and enhanced social welfare. To the extent the starting point is that people cannot copy copyrighted material without permission, the law would provide the basis for commercial demand for creative content⁴⁶. Of course there would be transaction costs, but the point is they are now lower with the development of the internet, justifying the limitation of fair use. At the same time the greater protection offered to copyright would provide greater incentives to invest in and supply creative material to the digital market. Moreover strengthened copyright would not only facilitate investment it would facilitate exchange, providing the basis for investment in marketing, and to the extent it supports a secondary market, arbitrage. In short strengthening copyright as in intellectual property right would create the basis for investment *and* exchange or distribution and dissemination of creative goods, in the same way property rights in physical commodities like cars does the same.

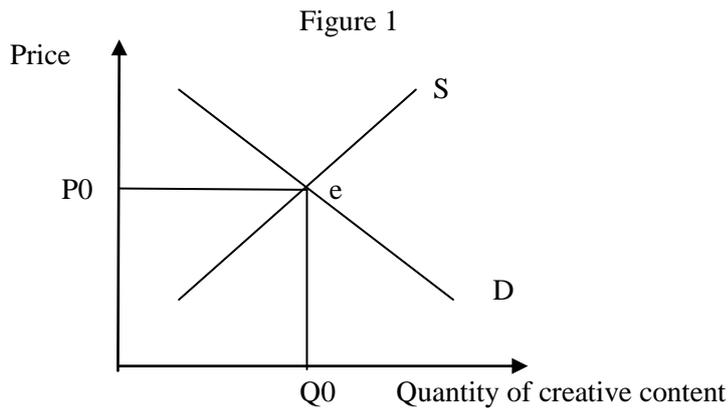
Having evaluated which exceptions should be abolished, and determined a new starting point for reform, then the costs and benefits of the proposed fair use exception proposed the ALRC could be considered, and one could evaluate whether it is worth pursuing. The ALRC however did not ‘unbundle’ and stage its analysis in this way. Indeed it did not identify any costs at all to its reforms.

The Costs of the ALRC’s Proposed Exceptions

In what follows we elaborate the economic analysis of the costs of extending fair use exemptions given the development of the digital economy and the impact of the internet in reducing transaction costs. First we model its’ likely static effects, and then turn to the dynamic implications of this for the availability of copyright content in the future, before turning to the evidence.

Figure 1 below presents a standard economic model of how the market for copyrights works under agreed use. On the horizontal axis we measure the quantity of delivered copyright content demanded by and supplied to consumers. On the vertical axis we measure the price of delivered copyright content. Economics predicts *demand* will be higher for copyright works, the lower the price of copyright goods, and demand will fall as price rises. This is represented by the downward sloping demand curve (D) in figure 1 below. On the other hand the *supply* of copyright material to the market will do the opposite. It will be low with low prices and increase as prices rise. This is represented by the upward sloping supply curve (S) the figure 1 below. The market will then come to an equilibrium price and quantity outcome where demand equals supply. Only where demand equals supply will the market have no tendency to change. If demand exceeds supply then price will rise, and so supply to the market will increase, while demand falls. If supply exceeds demand, then price will fall and so will supply to the market, while demand rises. Figure 1 identifies the point of equilibrium where demand equals supply at the point where the demand and supply curve intersect at the point e, with the price of copyright material P0 and quantity traded Q0. In this way copyright law provides the basis for a decentralised market in creative industries to work sending price signals to suppliers on what to invest in, and to users on what is most valuable and therefore to conserve.

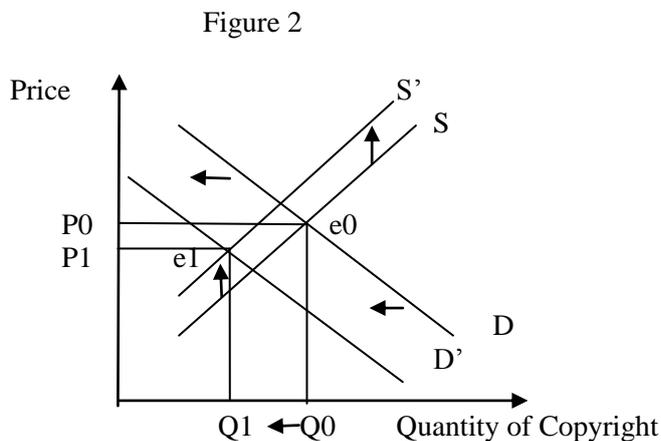
⁴⁶ Report of the Copyright Law Review Committee, 1959 to “Consider what alterations are desirable in the Law of the Commonwealth” (known as the “Spicer Committee”), para 13: The Franki Committee Report, para 1.05 : and *IceTV Pty Limited v Nine Network Australia Pty Limited* [2009] HCA 14, per French CJ, Crennan and Kiefel JJ at [24]-[25].



The likely economic effect on Copyright Industries of exceptions then can be analysed using this demand and supply framework as shown below in figure 2. The introduction of statutory “exceptions” will impose both *direct costs* and *opportunity costs* on the copyright industry. Neither of these costs are likely to be negligible and both will be an increasing function of the extent and uncertainty surrounding the exceptions granted.

On direct costs exceptions will *increase* the direct costs of supply as copyright owners need to negotiate and monitor compliance with these exceptions, so that the market is not undermined by people reclassifying their use as fair use and therefore free, thereby engaging in theft. This will shift the supply curve up as shown to S1 in figure 2.

Second of course demand will *fall* at any price as people reclassify their use as fair use and therefore free, shifting the demand curve inwards as shown to D1. At the new equilibrium intersection of demand and supply e1 in figure 2, , price will be lower and quantity sold lower causing harm to copyright holders in the form of foregone revenues – an opportunity cost.



Under agreed use the value of copyright to its owners is measured in figure 2 by the producers surplus at the old equilibrium, or by the triangular area under the old price line P_0 (which is what copyright owners receive for each unit of output) and above the old supply curve S (which measures the cost of supply for each unit). Under fair use the size of the producer surplus is smaller at the new equilibrium

shown by the area under the new price P1 and above the new supply curve S'. This difference between the size of these triangles, or in producer surplus, is the loss to copyright holders.⁴⁷

The likely loss in total social welfare over time however is likely to be much greater than this. This is because of the dynamic effect of copyright exceptions like fair use on incentives to invest and create and distribute copyright goods in the future. The greatest problem with the ALRC's proposal to broaden copyright exemptions is that they quite simply ignore the dynamic impact of such an initiative. The immediate short run or static loss of revenue and sales in the copyright market from the fair use law outlined above will reduce the incentive to invest in copyright over time. The short run or immediate loss of revenue and sales in the copyright market from the fair use law will therefore have a negative feedback effect over time, by reducing investment it will further reduce the overall size of the copyright market over time. Lower investment owing to lower expected revenues, will reduce future copyright output, and therefore consumer welfare, and more generally social welfare. Consumers and society in general in the long run are likely therefore to be better off without the exceptions because of this dynamic effect.

Turning to the evidence of the costs of US style fair use laws, Singapore in 2006 recently adopted the flexible language of the fair use system found in the USA to replace the Australian or European style laws that were in force. Recent research shows that before the amendments were introduced in Singapore copyright industries (including music, film, books, TV and radio) enjoyed an average growth rate of 14.16%, yet this slowed to 6.68% for the period after the amendments were introduced⁴⁸ confirming growth in copyright certainly slowed down in absolute terms in the one country that has recently introduced fair use laws of the kind proposed by the ALRC.

This potential loss in social welfare in the move from fair use to agreed use may arguably be why Australian law currently provides for only very specific and limited number of exceptions. It serves to limit these direct and opportunity costs to copyright content owners and users. Current Australian exceptions to copyright that permit people to use copyrighted material without permission however are focused around five highly specific "fair dealing" exceptions. These are limited to five statutory purposes

- research or study,
- parody or satire,
- criticism or review,
- reporting on the news and
- use for the purposes of judicial proceedings or legal advice.

This arguably has the benefit of limiting the costs of exemptions to areas where there may be associated *public benefits*, or what economists call positive externalities, for example in research or study, news reporting or judicial proceedings. Broadening the exceptions to areas without public benefits however would imply imposing costs in areas without commensurate public benefits.

⁴⁷ We do not discuss the implied loss in consumer surplus in the legitimate market using figure 2. This would traditionally be measured by the difference in consumer surplus under the *agreed use* and *fair use* equilibrium; or the difference *between*: on the one hand the triangular area above the old price line P0 (which is what consumers pay for each unit of output) and below the demand curve D (which measures consumer value attaching to each unit of output) under agreed use; *and* the smaller consumer surplus shown by the area above the new price P1 and below the new demand curve D' under fair use. The reason we do not include this analysis in the main body of the report is that this apparent loss to consumers under fair use in the legitimate market will be offset to some extent by consumers ability under fair use to by-pass the legitimate market shown in figure 2, and benefit from acquiring the right to copy copyright goods without paying for it using the fair use exception. This complicates the analysis and makes the consumer position in the short run ambiguous.

⁴⁸ R Ghafele & B. Gilbert (2012) The Economic Value of Fair Use Counterfactual Impact Analysis In Singapore Oxfirst at page 6 Available at: http://works.bepress.com/roya_ghafele/12

The problem however as we have seen is that with the advent and growth of the digital economy transactions costs have fallen, implying more limited benefits to even these exceptions, as the internet enables the positive externalities underlying the public benefits rationale for exceptions to be better internalised by contract. Thus with the advent of the internet researchers, satirists, critics and news reporters are all better able to contract both with the beneficiaries of their work, and with copyright owners for the uses they propose. Thus the benefits, and the efficient scope for all copyright exceptions, let alone fair use, has become more reduced. Implying the costs of current exceptions have been increasing over time, in the sense that a better market outcome is being foregone with the fall in transactions costs due to the internet. The current copyright exceptions may thus be acting as a barrier to a more efficient market and greater innovation - particularly where they are not technology neutral. There is certainly an increasingly weak case for expanding copyright exceptions.

