E-BOOKS, P-BOOKS, AND THE DURAPOLIST PROBLEM

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A. INTRODUCTION

Last year, antitrust regulators in the US and the EU challenged the e-book distribution agreements between Apple and leading book publishers. At the heart of these challenges was the publishers' concern about Amazon's discounted pricing for e-books. The lawsuits have alleged that the publishers colluded to move away from the wholesale pricing model, which allowed Amazon to buy e-books and resell them at whatever price it chose, and institute an "agency model" instead, under which the publishers set the retail price and the retailer gets a commission. By now, all of the publishers have settled with the regulators and agreed to discontinue the agency model. Apple still contests the allegation, but the focus on the litigation is whether Apple was the ringleader of the publishers' cartel or an innocent participant. The fact that the publishers might have colluded has not been really contested. Meanwhile, prices of e-books, which increased when the agency model was adopted, have plummeted since the beginning of the antitrust intervention (Greenfield 2013). Although this case may soon be over, it still opens a window into some fascinating aspects of the book trade, its peculiar economics, and the laws that regulate it.

In particular, it appears that arrangements among publishers to maintain high *retail* prices—or attempts to create such arrangements—is not a novel phenomenon limited to e-books, but one that has a long and persistent pedigree, both in North America and in Europe. However, the reason why publishers might be interested in setting high retail prices, and why they seek to collude among themselves and with booksellers to maintain them, is not at all obvious. That is, it may be easy to explain why publishers might be interested in reducing competition among themselves by fixing the *wholesale* prices of books, and it may be easy to explain why booksellers might be interested in reducing competition among themselves by fixing the retail prices of books. But standard economic theories of horizontal and vertical price fixing do not easily explain the interest of *wholesalers* collectively to set high *retail* prices.

This paper offers an explanation to this phenomenon. I show how the Coase Conjecture—the observation that a monopolist seller of a durable good may be forced to price at the competitive level—may explain many historic and contemporary practices in the book trade. I show how those practices have allowed publishers credibly to commit to monopoly prices, over and above what publishers could charge by virtue of their copyrights. I also discuss how the emergence of ebooks might change that.

B. History repeats

The latest skirmish about the pricing of e-books has had a long genesis. This was not the first time that discounting resellers displease book publishers have been unhappy about discounting reseller, and not the first time that they had colluded to prevent that. A century ago, an industry-wide two-level cartel of book publishers and booksellers was formed in order to prevent the discounting of books. The arrangement was designed to counter the discounting practices of the retail innovators of that time, such as Macy's, and culminated in two decisions of the US Supreme Court: in *Bobbs-Merrill v. Straus* (1908), the Court established the first-sale doctrine and limited the ability of publisher to fix the retail price of books, and in *Straus v. American Publishers' Ass'n* (1913) the Court held that the agreements would violate the antitrust laws.

At the beginning of the 20th century, Macy's was not quite what Macy's is today. At that time, Macy's was a retail innovator and a discounter—akin to Costco, or Walmart, in the brick-and-mortar retail, as well as to Amazon online. When Macy's opened its grand store at the corner of 6th Ave and 14th Street, the NY Times described the novelty in the following words:

> The special attraction of the house consists in the universality of the stock, almost every article of dress and household furniture being for sale there, and at the most reasonable prices. A lady can do all her shopping, however extensive it may be, and however long it may occupy her, without even leaving to seek refreshment elsewhere, for there is a special department devoted to this purpose (NY Times, Apr 4, 1878).

Macy's began selling books in 1869. Like other department stores, Macy's found books attractive to carry because selling them helped "adding an aura of seriousness and respectability to the store and attracting the kind of customer who had money to spend" (Thompson 2010, p.26). Macy's, who vowed to sell everything at a lower price, discounted the price of books too, and this did not bode well with publishers (Hower 1943, p.353).