Evidence on the Contribution of Copyright

WIPO has established the main method used to quantify the contribution of copyright to the macro-economy. The WIPO approach suggests it makes a substantial contribution. More recently however there have been attempts to model the contribution of the copyright-exceptions industries

Since 2002 the World Intellectual Property Organization (WIPO) has supported research on assessing the economic contribution of industries which are dependent on copyright and related rights protection – “the copyright industries” (CRI) . In 2003 WIPO published common guidelines on carrying out such research throughout the world (WIPO 2003, 2012a, 2012b). This methodology outlines four groups of copyright industries, identified on the basis of their level of dependence on copyright material.⁴⁹ It establishes a set of major indicators – contribution to GDP, employment and foreign trade, and lays out research standards and approaches. The WIPO guidelines were developed on the basis of best international practices reviewed by an expert group of renowned economists. The guidelines have been implemented in over 40 countries around the world (30 studies have been completed and published⁵⁰) and their improvement continues with the experience gained. In its recent review of these studies WIPO concludes that

“The overall performance of the copyright industries in the countries surveyed indicates the existence of a sizeable sector, which in most countries was found to be beyond the level of expectations. Copyright has often been perceived predominantly as a legal category and has not been analyzed as a growth factor of social and economic importance. The overview suggests that copyright industries have a significant overall economic contribution.” see WIPO (2012a) p2

It also clear from the WIPO studies that countries with stronger copyright industries perform better economically in terms of economic growth. As WIPO comments

The contribution to GDP varies significantly across countries from over 10% (USA, Australia), to under 2% for Brunei. With the average 5.4%, three quarters of the countries have a contribution between 4% and 6.5%. Three countries in the sample, the United States, Australia and Korea have shares considerably higher than the average. Countries that have

⁴⁹ The WIPO Guide distinguishes between core copyright industries, interdependent industries, partial industries and non-dedicated industries. The core industries are industries that are wholly engaged in creation, production and manufacturing, performance, broadcast, communication and exhibition, or distribution and sales of works and other protected subjectmatter

⁵⁰ One can find 30 country studies prepared by local researchers with the assistance of WIPO experts, a general analysis of WIPO Studies and a Table on Results of the Studies published in January 2012 at http://www.wipo.int/ip-development/en/creative_industry/economic_contribution.html

experienced rapid economic growth typically have above average share of GDP attributed to copyright industries. see WIPO (2012a) p2

The next section presents a critique of a number of recent studies which have departed from the widely accepted WIPO approach outlined above and instead attempted to estimate the economic effects of what they call copyright exceptions industries (CEI) that rely on *exceptions* to copyright law⁵¹. These studies in effect attempt to challenge the approach of the WIPO and assert that *exceptions* to copyright law might make a larger economic contribution than copyright law itself. They also seem to underlie the analysis of those promoting US Style fair use exceptions worldwide including the ALRC in Australia.

Evidence on the Economic Effects of “Copyright Exceptions” or “Fair Use”

As noted the main assertions of the ALRC is that US style “fair use” copyright exceptions would

- 1) “enhance adjustment to the digital environment” (Para 4.94) and “provide flexibility to respond to changing conditions” (Para 4.93)
- 2) “minimise unnecessary obstacles to an efficient market; (para 4.93)
- 3) reduce transaction costs” para 4.9“
- 4) “assist innovation” (para 4.93) “foster an entrepreneurial culture which contributes to productivity.... and assist in making Australia a more attractive market for technology investment and innovation” see para 4.97
- 5) “have little or no impact on copyright-holders.”

The ALRC does not present any detailed economic analysis to justify these conclusions. Rather its discussion document consists largely of a review of the submissions made to it, with the proposals for reform not clearly derived from economic theory or evidence, but rather seemingly plucked out of the air based on its review of the arguments. This makes it difficult to assess the detail of the ALRC argument.

In the section of the discussion paper where these conclusions are drawn however, the ALRC makes reference⁵² to only two economic papers, neither of which were published nor peer reviewed⁵³ in particular:

1. R Ghafele and B Gibert, *The Economic Value of Fair Use in Copyright Law: Counterfactual Impact Analysis of Fair Use Policy On Private Copying Technology and Copyright Markets in Singapore* (2012), prepared for Google⁵⁴ (cited by Copyright Advisory Group—Schools, *Submission 231*) and
2. Lateral Economics, *Excepting the Future: Internet Intermediary Activities and the Case for Flexible Copyright Exceptions and Extended Safe Harbour Provisions* (2012), prepared for Australian Digital Alliance (cited by Google, *Submission 217*)

⁵¹ The copyright-exceptions studies are summarised in Appendix I.

⁵² See ALRC Discussion Paper footnote 184

⁵³ Besides the Lateral economics and Ghafele and Gibert papers the ALRC also cites PricewaterhouseCoopers, *The Startup Economy: How to Support Start-Ups and Accelerate Australian Innovation* (2013); and R Burrell and others, *Submission 278*.

⁵⁴ R Ghafele and B Gibert, *The Economic Value of Fair Use in Copyright Law: Counterfactual Impact Analysis of Fair Use Policy On Private Copying Technology and Copyright Markets in Singapore* (2012), prepared for Google; Google, *Submission 217*:

In what follows I provide a review of the evidence presented in these two papers, and conclude they are unable to support the claims made by the ALRC about the likely economic benefits from the adoption of fair use laws.

The Singaporean Fair Use Study

The first paper suggests the introduction of fair use policy in Singapore positively influenced growth rates in the private copying technology industries and did not have significant adverse effects on copyright holders. Thus the ALRC notes

3.26 Commissioned research on the economic benefits of fair use in copyright law, using Singapore as a case study, found copyright industries to be ‘relatively unaffected’ by the introduction of fair use although significant stimulation of growth in private copying technology occurred

As discussed the Ghafele and Gibert research in fact suggests that the average growth rate of copyright industries in Singapore (including music, film, books, TV and radio) fell by over half after the amendments were introduced.⁵⁵ It fell from 14.16%, before the amendments to 6.68% for the period after the amendments were introduced. This is consistent with fair use adversely affecting economic growth in copyright industries in a country that has recently introduced fair use laws of the kind proposed by the ALRC. The fall of over 50% in the growth rate also seems to be quite a significant potential reduction compared to the ALRC claim that the research “found copyright industries to be ‘relatively unaffected’ by the introduction of fair use”.

The other key claim made by the ALRC is that the Ghafele and Gibert study showed fair use laws in Singapore provided a “significant stimulation of growth in private copying technology”. To quote Ghafele and Gibert they claimed that

Singapore’s fair use amendments are correlated with a 3.33% increase in value-added (as % of GDP) for private copying technology industries. Prior to the amendment of fair use policies, private copying technology industries experienced - 1.97% average annual growth. After the changes were introduced, the same industries enjoyed a 10.18% average annual growth rate. This resulted in a total increase of € 2.27 billion in value-added for private copying technology industries in that period. The results show that, prior to fair use amendments, the private copying industries in Singapore were in recession. After fair use amendments, this group experienced a rapid increase in growth rates and continued to exhibit strong growth over the five year period.⁵⁶

Thus Ghafele and Gibert are clearly claiming that the fair use laws in Singapore significantly increased the annual growth rate of private copying technologies. Three key problems with the study however mean this claim from the Singapore fair use study is quite simply incorrect and very misleading.

1. First, at the time fair use was introduced Singapore engaged in numerous other IP related reforms. It is thus not possible to isolate the effect of the fair use law, or separate it from the effect of other legal changes.

⁵⁵ R Ghafele & B. Gilbert (2012) The Economic Value of Fair Use Counterfactual Impact Analysis In Singapore Oxfirst at page 6 Available at: http://works.bepress.com/roya_ghafele/12

⁵⁶ Ibid p 5

2. Secondly Singapore is a small open economy and most of its output of private copying technology is exported. Indeed over 95% of Singapore's electronic goods are exported.⁵⁷ Clearly Singapore's fair use laws can not affect demand conditions in the countries to which Singapore exports. The sudden growth in value add of Singapore's private copying technology found by Ghafele and Gibert (G&G) after 2005 was therefore due to changes in demand conditions in the countries to which Singapore exported. It was not in any way likely to be due to changes in Singapore's fair use laws, which only affect domestic demand for private copying technology. It is clear that if domestic sales of electronic goods in Singapore is less than 5% of the total output, then domestic sales could not generate the kind of increases in growth in total value add outlined. To generate an additional 11% growth in total value add, domestic sales would have had to increase by over 200% under certain assumptions. Thus the G&G study is flawed in that it seems to assume Singapore's fair use law affects Singapore's exports. At best it only affects domestic demand. The focus should be on the effects of the law on Singapore's domestic market, not its exports.
3. Third a key problem with their claim that the private copying industry has benefited from the fair use law however is that there are obviously significant other reasons for the boom in their the private copying technology industry group other than Singapore's 2005 Fair use amendment. These reasons moreover are industry specific or specific to the industries included in the private copying group, and can not be controlled for using "the control group. On this third point for example a quick analysis of Ghafele and Gibert's data on the private copying group shows the boom growth of the "fictional" Private copying technology industry group is in large part due to the growth of computers which can hardly be linked solely, nor attributed if at all to fair use copyright reform. Thus 66% of the growth of the fictional private copying group post 2005 is accounted for by growth in computers. This 66% breaks down as follows
- 37% of the 66% = SSIC code 26201 = Manufacture of computers and data processing equipment except computer peripheral
 - 29% of the 66% = SSIC 4651 and 4741 = Wholesale and Retail of Computers, Computer Peripheral Equipment and Software

Computers wholesale and retail demand and supply is hardly likely to be driven primarily by a fair use copyright law. The cause of growth needs further examination as to the determinants of demand and supply of computers in Singapore that may be specific to the industry and not captured therefore in the control groups growth rate.

The other major contributor to growth of the "fictional" Private copying technology industry group is the 33% which is accounted for by three SSIC categories which they have combined, but we should seek a breakdown on from Singapore - these are

- 18200 Reproduction of recorded media (including reproduction of phonograph records, recorded magnetic tapes, compact discs and non-customised software)
- 26801/Manufacture of disk media
- 26802/Manufacture of blank magnetic tapes, diskettes, Bluray technology discs, CDs, DVDs and VCDs

⁵⁷ I am grateful to Professor Ivan Png, at the NUS Business School, National University of Singapore and President, Society for Empirical Research in Copyright Issues for this insight and statistic on export sales.

The boom in the growth of industries classified in the private copying group in Singapore may be driven by recent product innovation that are specific to key industries in the private copying segment, rather than Singapore's fair use law. In particular one would need to consider the industry specific effects of product innovations related to MP3 players like the iPod, smart phones like iPhone, and tablets like iPad.

The Australian Digital Alliance Study

My main focus in the rest of this paper is on the second paper cited by the ALRC, commissioned by the Australian Digital alliance (ADA) it provides the most comprehensive attempt to make the case for the ALRC's conclusions, and indeed includes reference to the first Singaporean paper where relevant and so subsumes it.

The Australian Digital Alliance (ADA) commissioned the Lateral Economics (LE) study, *Excepting the Future: Internet Intermediary Activities and the Case for Flexible Copyright Exceptions and Extended Safe Harbour Provisions* (2012), which claimed that

- “flexible copyright ‘exceptions’ and better crafted ‘safe harbours’ would make a substantial contribution to Australia’s economic growth and innovation with negligible downsides for rights holders; and
- the recommended changes would improve productivity growth. Over time the additional value added to the Australian economy is conservatively estimated to grow to around \$600 million annually.⁵⁸

The ALRC conclusions clearly accord with the LE study of the economic impact of more flexible exceptions in Australia. For this reason this paper focuses on the analysis conducted in the LE paper as also representative of the ALRC's thinking on the matter.

As we shall see there are three fundamental flaws in the LE's papers analysis that make the analysis unreliable and its recommendations irrelevant.

- The first is fundamental weaknesses in the theoretical economic analysis of the costs and benefits of broadening copyright exemptions;
- The second is fundamental weaknesses in the empirical analysis;
- The third is fundamental weaknesses in the legal analysis.

Economic theory suggests that *if* there are flexible copyright ‘exceptions’ that would make a substantial contribution to Australia’s economic growth and innovation, with negligible downsides for rights holders, then in all likelihood they would have *already been agreed to in the market or may be expected to emerge over time through automated market based electronic payment systems*.

Contrary to the LE reports claim, economic theory suggests that any weakening in the enforcement of copyright, through introduction of ill defined exceptions and safe harbours of the kind promoted in the LE reports, would have significant *negative* economic costs, and little or no benefit.

⁵⁸ Snapshot page 2

Outline

The remainder of this section consists of five sub-sections

1. The paper first briefly outlines the background or provenance and pedigree of the ADA study
2. The paper then briefly summarises and reviews the specific reform proposals promoted by the ALRC and LE to provide the basis for further analysis
3. The paper then assesses first the costs and then the benefits of these proposal from a theoretical point of view and identifies a number fundamental weaknesses
4. The paper then reviews the empirical analysis of the LE papers
5. Finally the paper reviews the legal analysis underlying the LE papers and recommends a better legal reform strategy for copyright that involves strengthening copyright to meet the challenges of the digital economy

The Background and Provenance or Pedigree of the ADA Study

The Computer & Communications Industry Association (CCIA) CCIA issued the first of the “copyright exceptions” or “fair use” studies in 2007, under taken by Capital Trade Inc (CT)⁵⁹ which purported to measure CEI in the US during the period 2002-2006. CCIA has since commissioned CT to update this study in the US twice, first in 2010⁶⁰, and then in 2011.⁶¹

In 2010 the CCIA further commissioned a study of the European Union (EU) this time by SEO Economic Research⁶² which adapted and applied the same approach used by CT in the US.⁶³

Recently in September 2012 the Australian Digital Alliance (ADA) similarly commissioned and released two reports written by Lateral Economics (LE) that adapted and applied the methodology used in the US and EU to Australia. The two reports plus the ADA summary document (Snapshot) were entitled:

- [Part 1: Exceptional Industries](#)
- [Part 2: Excepting the Future](#)
- [Snapshot: Lateral Economics reports](#)

In what follows we focus our critique on the economic modelling of the benefits of copyright exceptions primarily on the LE Australian study as it is the most recent attempt to measure copyright exceptions by applying the methodology developed in the US. Our critique of the LE approach however can further be readily generalised to the older US and EU studies⁶⁴. Thus our critique of

⁵⁹ Rogers, T., and Szamosszegi, A. (2007)

⁶⁰ Rogers, T., and Szamosszegi, A. (2010)

⁶¹ Rogers, T., and Szamosszegi, A. (2011)

⁶² Akker, I. Noll, R van der, Poort, J. Tewes F. (2010)

⁶³ Akker, I. Noll, R van der, Poort, J. Tewes F. (2010)

⁶⁴ The EU and Australian studies are slightly more similar to each other than to the US, as some industries which were included in the US study were excluded from the studies of EU by SEO, and of Australia by LE. This was done because the EU and Australia both adopt a more narrow approach to copyright exceptions involving a specific list of exceptions, rather than the more general US approach involving a general fair use exception. The industries excluded from the EU and Australia studies were deemed to have a weak association with copyright exceptions in a European and Australian context.

LE's conclusions and approach entails an equal if less direct criticism of these other CEI studies as well.

The LE study however warrants specific attention as it goes further, and is more transparent in its policy claims than the earlier studies. In particular the LE study goes on to measure what it claims would be the impact on CEI of broadening exceptions to copyright, and moving from the narrow list based approach to exceptions adopted in the EU and Australia to the more general US style fair use approach.

Having measured CEI using the US methodology, the LE study then suggests that broadening copyright exceptions by introducing the more general US approach might further increase real growth of CEI by 1% over 3 years⁶⁵. On this basis LE claims any copyright reform in Australia which broadened copyright exceptions and adopted the more general US approach would provide the potential for a \$600m annual economic boost in Australia.

This analysis then appears to have been relied upon by the ALRC in coming out in favour of adopting US style fair use exceptions in Australia.

Given the EU currently relies on the more narrow list based approach like Australia, then by implication the LE study must also suggest that a move to broaden copyright exceptions and adopt a general US fair use approach in the EU would provide an even greater economic boost to the EU and world economy.

In this regard at least the LE paper is transparent about the fact that it is not only seeking to use the CEI methodology developed in the US to justify the retention of exceptions to copyright, but is also seeking to secure the broadening of exceptions. This tends to be less explicit and more implied in the US and EU studies, and provides a further reason to focus more critically on this element of the Lateral Economics (LE) papers.

The Proposed US Style Exceptions reform

LE and the ALRC essentially propose Australia adopt US style exceptions to copyright. Under the US doctrine a use is "fair" considering the following tests:

1. the purpose and character of the use, including whether such use is of a commercial nature or is for non-profit educational purposes;
2. the nature of the copyrighted work;
3. the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
4. the effect of the use upon the potential market for or value of the copyrighted work.

The ALRC and LE implicitly then seem to claim that if these "flexible exceptions" were used to replace the specific list of exceptions in Australian law currently this would improve Australian law and LE estimate generate 600 million in welfare gains. The precise mechanism by which this would occur however is not specified as we shall see in greater detail later.

To be able to assess the economic effect of adopting US style fair use exceptions in any country, one needs to consider two questions. First in what way would the adoption of US style law change current

⁶⁵ from 2007 through 2010

law specifically? And second how would this specific change in turn generate economic effects? These are the critical questions. We turn to the second question in later sections.

On the first question, it is important to note that like the EU, Australian Law currently already includes exemptions. The impact of any new US style exemptions can therefore only be marginal, that is marginal to the effect already incorporated in current Australian law on exemptions. Many of the potential benefits of copyright exemptions are thus already incorporated in Australian Law. LE may thus fall foul of “double counting”.

Current Australian exemptions are focused around five highly specific "fair dealing" exceptions that are limited to five statutory purposes

- research or study,
- parody or satire,
- criticism or review,
- reporting on the news and
- use for the purposes of judicial proceedings or legal advice.

One can understand the public benefits perceived from these exemptions in Australian law. Specifically what additional areas not already covered by these Australian exemptions would be picked up as a result of the US law is not clear. Indeed according to table 1 on page 6 of the LE report “Exceptional Industries” the additional value LE claims for US style laws is said to come from industries that already benefit significantly from the above Australian legal exemptions, including Printing including recorded media (3%), Education and Training (12%), Professional, Scientific and Technical services (59%), Information Media and Telecommunications (25%), and Arts and Heritage (1%) It is difficult therefore to understand where the purported *additional* 600 million the LE report suggests would come from under a US style law, or why any additional areas would *not* otherwise have been covered by exceptions under Australian law *or otherwise agreed to by commercial parties?*

Compared to current Australian Law, LE’s US style tests will not only be marginal in their effect if any, they are also likely to be negative as they are clearly more vague, and are therefore not likely to add any value to current law, but rather instead only exacerbate uncertainty, imposing significant costs and risks on content rights holders, without being likely to confer any benefits compared to the existing regime. In the following sections we turn to analyse the likely economic costs and benefits of broadening the exceptions in Australian law as proposed by LE.

The Benefits of Exceptions

On the benefits of broadening exceptions LE claims that

“flexible copyright ‘exceptions’ and better crafted ‘safe harbours’ would make a substantial contribution to Australia’s economic growth and innovation ... and...would improve productivity growth. Over time the additional value added to the Australian economy is conservatively estimated to grow to around \$600 million annually. “Snapshot” page 2

From a theoretical point of view the critical flaw in the LE papers is their failure to adequately define and analyse “the problem” which it claims requires copyright reform. Moreover the LE papers fails to sufficiently define, or elaborate any specific details of the “solution” or copyright reform it proposes. This prevents analysis of the likely effects of the LE proposals. So we are left both without a well defined “problem”, or a well defined “solution”. It also undermines any claim that the reform would have significant beneficial effects.

In addition the LE papers do not specify the mechanisms by which its proposed law change would improve outcomes. The LE papers do little more than simply assume its ill defined reforms will add a percentage point to economic growth rate. They could just as easily take a percentage point off the growth rate - or of course more.

LE thus fails to provide a theoretical foundation for its alleged 600 million per annum increase in welfare from more flexible copyright and broader safe harbours. There are numerous flaws in their underlying economic analysis. We organise our discussion here under two main headings as follows:

- 1) Counterfactual Analysis - they misinterpret the appropriate Counterfactual to use in their analysis by using inappropriate
 - a) Copyright Analysis- they misinterpret Copyright as imposing limitations rather than creating markets and facilitating investment and exchange
 - b) Market Failure Analysis – they misrepresent the capacity of markets to internalise the 60 million benefits and overcome the problems they suggest
 - c) Cost and risk Analysis – they misinterpret the costs and risks to Intermediary firms and understate the ability of these firms to bear these costs and risks
 - d) Organisational Alternatives to exceptions – they fail to acknowledge and analyse better organisational Alternatives to exceptions are likely to emerge over time
- 2) The Relevance, Role and Impact of US Style Legal Exceptions – not only do they misrepresent the counterfactual they misrepresent the Relevance, Role and Impact of the exceptions under the US ‘Fair Use’ doctrine.

LE’s Mistaken Counterfactual

As noted LE misinterpret the appropriate Counterfactual to use in their analysis. This is due to four errors we discuss in this section including inappropriate a) Copyright Analysis b) Market Failure Analysis c) Cost and risk Analysis and d) Organisational Alternatives to exceptions.

LE’s Misrepresentation of Copyright

Basically the LE papers simply assume that copyright law imposes “*limitations*” on the production and or distribution of creative content, without any real analysis of the underlying incentives it creates for distribution and dissemination of creative content. Thus it assumes a problem rather than establishes it. As we have seen however copyright law quite simply does not do what the LE papers assumes. Rather economic theory suggests copyright does the opposite.

Copyright law does not limit distribution and dissemination, copyright law limits unauthorised distribution, or coercion - but not voluntary exchange and legal dissemination. Copyright does not prevent distribution, it only requires *permission* be obtained from the copyright holder. Copyright thereby creates the conditions under which greater investment and greater exchange can occur - it does not limit it. Indeed copyright facilitates exchange and dissemination, in the same way that a property right over a car enables and facilitates its sale by prohibiting its theft.

Copyright also does not create transaction costs- rather it reduces them - counter-intuitively perhaps. As copyright holders are relieved of the need to identify and contract with potential thieves, and instead have better incentives to market, distribute, license and sell their work for reward to legitimate buyers. While those who want to use it legitimately are in turn better able to identify copyright holders, and better able to rely on there being a strong and legitimate secondary market for the rights they acquire.

Rather than the market being undermined by theft and replaced by a black market, with strong copyright law it thrives and grows. In the absence of copyright law there would be free riding on

creative output, coercive exchange and not free exchange. So rather than limiting exchange and flexible arrangements, copyright permits it – by limiting theft, it facilitates exchange. Counter-intuitively perhaps by enabling exclusive use copyright encourages exchange and dissemination.

LE's Market Failure Analysis

The counterfactual in LE's analysis is not clearly defined. They purport to measure the gains from their proposed reform by adding a percentage point to the growth rate of various industries, but do not really identify the mechanism by which this occurs. What happens in the absence of the exceptions they promote? Why wouldn't the parties themselves have agreed to the kind of exceptions LE is promoting if they are so valuable? What is the problem definition? Why does the market fail?

Thus the paper begs the question as to the need for reform, if any, in the first place. The paper basically fails to make a coherent case for reform of the kind advocated. The reason is that it fails to identify *why wouldn't the relevant parties affected by copyright 'exceptions' and 'safe harbours' be able to agree to the "more flexible" and "better crafted" arrangements themselves - without need for reform.*

Why wouldn't the relevant parties agree in contracts or copyright licensing agreements to more flexible terms, and "better crafted" arrangements particularly if as alleged such terms would make a substantial contribution to Australia's economic growth and innovation with negligible downsides for rights holders? The estimated 600 million per annum from flexible copyright reform if it existed would surely be enough to pay for such flexible terms if there were negligible downsides for rights holders.

Thus while "more flexible" and "better crafted" copyright terms may have benefits, there is no clear case made there is a problem here to address. In all likelihood the estimated benefits of 600 million per annum from flexible arrangements that the LE papers cite, have already been captured and internalised.

The papers simply do not acknowledge that the system is working adequately already using automated processes by which content providers can grant permission for intermediaries to handle and thus copy their material. This is even though the paper itself notes

many intermediaries automate the process by which rights holders can opt out of the process.
Page 29 Excepting the future

and elsewhere acknowledges that

"The benefits of flexible exceptions and extension of safe harbour provisions lie not so much in additional gains in use, as much already takes place." Page 34

which implies that most of the gains from fair dealing are already realised. The paper nevertheless claims the benefits of "flexible" and "better crafted" regime benefits lie elsewhere

Rather it is in reducing risk and uncertainty, which can have a substantial impact on investment and innovation. Page 34

But as we shall see the risk and uncertainty associated with the ill defined exceptions the LE papers argue for are greater. Any risk facing investors and innovators from copyright held by others is also minimal to extent it can be overcome simply by agreement or securing permission to use. Thus the paper "excepting the future" claims that

Some of the most common internet activities, including search and indexing, caching and hosting, involve copying and communicating content, so these internet activities *risk infringing Australian copyright law unless exceptions apply or the use is otherwise permitted*.
Page 11 “Excepting the Future”

The paper does not focus on the last clause “*unless the use is ...otherwise permitted*” The fact is that copyright provides the basis for such permission to be granted. The paper instead tends to interpret copyright as imposing limitations. However not only does copyright *enable* permission for copying and communicating content on the internet to be given, there is a clear incentive for such permission to be given, as the mutual benefit from such an agreement is clear as the paper itself notes

“Search engines provide a service *both* to end users, enabling them to more easily locate the information they need, *and* to internet content publishers, by making the information they publish more easily discoverable, thereby bringing users to their content.” Page 11
“Excepting the Future”

Thus licensing arrangements with between web content owners, their web hosts and search engine owners seem eminently feasible and likely under copyright law – not limited by it assumed by the LE papers.

Thus in fact as the LE papers themselves cannot avoid noting, most often permission to appropriately cache or copy for the purposes of enabling search and contact, access and downloading is in fact granted – to quote:

*A great deal of online content is in the form of free-to-use website information and promotional material put online for the purposes of enabling search and contact, access and downloading by agencies and people motivated to do so as a part of the role or job page 33
Excepting the future*

LE’s argument regarding the risk and uncertainty associated with ill-defined exceptions was not accepted in the United Kingdom’s recent “Review of Intellectual Property and Growth” . The Hargreaves Report specifically commented that the economic benefits imputed to the availability of Fair Use in the United States have been over stated:

*“Does this mean, as is sometimes implied, that if only the UK could adopt Fair Use, Est London would quickly become a rival to Silicon Valley? The answer to this is certainly not. We were told repeatedly in our American interviews, that the success of high technology companies in Silicon Valley owes more to attitudes to business risk and investor culture, not to mention other complex issues of economic geography than it does to the shape of IP law”.*⁶⁶

The Costs, Risks and Capabilities of Intermediary Firms

The paper further asserts various costs and risks that face intermediaries which it does not establish are anything more than the ordinary cost and risk of doing business. Why should the law shift these costs and risks onto others, when the intermediaries are best placed to manage and minimise these risks, including legal compliance ?

⁶⁶ Para 5.17 “Digital Opportunity – A Review of Intellectual Property and Growth” – Professor Ian Hargreaves. 2011

Particularly when the main internet intermediary firms identified by the LE papers can clearly afford to pay for the rights they seek, and manage the risks they face. This is clear when one considers the list of firms that the LE papers seems to claim need to be saved from the inherent costs and risks of their business, and instead effectively be subsidised by content owners. The internet intermediaries listed by the LE papers all have enormous revenues, and enjoy above average profits or rates of return of capital, leading to high market capitalisations, which verifies their ability to pay the costs and bear the risks they incur in doing business,. The firms cited by LE include Apple (market capitalisation of 500 billion in 2011, on annual revenues 108 Billion); Google (market capitalisation 194 billion in 2011, on annual revenue 38 Billion); Facebook (IPO value of 60 Billion in 2011 on revenue of 3.7 billion) and Yahoo (market capitalisation of around \$19 billion in 2011, on revenue of around \$4.4 billion).

There is also a questionable error in the “economics” propounded in the LE papers, where it states for example that

the level of revenue a search service provider generates from advertising has nothing to do with the potential revenue of the rights holders or the incentive to produce content. Page 33

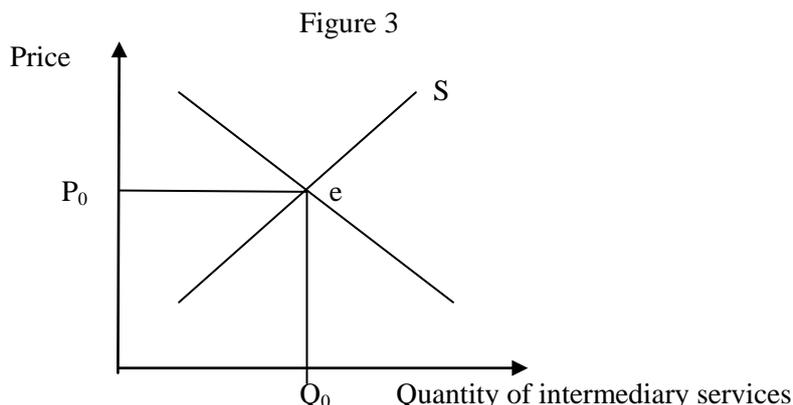
It can be justifiably argued that it is the benefits and potential value of delivered content on the internet, and therefore primarily the potential value and revenue of content holders, that generates much of the demand for internet intermediary services (IIS) . This counter argument is supported by the “OECD Internet Economy Outlook 2012” report which states:

Digital content is arguably the most important driver of consumer internet adoption”⁶⁷

If there was nothing of value in terms of content on the internet there would be notably less demand for internet intermediary services (IIS) such as search. The revenues of an IIS provider is undoubtedly derived from the value of delivered content on the internet. In economics therefore the demand for IIS is called *derived demand*. The demand for IIS is derived from the benefits of the transactions in content they make possible. IIS are inputs, or factors of production.

The costs of any IIS like any firm then include transaction costs, (such as the costs of negotiation with rights holders) but also too production costs and various risks. But this is no different from any other market. In a complete market the firms will then seek to minimise both their transaction and production costs and risks, with the cost of online search and advertising however depending on how it is organised. The standard economic analysis is presented in figure 3 below with the quantity of intermediary services measured on the horizontal axis and cost and price on the vertical. As shown by the upward sloping supply curve (S) the costs of intermediary services would typically increase as more is provided to the market. The value of intermediary services on the other hand would decline the more that was provided, generating a downward sloping demand curve as shown (D).The equilibrium then is where demand equals supply at e, with the price set at P₀ and quantity at Q₀.

⁶⁷ Page 158 - “OECD Internet Economy Outlook 2012”



As noted the costs of intermediaries indicated by the supply curve will include their production and transaction costs but also their risks including the risks of litigation. Thus of course the IIS need to negotiate with and pay rights holders for copying and indexing and caching their material, and of course this is costly - however the revenues or demand for their services pays for this, and it is no different than the situation facing firms in other markets. In other markets people pay for the rights they want to buy, and do not buy rights they cannot afford. Hence there is a limit to the intermediary services markets size determined by the equilibrium of the demand and supply curves. One is suffering from a free lunch fallacy if one believes a simple change of copyright law could magically reduce costs and enable the market to expand limitlessly.

Organisational Alternatives & Innovation

Organisational innovation involving the development of markets in digital rights by the firms and commercial players involved in these transactions will contribute more to growth than LE's proposed legal change, and is at least as important as technological innovation for thinking about how this market for intermediaries might evolve over time. Over time organisational arrangements are likely to become more efficient, as long as they are developed in the context of competitive markets, rather than by central legislative fiat. If a competitive market is allowed to develop one will see the emergence of efficient contractual and other rights-management arrangements. This includes the development of automated market based electronic payment systems. These organisational innovations will lead to lower transaction costs and the supply curve shifting out to the right, with the prices of intermediary services falling and output increasing.

The LE papers are unwilling to give this time, but instead are proposing ill defined exceptions and safe harbours. Thus rather than IIS paying for access rights in a competitive market the ADA paper seems to recommend legislative fiat to transfer rights. It is like a coalition or cartel of road or railroad builders seeking the right to acquire easements across private property without paying the market price. The effect of this subsidy will be to lead to IIS inefficiency higher prices and reduced supply of content in the short run, and long run.

The Relevance, Role and Impact of US Style Legal Exceptions

Finally the ADA paper cites US fair use doctrine as offering a better option than Australian fair dealing doctrine. Under the US doctrine a use is "fair" considering the following tests:

1. the purpose and character of the use, including whether such use is of a commercial nature or is for non-profit educational purposes;
2. the nature of the copyrighted work;

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3. the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and
4. the effect of the use upon the potential market for or value of the copyrighted work.

As already noted these tests however are vague, and exacerbate uncertainty, without being likely to confer much benefit, while imposing significant costs and risks on content rights holders. There is no hard evidence presented in the LE papers that these ‘exceptions’ have ever generated any benefits compared to what might have emerged through market negotiations with more strictly and strongly enforced copyright laws. Only speculation.

The original logic however for the fair use doctrine in the US was that it would allow it for limited purposes where value was less than the transaction costs involved in securing a copyright license. This is clear from the four conditions identified in the US law and cited above from the LE papers. All of the four tests can be understood to be designed to isolate situations where

- i) the commercial value that may be derived from use was small, and so
- ii) the costs of transacting might prevent the value being realised.

In what follows in this section we first review the LE’s transaction cost based analysis of the role of fair use doctrines. Second we use the LE’s own economic approach to illustrate why in fact the internet reduces the benefits of fair use, and justifies its limited use, rather than its expansion as claimed by LE. Third and finally we review several problems with LE’s attempts to measure transaction costs and justify the extension of fair use in the first place.

LE’s Transaction cost based analysis of the role of Fair-use doctrines

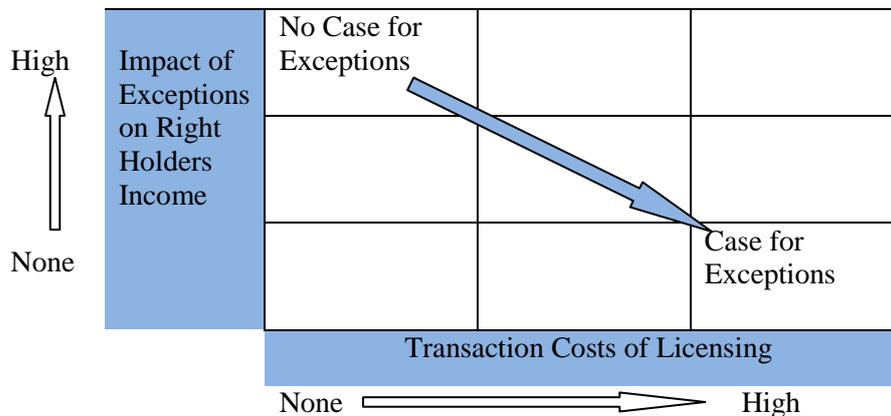
LE uses the highly stylised or simplified matrix presented in figure four below to justify fair use exemptions. LE claims the matrix below

“illustrates the economic framework PwC apply to considering individual copyright exceptions. It shows that exceptions will be beneficial *where transaction costs are high* and the impact on rights owners expected income is low or zero.”⁶⁸

Thus LE argues for the US style fair use exemptions to cover cases shown in the bottom right hand cell in the matrix or only *where transaction costs are high* and the impact on rights owners expected income is low or zero.

⁶⁸ pp52-54

Figure Four; LE Exceptions Framework



The above matrix however first does not provide a correct *economic framework* for the analysis of fair use, and second overstates the potential role for fair use. First the relevant measure of economic value that should be shown on the *vertical axis* of the LE matrix diagram above is not *the impact on owners' income* as shown in the matrix, but rather the value of copyright to both parties, or the *joint value* of the copyright, which inevitably will be more. Failure to account for the value of the copyright to the user as well as the owner will understate the value of the copyright and tend to push more observed copyright cases into the bottom right of the matrix, implying a broader scope for exceptions.

Second the economic test for fair use is not whether transaction costs are *high*, and the impact on value is low or zero - as implied in the above 2x2 matrix diagram as this implies an analysis of *absolute* values. So long as the joint value of copyright is positive, then rather than the absolute size of transaction costs being the central concern (high or low), it is the *relative* size of the transaction costs compared to transactional value. There should only be exceptions if transaction costs are *greater than* the joint value, not per se high. Thus the test for fair use is "when *the joint economic value* of any transaction relating to the copyright is positive, but *less than* the transactions costs required to complete the transaction". This implies a different kind of analysis to that presented in figure four above. Moreover contrary to figure four if the joint value of the copyright is zero or none, then there is no case for exceptions. Indeed a more general analysis would suggest that the joint economic value at stake must not only be positive, but exceed the costs of legal intervention to correct outcomes, otherwise legal reform is not justified.

Expanding the measure of value on the vertical axis, and applying the more precise economic test together imply a more narrow role for fair use than claimed by LE. They then claim that fair use is relevant where transaction costs are *high*, and the impact on rights owners expected income is low or zero - as implied in the above 2x2 matrix diagram - leads to incorrect conclusions and an excessive fair use doctrine. In particular fair use might not make sense when transaction costs are *high*, and the impact on rights owners expected income is low— as the *joint value* of the copyright is always likely to be higher than rights owners expected income and therefore more likely to be higher than the transaction costs.

The Impact of the Internet on Transaction costs and the Fair Use Doctrine

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Returning to the US fair use exemptions as noted earlier it is arguable that the ‘fair use’ doctrine in the US is becoming increasingly outdated with the introduction of the internet. As noted above the four tests embodied in the US law can be understood to be designed to isolate situations where

- i) the commercial value that may be derived from use was both small, and
- ii) less than the costs of transacting – which might prevent value being realised.

These two conditions seem more likely to hold before the advent of the internet and the digital age than they are likely to after. First of all the commercial value that may be derived from copying by the likes of Apple, Google, Facebook and Yahoo hardly seems small. Moreover or in any event, the internet has considerably reduced the transaction costs since the time the copyright fair use laws were drafted. The fair use doctrine was more relevant to a time when transaction costs of dealing with copyright owners was greater than they are today in the digital economy.

This case for reducing fair use with the advent of the internet and the digital age can moreover be simply demonstrated using the analysis presented by LE in figure four above.⁶⁹ Clearly if transaction costs fall with the advent of the internet, then one moves from the bottom right hand cell in figure four back towards the origin. In doing so therefore, under LE’s analysis, as transactions costs fall, and become lower there is less potential case for the exceptions identified in the bottom right hand cell in figure 4. If, as has been widely acclaimed, the internet has not only lowered transaction costs (which seems clear), but also arguably made copyright more valuable, then this implies an even more reduced role for fair use laws as there will have been a move towards the top left or northwest quadrant in figure 4 further away from where exceptions are justified in the bottom right hand cell.

The LE papers however fails to adequately acknowledge the impact of the internet in reducing transaction costs, and therefore in reducing the implied role of fair use exceptions. Instead LE basically misrepresents the nature and scale of the transaction costs relevant to the horizontal axis of the 2x2 matrix in figure 4 above. It is useful to explore this misrepresentation of transaction costs on the internet in more depth.

Internet Intermediaries Transaction costs

LE’s analysis of transaction costs on the internet in the copyright licensing chain⁷⁰ is replicated in table 1 below. LE notes this table is largely a direct copy of a table developed by PWC.⁷¹ LE however fails to specifically mention the caveat that the data in the table was developed by PWC as a “guesstimate” of the hypothetical (not actual) transactions costs that higher education institutions (HEI) might face if “collective licensing” under the Copyright Licensing Agency Ltd (CLA) in the UK were abolished and HEI had to directly contract with the author (an ‘atomised system’). It was thus not even intended as a model of the actual copyright licensing process for books in the UK, let alone as a model of copyright licensing on the internet between internet intermediaries and internet content publishers as implied by LE .

⁶⁹ “Excepting the Future” figure 3 on page 2. Based on the analysis of PwC (2011) An economic analysis of Copyright; secondary copyright and collective licensing p53

⁷⁰ Excepting Future page 28 based on an activity cost model developed by PWC

⁷¹ Table 10 PwC (2011) An economic analysis of Copyright; secondary copyright and collective licensing pp75- 76.

TABLE 1: PWC'S COPYRIGHT LICENSING ACTIVITIES TRANSACTION CHAIN

ACTOR	TRANSACTION	ACTIVITY	FREQUENCY	TIME	COST BASE
Rights holder	Responds to user's contact	Responds to e-mail/receives telephone call to arrange date and time for discussion	One-off	30 minutes	Average earnings
Rights holder	Negotiation with user	Negotiates the price and terms of the copyright licence with the user	Annual	3 hours	Average earnings
Rights holder	Invoices user	Draws up an invoice on a word processing application and sends to user over e-mail	Annual	30 minutes	Average earnings
Rights holder	Receives and processes payment	User sends payment through PayPal and Author logs on to receive funds and transfers into bank account	Annual	30 minutes	Average earnings
Intermediary User	Searches for the rights holder	Involves an in-depth search using different means if necessary including contacting publishing groups as well as searching for creator directly and contacting other agencies	One-off	1 hour	Average earnings
Intermediary User	Makes contact with the rights holder	Writes e-mail/undertakes a telephone call to arrange date and time for discussion	Annual	30 minutes	Average earnings
Intermediary User	Negotiation with rights holder	Negotiates the price and terms of the copyright licence with the rights holder	Annual	3 hours	Average earnings
Intermediary User	Undertakes payment	Receives invoice through e-mail and sends payment through PayPal	Annual	30 minutes	Average earnings

Source: Based on the analysis of PwC (2011) *An economic analysis of Copyright; secondary copyright and collective licensing* pp75- 76.

The time periods identified in column 5 of table 1 above are what PWC simply assumed HEI's in the UK would face for each activity required to obtain copyright licenses for books in the absence of collective licensing. LE then simply uses these to estimate the transaction costs for every copyright licensing transaction on the internet. Thus the sum total of the time required for each activity shown in column five of table 1 above is 9.5 hours per licensing transaction. LE then estimates costs using the ABS reported average weekly wages in Australia in November 2011 of \$1,034, which at 40 hours per week is around \$26 per hour. This gives the ADA's assumed total transaction cost of \$247 per copyright licensing transaction on the internet ($9.5 * \$26 = \247).

Relating this estimate back to the earlier 2x2 matrix above in figure 4 which LE used to justify fair use exceptions, LE's estimate of transaction costs of \$247 per licensing transaction on the internet does not in fact seem to qualify it as "high" in terms of the horizontal axis of the 2x2 matrix. Certainly

not high enough to justify the need for a fair use exemption. It seems hard to believe the joint value from copyright licensing a website for example might be less than \$247. Add to this the fact that \$247 is no doubt an overestimate of the transaction costs for reasons outlined below then this further undermines the case being made by LE . In any event presumably licensing, royalties and cost recovery, could all be triggered off traffic volumes as proxies of value, with minimum threshold traffic volumes being used to limit transaction cost concerns.

In fact however LE generally misrepresents the likely internet copyright licensing process in table 1, or the likely trading process involving internet intermediaries like Google and Yahoo. As a result the estimate of \$247 is likely to significantly overstate the transaction costs. Table 1 can be understood rather to model what an economist would call a simple and hypothetical “search market”, with very low or thin volumes, resembling the one-on-one trades made by senior school children, buying and selling second hand clothes. This is not what one might expect from commercial intermediaries on the internet. The description of the trading process in table 1 might thus be reasonably compared to the systems used for buying and selling agricultural commodities **before** the development of the Chicago Board of Trade (CBOT), established in 1848. But it cannot be compared with the process of trade which has for example since evolved and now exists in the CBOT, the world's oldest sophisticated futures and options exchange for commodities. Nor can it be compared with what is likely for copyright licensing on the internet in the 21st century. Indeed if fair use copyright exceptions were removed in the US, it is likely a well designed electronic market place or clearing house for digital rights would develop (perhaps like the CBOT) where automated transactions occur in split seconds, at market prices, based on reservation prices quoted by buyers and sellers for different transactions, with rights aggregation and arbitrage enabling the market to function well, and sophisticated futures and options exchanges facilitating the exchange of rights, which previously fell under an exception. Not the time intensive one-on-one laborious search processes outlined in table 1.

The Flawed Empirical Analysis

As outlined above the LE reports suffer from a number of critical theoretical flaws. These flaws then both contribute to, but are also exacerbated by, the paper's flawed empirical analysis. As noted the paper fails to formulate the so-called counterfactual or alternative for its empirical work. At best, the estimated benefits from flexible arrangements that the paper pulls out of a proverbial hat, have already been captured and internalised in current law or in the market. At worst the proposed legislative reforms that the paper often vaguely and tautologically defines as “better crafted exceptions” are instead likely to be outdated and have significant negative economic effects. LE's analysis in any event fails to adequately specify the nature of the reform it proposes nor adequately model or specify the mechanism by which the proposed law would affect outcomes.

Rather LE quite simply just assumes 600 million in welfare gains will result from adopting US style fair use laws. To quote the LE report this estimate is derived as follows

“We have simulated a scenario in which, as a result of introducing flexible exceptions real growth is just one-hundredth higher than it was from 2007 through 2010 *for those industries we have identified as relying on limitations and exceptions to copyright*. This increases aggregate annual industry value added through time so that after ten years the additional annual value added or welfare gain to the Australian economy would be \$593 million.”
 “Excepting the Future” Page 3

This of course quite simply doesn't prove anything. It is just playing with numbers. One could just as easily simulate a scenario in which there would be a welfare loss to the Australian economy of \$593 million after ten years. This would occur if one assumes introducing exceptions leads to *lower* (not

even negative) real growth in the industries the LE have identified. Perhaps there could be an even greater loss to the industries LE have identified, or to other industries such as the copyright industry? Or no effect at all.

Other empirical flaws are also numerous and deep rooted. First the paper suggests it is possible to identify copyright exceptions, and copyright limitations industries which form the basis for the simulations described above. LE suggests this can be done by coding industries as either “relying” on copyright exceptions and/or copyright limitations using the CEI methodology which LE adapted from the earlier US⁷² and EU studies⁷³. Quite simply however such a notion is meaningless –an irrelevant fiction - for reasons outlined below. As noted the LE papers however use this “fictional” limitations and exceptions industry as the basis for deriving its 593 million welfare gain from fair use exemptions.

Coding industries as “relying” on copyright exceptions and/or copyright limitations is however flawed for a number of reasons – as a result the copyright Exceptions industry is an irrelevant fiction for reasons we turn to now. In the description of their methodology LE claim that “*Exceptions or limitations are an input to a production process*”⁷⁴. This is however very misleading, misconceived and fundamentally undermines their analysis. Exceptions and limitations are not inputs to a production process. Copyright is the input - a complementary input in some industries. Exceptions may imply users do not need to pay or compensate copyright owners for using copyright as an input, but this does not make exceptions the input. The input is still the copyright, it is just free. Exceptions are thus not an input, copyrighted goods are the input. Any exceptions affect the price of an input (copyright) but exceptions are not an input themselves. This is the correct way to understand how exceptions affect production. LE’s misrepresentation or misconception of exceptions as an input undermines the basis of their simulation which “*focuses on industries dependent on limitations and exceptions to copyright*”. The concept of an exceptions or fair use industry however that could be identified on the basis that exceptions are an input to them in this way is meaningless – a fiction. Markets and industries are places where tradeable property rights (over tangible and intangible goods and services) are transacted - not “exceptions” and “limitations”.

Thus LE suggest the exceptions industry includes such industries as:

- Educational and research institutions;
- Internet search and web hosting providers and
- Producers of devices allowing individual copying of copyrighted content, like mp3 players.

The key point however is that these industries are not best understood to rely on exceptions as inputs, rather they are best understood to rely on copyrighted goods as complementary inputs. Students need access to both libraries and copyrighted books to study. Internet users need access to both search engines and copyright material (e.g. on websites) to gain access to information. Of course these industries may seek to benefit in the short run if a complementary input like copyright which is necessary to their production process is made free. Thus there may be an increase in demand for the now free input. The problem is that limiting the price that may be charged for copyright as an input in this way will have a negative impact on the supply of the copyrighted input over time, and this will in turn limit the output of the above industries in the long run. There are some standard economic methodologies relevant to analysing these short run and dynamic effects. This is not however how LE proceeds. Rather it simply renames the above industries as exception industries and assumes a positive increase in output from making copyright free to them under broadened exceptions.

⁷² Rogers, T., and Szamoszegi, A. (2007) (2010) (2011)

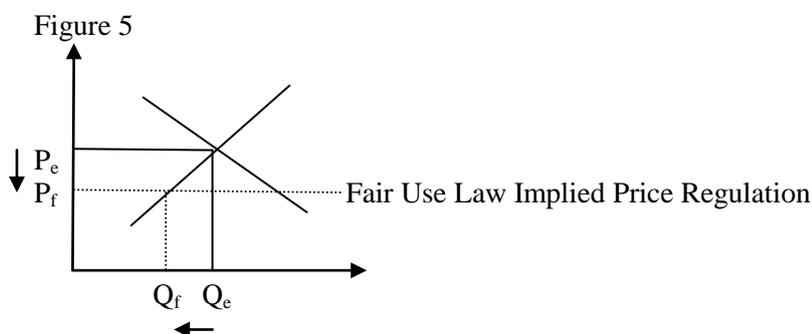
⁷³ Akker, I. Noll, R van der, Poort, J. Tewes F. (2010)

⁷⁴ Exceptional Industries p18

Moreover as noted earlier the concept of copyright “limitations” is similarly at best misleading. LE uses this concept however as the basis for defining limitations industries that depend on copyright “limitations”. For the purpose of developing economic analysis however, copyright is best understood to create a bundle of rights commonly associated with any property – not limitations. Classically defined the bundle of rights is said to include the right to use, the right to income, and the right to transfer or trade. These elements of any property right like copyright, expands opportunities, it does not limit them. It is well known that there tends to be no market when there are no property rights to trade. There is instead predominantly only “theft”, as why would people buy goods when they don’t have to pay for their use? Of course any right entails the obligation to respect the right. This is just a necessary corollary. A property right thus in classical law entails an obligation (e.g. not to steal or to respect the right) - an obligation that is backed by a sanction. This forms the basis for market trading, rather than theft. It prevents what Posner calls the possibility of bypass of the market.⁷⁵ But in economics one analyses market trades in rights, not trade in obligations or limitations. Thus economic analysis of markets is the analysis of the demand and supply of rights not the inverse, i.e. not the demand and supply of obligations or “limitations”.

Thus all the markets or industries identified in the LE reports *rely on copyright* - full stop - not on limitations or exceptions to copyright. It is redundant, unnecessary and misleading to reference “limitations or exceptions” in this context.

By definition then, a copyright exception which denies the owner of copyright the right to charge for use will of necessity reduce market trade in such rights. Under a fair use law any consumer that does not want to pay the price charged may simply claim fair use, and take the copyright for free, and will do so to avoid the market price, if the risk of litigation by the copyright owner entails lower expected costs. By definition then a fair use law restricts the charge that may be levied by a copyright owner. This market price control effect of any fair use law can be shown using the standard economic analysis of price regulation. This is shown in Figure 5 below



In the absence of fair use laws the market is in equilibrium where the demand curve intersects the supply curve at Price P_e , and output Q_e . A fair use law will limit the price below the market clearing level P_e , at the fair use law price level P_f . As a result output will fall from the market determined level Q_e at the intersection of demand and supply to the new output determined by the supply curve at Q_f .

Given markets rely on property rights; exceptions to copyright owner’s property rights will then see a reduction or elimination of supply. The direct effect of expanding exceptions then will be to undermine or reduce the tradeable markets size, and the value of exchanges in copyright affected by fair use– as shown in figure 5 from $(P_e * Q_e)$ to $(P_f * Q_f)$ It will directly eliminate the market currently involved in the granting of use, now covered by the exception. Markets depend on rights, and exceptions undermine them. Exceptions might also drive up the price of non exempt copyright

⁷⁵ Posner, Richard. "An Economic Theory of the Criminal Law." *Columbia Law Review*, vol. 85, no. 6 (October 1985).

material to compensate for this loss of revenue, which with elastic demand, would further shrink the overall size of the market relying on copyright.

In any event as outlined earlier the greatest problem with LE's empirical analysis of the impact of fair use laws is that they quite simply ignore the dynamic impact of the fair use law. The immediate loss of revenue and sales in the copyright market from a fair use law outlined above will reduce investment in copyright over time. This basic premise is supported by ADA Director, Kimberlee Weatherall.⁷⁶

The short run or immediate loss of revenue and sales in the copyright market from the fair use law will have a negative feedback effect, by reducing investment it will further reduce the overall size of the copyright market over time. Lower investment owing to lower expected revenues, will reduce future copyright output. This in turn will limit the growth of the internet intermediary services market.

The paper does not explain how these direct negative static and dynamic effects on copyright market value will be offset by any positive effects.

Second the LE papers suggest that the copyright exceptions industries encompasses and is larger than the copyright limitations industries. Again this is a misleading idea. To the extent the LE reference to a copyright limitations industries is a reference to copyrighted material, any fair use right to copyright material as defined by the US law will always be worth less the original copyrighted materials. This in large part is because the US law intentionally limits its value by seeking to limit both

- i) the amount and substantiality of the fair use portion in relation to the copyrighted work as a whole; and
- ii) the effect of the use upon the potential market for or value of the copyrighted work.

If the copyright exceptions industries encompasses and is larger than the copyright limitations industries then it's not fair use!

Third it then assumes rather than derives, and applies an arbitrary positive percentage (1%) as a measure of the likely positive effect of copyright reform on the combined size of the industries it has measured. On the last point, as we have seen, it is more likely that the papers proposed copyright reform would led to a large negative percentage fall in the output of the industries analysed.

Legal Flaws

The LE paper makes an analogy with air and space law to bolster its case for its proposed copyright law reform in Australia. The LE papers suggests the ability of copyright owners to prevent copying of their works on the internet is similar to the ability of land owners to prevent air travel above their land with the advent of aviation. LE thus claim:

This situation is dysfunctional. It is not unlike the state of air-space law at the point at which the development of aviation had rendered it obsolete. In the early twentieth century, following Roman Law, land owners held exclusive rights "up to Heaven and down to Hell" giving them impracticable veto powers over air routes.⁷⁷

⁷⁶ Page 11 of "Fair Use, Fair Dealing: The Copyright Exception Review & the Future of Copyright Exceptions in Australia" 2005 – Kimberlee Weatherall – states that "...a full, free exception to copyright for private copying...would not provide any remuneration to the creators of copyright works and might lead to less production of copyright works"

⁷⁷ Excepting the Future page 4

This analogy suggests that copyright holders are like the owners of land who stood to hinder the development of air travel. LE thus cite the example of a chicken farmer who sued the US Military for the impact their low-flying bombers had had on his chickens in 1942⁷⁸. LE note that ultimately, the US Supreme Court upheld the farmer's complaint, agreeing that he did indeed have a right to the air above his land, and awarded him compensation. However in doing so as LE notes the US Supreme Court the Court drew an important distinction between 'usable' and 'navigable' airspace, declaring that navigable airspace was a "public highway" for air travel and not under the exclusive control of landowners. LE's suggestion is that a similar analysis, and use of exemptions should apply to copyright and the internet.

The analogy however is simply not relevant, as land owners have no capacity to create or increase the amount of air space above their land. Air space is clearly in fixed supply it is scarce and it is not being made anymore. By comparison copyright holders create their creative works which would not exist without copyright. Allocating copyrights to creators serves to bring forth more supply and reduce scarcity. Hence the logic for having it. Overriding the exclusive rights or limiting copyright will only reduce the supply of creative goods, an effect which is undesirable, but which is not present in air and space law - making air and space law not comparable. Air and space law became limited to protecting productive activity of landowners such as chicken farming from interference from the air.

The LE papers further draw an analogy in Box 5 on page 31 between copyright holders and the robber barons who set up toll stations on the Rhine during the middle ages which deterred the use of the river. Once again the LE papers are trying to focus criticisms of copyright on the way it enables owners to exclude, deny access, or veto the right of others to copy their creative work and drawing an analogy to toll stations on the Rhine noting that

during the Great Interregnum of 1250-1273, when there was no Roman Emperor and the grip of the Roman Empire loosened, the number of tolling stations exploded. So-called 'Robber Barons' erected their own castles and towers in between the officially-sanctioned stations, and began collecting their own, often arbitrary, tolls. The effect on trade was crippling.⁷⁹

LE however conveniently ignores the fact that the Rhine in the middle ages constituted what economists call a natural monopoly. The Rhine enjoyed a natural monopoly as a trade route in its geographic area in the middle ages as it offered such a relatively efficient means of commercial transportation at the time. The toll stations of the robber barons were therefore exploiting the underlying monopoly power that attached to the Rhine. It was the unregulated abuse of monopoly power by the toll stations, based on their ability to expropriate monopoly rents associated with the Rhine that caused the adverse effect on trade.

By comparison any copyright holder typically faces stiff competition from close substitutes and typically enjoys little or no monopoly power.⁸⁰ Copyright law instead supports product differentiation and competition, not the abuse of monopoly power as in the Rhine Toll Stations example. Indeed Professor Christopher Woo of University of Pennsylvania has thus argued that strengthening critical aspects of copyright benefits both creators and consumers because it generates product differentiation, promotes competition, and nurtures incentives to create:

The "idea-expression dichotomy" limits copyright protection to the form of expression without offering any protection for the underlying ideas expressed in the work. This basic

⁷⁸ Excepting the Future page 9

⁷⁹ Excepting the Future page 31

⁸⁰ Copyright holders are moreover subject to competition law in Australia

principle effectively guarantees that any competitor willing to undertake the same fixed-cost investment as the original author remains free to create alternative works with the same functional characteristics as any existing work. ... [T]he differentiated products approach to copyright largely renders moot the objection that strengthening copyright protection and facilitating price discrimination raise distributional concerns.⁸¹

In short, by incentivizing creators to enter the market and produce products with the same functional characteristics as the market leaders, copyright increases competition and limits the capacity of any copyright owner to engage in excessive rent-seeking. As Professor Woo concludes, the fact that copyright promotes product differentiation, ensures that wide scale access to copyrighted works may be promoted by the “strengthening of copyright protection”:

[T]hese insights falsify the claim that simultaneous promotion of access and incentives is impossible and that copyright necessarily devolves into a trade-off between the two. The supposed tension between access and incentives turns out to be nothing more than an artefact of the traditional approach’s reliance on monopoly and oligopoly models that fail to account for entry. The differentiated products approach reveals that encouraging entry can promote both types of efficiency simultaneously.⁸²

The LE papers however also link the toll station analogy and its critique of copyright to the anti commons idea of Michael Heller⁸³ Thus LE argue that

The current architecture of copyright establishes an *anti-commons* or property rights thicket which cannot be negotiated without exorbitant cost.⁸⁴

In doing this however LE misapplies Heller’s original anti-commons insight. Heller developed the insight originally to analyse the phenomenon in Russia in the post communist era, where there were a large number of retail stores left empty while businesses set up on the street. Thus in 1998 Heller asked “Why are many storefronts in Moscow empty, while street kiosks in front are full of goods?” The reason he found was that

Transition regimes ...often failed to endow any individual with a bundle of rights that represents *full ownership* of storefronts or other scarce resources... In a typical Moscow storefront, one owner may be endowed initially with the right to sell, another to receive sale revenue, and still others to lease, receive lease revenue, occupy, and determine use. Each owner can block the others from using the space as a storefront. No one can set up shop without collecting the consent of all of the other owners.⁸⁵

This analysis however does not apply to copyright owners. Copyright owners do hold the full bundle of ownership rights over their creative works, and they have clear incentives to license or sell access to their copyright - not leave it idle and deny access to it in a competitive market. LE’s attempt to apply anti commons analysis therefore ignores the key fact that copyright provides the basis and incentive to do the opposite to the toll road barons - namely to contract and sell access, or transfer the right to others – not restrict access. The benefits of intellectual property rights like copyright include

⁸¹ Christopher Woo, “Copyright and Product Differentiation”, 79 *N.Y.U. Law Review* 212 at p.250 (April 2004).

⁸² *Id.*, p. 251.

⁸³ Heller 1998 The Tragedy of the Anti Commons Property in Transition from Marx to Markets 111 Harvard Law Review

⁸⁴ Excepting the Future page 30

⁸⁵ Heller 1998 The Tragedy of the Anti Commons Property in Transition from Marx to Markets 111 Harvard Law Review p 623

the extraction of private value from creativity and innovation, which provides the incentive to not only disclose and encourage the use and dissemination of the creative good, but also to encourage follow-on creativity and innovation in the future. Copyright holders have the incentive to maximise the potential value of their copyright through encouraging collaboration and follow-on innovation.⁸⁶ Through coordination of the efforts of subsequent, otherwise competing, users of their copyright work, the copyright holder can increase the efficiency of the exploitation of their copyright and therefore the potential returns they enjoy.⁸⁷ The potential to achieve greater returns by facilitating use, collaboration, and follow-on creativity and innovation create incentives to initially create the copyright works; thus the potential reward from obtaining copyright depended in part on a perceived ability to best coordinate follow-on use, collaboration, and innovation.

Rather than air and space law and toll stations on the Rhine, there is however a more apposite analogy in law reform that suggests an alternative and better perspective for the future of copyright reform. A more appropriate analogy is between the history and evolution of the regulation of traditional physical highways, and the current regulation and likely future regulation of the so-called “information highway”. Physical highways, unlike the airways, require investment to create, and maintenance expenditure to maintain quality. They are also more comparable to the information highway.

The law on physical highways has moreover moved over a period of years, from initially providing immunity (or exceptions) from liability for physical highway owners and providers, to requiring that highway owners and providers meet reasonable standards of care, where they were able to prevent harm to highway users. This move brought highway law in line with modern developments in the general law of negligence, and legal principle in other areas, and economic efficiency.

In the modern digital economy, it is now also time to similarly move away from a world where owners and providers of the “information highway” or intermediaries currently have been granted legislative immunities or exceptions from liability to copyright holders and others. We need to normalise regulation of the internet and move to a world where owners and providers of the “information highway” or intermediaries are instead required to meet *reasonable standards of care*, where they are able to prevent harm to consumers and copyright holders. The basis for determining the *reasonable standards of care* should be efficiency which would discourage theft and encourage market based transactions.

Thus rather than as proposed by LE moving to grant owners and providers of the “information highway” or intermediaries more exceptions from the law, there is a strong case to do the opposite and strengthen their obligations, bringing them in line with those facing everyone else, and as a corollary strengthen and normalise the rights of copyright holders. This would provide the basis for the development of aggregators, and market type clearing houses for digital rights

Conclusion Summary & Overview

Contrary to the ALRC discussion paper and various Copyright exceptions reports, economic theory suggests that any weakening in the enforcement of copyright, through introduction of ill defined

⁸⁶ See F. Scott Kieff, Co-ordination Property and Intellectual Property: An Unconventional Approach to Anticompetitive Effects and Downstream Access 2006 Emory Law Journal Vol. 56 p327 at 405; F. Scott Kieff, On Coordinating Transactions in Information: A Response to Smith’s Delineating Entitlements in Information, 117 Yale L.J. Pocket Part 101 (2007), <http://thepocketpart.org/2007/10/10/kieff.html>, at 102 Edmund W. Kitch, The Nature and Function of the Patent System, 20 J L & Econ 265 (1977), John F Duffy, Rethinking the Prospect Theory of Patents, 71 Chi U L Rev 439 (2004).

⁸⁷ Kieff, *Coordination*, *ibid* at 415.

exceptions would have significant *negative* economic costs, and little or no benefit. Economic theory suggests that the advent and development of the digital economy far from expanding the role of copyright exceptions including fair use should trigger the reduction in the scope and extent of such exceptions. Finally in the new environment economic theory suggests that *if* there are flexible copyright ‘exceptions’ that would make a substantial contribution to Australia’s economic growth and innovation, with negligible downsides for rights holders, then in all likelihood they would have *already been agreed to in the market or may be expected to emerge over time through automated market based electronic payment systems.*

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APPENDIX I: Summary of Recent Research on the Effects of Copyright Exceptions

The Computer & Communications Industry Association (CCIA) issued the first of the copyright exceptions or “fair use” studies which departed from the WIPO approach to measuring Copyright Industries (CRI). The report was prepared for CCIA by Thomas Rogers and Andrew Szamosszegi of Capital Trade Inc (CT) was published for the US in 2007⁸⁸ and purported to measure the economic size of US copyright exceptions industries (CEI) that were deemed to rely on exceptions or limitations to copyright law including fair use during the period 2002-2006. This study in the US has since been updated twice. The first in 2010 covered 2007⁸⁹, and the second⁹⁰ in 2011 covered the period 2008 and 2009.

In 2010 the CCIA also commissioned a study to measure CEI in the European Union (EU) The report was prepared by Akker et al of SEO Economic Research⁹¹ which adapted and applied the same approach used in the US. The problem that SEO had to address however was that the EU does not have a US style general fair use exception. Rather the EU adopts a specific list of exceptions to copyright. SEO therefore had to excluded from its EU study some industries which were in the US study, as their association with limitations and exceptions to copyright was deemed weak in a European context. Thus Directive 2001/29/EC of the European Parliament and of the Council, dated 22 May 2001, presents in Article 5 a list of limitations and exceptions to copyright that are permitted at the EU member State or national level. This list approach of listing of permitted exemptions is unlike the US style exemption approach which is more general. Dealing with 27 EU Member States, each with their own national laws SEO adopted the following procedure to select industries: (a) the list of industries in Rogers and Szamosszegi (2007) was taken as a starting point; (b) The industry codes from step (a) were converted to codes used by Eurostat; (c) Industries from step (b) for which the correspondence with step (a) was deemed poor have been eliminated and (d) Industries from step (c) for which the association with limitations and exceptions to copyright was deemed weak in a European context were eliminated. Data was collected from Eurostat, for 2003 and 2007. In the end they included 35 industries in their measures (in manufacturing, publishing, trade, services, education and the creative industries) which they claimed either use exceptions or limitations as an input in their production process or derive their demand from exceptions or limitations.

Recently in September 2012 the Australian Digital Alliance (ADA) commissioned and released two reports written by Lateral Economics (LE) that adapted and applied the same methodology used in the US and EU to Australia. The problem that the LE (like SEO) was that Australia did not have a US style fair use exceptions. The industries included in LE study is close to that of the previous US and European studies using the same approach, a few differences. Thus the US studies of fair use industries include education, securities and other financial investment and insurance whereas the European studies of industries relying on limitations and exceptions include public education but not private education or government The coverage in the LE study includes both private and public education but does not include finance and insurance, retail and wholesale trade.

The differences in coverage are clarified in the table below.

⁸⁸ Rogers, T., and Szamosszegi, A. (2007)

⁸⁹ Rogers, T., and Szamosszegi, A. (2010)

⁹⁰ Rogers, T., and Szamosszegi, A. (2011)

⁹¹ Akker, I. Noll, R van der, Poort, J. Tewes F. (2010)

Industry	US	EU	Australia
Securities and other financial investment and insurance	√		
Public education	√	√	√
Private education	√		√
Retail and wholesale trade	√	√	

There is considerable overlap between the industries included in the WIPO copyright-based approach and the copyright-exceptions approach adopted in the US EU and Australian studies. The principal difference is the inclusion of a somewhat wider set of industries in the copyright-exceptions approach (e.g. education and some professional and technical services). As a result, the economic contribution estimated using the copyright-exceptions approach will typically be somewhat larger than the copyright industries identified using the widely accepted WIPO method. It is thus quite simply an artefact of coding more industries as CEI than CRI.

Finally a recent study by Ghafele and Gibert (2012) further tries to assess the impact of the introduction of US style Fair use law in Singapore in 2005. For this Ghafele and Gibert focus analysis on three industry groups classified as

- 1- copyright industries,
- 2- private copying technologies, and
- 3- a “control group” of other industries

The Ghafele and Gibert paper notes that the Time-series data on industry value added is aggregated using Singapore’s 2010 SSIC classification system.

- Table 1. identifies the SSIC aggregated for the Private copying technology industry group,
- Table 2. identifies the SSIC aggregated for the Copyright industry group and
- Table 3. identifies the SSIC aggregated for the Control group

The first one, “Copyright industries” are defined as in the WIPO approach as those industries whose primary source of revenue are the reproduction, distribution, publication and sale of copyrighted materials, including film, audio and text. The second industry, private copying is obtained however by arbitrarily recoding industries from Singapore’s Standard Industrial Classification (SSIC) depending on whether they manufacture and sell technologies – and related electronic components, infrastructure, and services - that enable consumers to record, store, and transmit copyrighted material for their own personal use. Clearly these industries however have a much wider set of other primary and ancillary uses and purposes, and classifying them in this way appears arbitrary. The third “control group” industry includes those not included in the other two categories. The “control groups” growth rate for example is then used to evaluate whether the first two industries grew relatively faster or slower than the control group after the introduction of the Fair use law. If they grew faster than the control group then they are assumed to have benefited by the new law. If they grow slower than the control group they are assumed to have been harmed by the new law.

As noted in the body of our report Ghafele and Gibert show that the growth rate of the first industry group or what they call the copyright industry, slows after the introduction of a fair use law, suggesting it has been harmed by the law. This seems a reasonably sound result, and consistent with theory to the extent the copyright value add they measured relates predominantly to domestic sales

and not exports, which is something I have not been able to verify at this stage but seems reasonably likely. Clearly Singapore's fair use law would affect domestic consumption of copyright. It would not however affect demand in foreign countries to which Singapore's copyright exports are destined. Singapore's fair use law does not affect demand for copyright goods in foreign countries only demand in Singapore.

Ghafele and Gibert (G&) however also claim that their so-called "private copying group" has significantly improved growth after the introduction of the fair use Law and implying it has benefited from the law. For numerous reasons we do not think this is a reliable result or conclusion to draw at this stage. There are numerous problems with this analysis as well as data issues we outline below that prevent us being able to rely on it at all.

First of all the private copying group identified by G& G is quite simply a "fiction" created by combining certain industries with multiple primary and ancillary uses and purposes on the tenuous basis that they can be used in copying. The private copying group thus includes manufacturers of computers, data processing and peripheral equipment, disk media, storage subsystems, audio and video combination equipment as well as the wholesale and retail sale of computers, peripheral units and recording equipment. These technologies, including devices such as digital video recorders (DVRs), TiVO boxes, personal computers and mp3 players, facilitate the space- and time-shifting of copyrighted works by the public.

Ghafele and Gibert assume that fair use policy, by protecting these copying activities, is thus likely to have an important impact on these industries. The key problem with the G&G study is their flawed analysis of the private copying technology group. Their Private copying technology industry group includes the following 2010 Industry SSIC identified in Table 1 on pages 17-18 of their report

SSIC 26201 Manufacture of computers and data processing equipment except computer peripheral

SSIC 26202/26203/20204/26205/26209 covering

Manufacture of disk drives (including CD-ROM drives, DVD-ROM drives, optical drives, flash drives, tape drives, solid state drives)

Manufacture of storage subsystems

Manufacture of printers

Manufacture of smart cards and related products (eg smart card readers)

Manufacture of computers and peripheral equipment nec

SSIC 26401/26402/26403/26409 covering:

Manufacture of television sets and sub-assemblies (including television chassis) – included due to grouping⁷

Manufacture of microphones, loudspeakers and amplifiers - included due to grouping⁸

Manufacture of audio and video combination equipment (eg radios, television sets, record players and tape recorders/players combined with each other and with clocks, VCD and DVD recorders/players)

Manufacture of consumer audio and video equipment

SSIC 18200 /26801/26802 covering

Reproduction of recorded media (including reproduction of phonograph records, recorded magnetic tapes, compact discs and non-customised software)

Manufacture of disk media

Manufacture of blank magnetic tapes, diskettes, Bluray technology discs, CDs, DVDs and VCDs

SSIC 46436 Wholesale of audio and video equipment except electrical and electronic components (eg radio and television sets, sound reproducing and recording equipment)

SSIC 4651 Wholesale of Computers, Computer Peripheral Equipment and Software

SSIC 4741 Retail Sale of Computers, Peripheral Units, Software and Telecommunications Equipment in Specialised Stores

SSIC 4742 Retail sale of audio and video equipment in specialized stores

In Annex 1 they comment that "all data on manufacturing industries was aggregated by the statistical services of the Singapore Economic Development Board" and that "All data on service industries was aggregated by the Business Statistics Department of the Department of Statistics, Singapore".

I obtained permission from the Singapore Department of Statistics to directly access the data given to the authors for their study.

It was clear from this data that a key flaw in their study is that they included in their value add measure for their private copying industry that part of it which was exported. In 2005 it is likely that over 95% of the value add of G&G private copying industry was exported. The value-added of all Singapore electronics manufacturing industries for example was \$79 billion, of which \$75.3 billion was exported.⁹² Clearly Singapore's fair use laws can not affect demand conditions in the countries to which Singapore exports. The sudden growth in value add of Singapore's private copying technology found by Ghafele and Gibert (G&G) after 2005 was therefore due to changes in demand conditions in the countries to which Singapore exported discussed further below. It was not in any way likely to be due to changes in Singapore's fair use laws, which only affect domestic demand for private copying technology not demand in export countries.

The key problem with their claim that the private copying industry has benefited from the fair use law is that there are significant other reasons explaining the boom in their the Private copying technology industry group which are not related to the 2005 Fair use amendment to Singapore Copyright law. For example a quick analysis of Ghafele and Gibert's data on the private copying group shows the boom growth of the "fictional" Private copying technology industry group is in large part due to the growth of computers most of which were exported to other jurisdictions, or purchased by tourists, implying the growth in value add can hardly be linked solely, nor attributed if at all to Singapore fair use copyright reform.

Thus 66% of the growth of the fictional private copying group post 2005 is accounted for by growth in computers. This 66% breaks down as follows

- 37% of the 66% = SSIC code 26201 = Manufacture of computers and data processing equipment except computer peripheral
- 29% of the 66% = SSIC 4651 and 4741 = Wholesale and Retail of Computers, Computer Peripheral Equipment and Software

The other major contributor to growth of the "fictional" Private copying technology industry group is the 33% which is accounted for by three SSIC categories which they have combined, - these are

- 18200 Reproduction of recorded media (including reproduction of phonograph records, recorded magnetic tapes, compact discs and non-customised software)
- 26801/Manufacture of disk media

⁹² I am grateful to Professor Ivan Png, at the NUS Business School, National University of Singapore and President, Society for Empirical Research in Copyright Issues for this insight and statistic on export sales.

- 26802/Manufacture of blank magnetic tapes, diskettes, Bluray technology discs, CDs, DVDs and VCDs

The boom in the growth of industries classified in the private copying group in Singapore would again be mainly due to export demand, mostly in turn driven by recent product innovation that are specific to key industries in the private copying segment, rather than Singapore's fair use law. In particular one would need to consider the industry specific effects on increased sales of product innovations related to MP3 players (like the iPod), to smart phones (like iPhone), and tablets (like iPad).