Bobbs-Merrill was the publisher of a novel titled *The Castaway* by Hallie Ermine Rives.[1] A notice printed on the book prohibited anyone from reselling it for less than $1, and threatened to treat any violation of this condition as copyright infringement. Macy's purchased copies of the book from a distributor and sold them for ¢89 each. Bobbs-Merrill sued for copyright infringement. The Supreme Court dismissed the action, relying on the principle of exhaustion borrowed from earlier patent cases, as well as on the general policy against restraints on alienation.

The Court's decision in *Bobbs-Merrill* reads as if it involved a dispute between a single publisher, interested in maintaining the retail price of a book, and a single recalcitrant retailer. The Court's decision ends with a remark explaining that in light of the Court's conclusion dismissing the copyright infringement claim, "it [is] unnecessary to discuss other questions noticed in the opinion in the circuit court of appeals, or to examine into the validity of the publisher's agreements, alleged to be in violation of the acts to restrain combinations creating a monopoly or directly tending to the restraint of

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[1] HALLIE ERMINE RIVES, THE CASTAWAY (The Bobbs-Merrill Company 1904).

[2] Except on special order, through libraries, or as second-hand. The first option may not be available at a reasonable price and within reasonable time, the second may be highly inconvenient, and the third may be highly unreliable, or inconvenient, or costly.

[3] This is similar to the example of an artist who commits to limited production of a lithograph by

trade."

This single allusion to antitrust, opens the door to a much richer antitrust history discussed in the lower courts' decision, and reveals remarkable similarities to the current e-books controversy. It turns out that the dispute in *Bobbs-Merrill* did not involve a single publisher desiring to exercise control over the distribution system of its books. Rather, the case concerned an industry-wide cartel established in 1900, comprising the majority of book publishers and booksellers who conspired to "correct some of the evils connected with the cutting of prices on copyright books" by requiring all publishers to fix the retail prices of their respective books, to prevent discounting, and eliminate discounters by collectively refusing to deal with them. Resale Price Maintenance (RPM) was the means to enforce the cartel and copyright was an effective method to enforce the RPM. The case was not about the vertical relationships between a publisher and a reseller, but had horizontal aspects as wide as horizontal aspects can be.

Macy's considered this scheme as a direct assault on "its cardinal principle of underselling its competitors. … Macy's did not propose to make such a sacrifice—to permit its customers to be sacrificed—without a protest. And such a protest it prepared to make" (Hungerford 1922, p.133).,

In 1903 Macy's attempted to fight the cartel by suing the American Publishers' Association and the American Booksellers' Association relying on the Sherman Act and its equivalent New York Anti-Monopoly Act. Macy's bid was only partially successful. The New York Court of Appeals found in favor of Macy's on the basis that the publishers' and booksellers' rules sought to prevent the discounting of all books, copyrighted and non-copyrighted alike.

Relying on *Bement v. National Harrow*, however, the court held that a combination to fix the prices of copyrighted books alone would be legal. Soon thereafter, the respective associations' rules were amended to cover copyrighted books only, and Bobbs-Merrill commenced its copyright infringement suit against Macy's. In its defence, Macy's argued that the notice could not restrict the right of an owner of a copy of a book, lawfully printed and sold, to resell it as it saw fit. Macy's further defended the suit on the grounds that the action was an attempt to enforce an unlawful combination. The circuit court sided with Macy's on both issues and refused to construe *Bement v. National Harrow* as broadly as the state court did. On appeal, the Court of Appeals affirmed, but addressed only the copyright question. The Supreme Court, as noted above, mentioned the antitrust issue only in passing and based its decision solely on copyright grounds.

There are remarkable similarities between the turn of the 20th century case and the present one. Both of them involve resellers who revolutionized retail, and whose ability and willingness to sell books at discounted price threatened the existing business models of publishers and retailers. Both cases involved collusion, not only among publishers, but also agreements between publishers and retailers, in order to counter a perceived threat by a discounting retailer and force a shift from a traditional wholesale model to a model that allows the publisher to control the retail price. There are some differences, of course. The old case involved a retail innovator and collusion between publishers and resellers of yore, whereas the current case involves, in addition to publishers, two innovators (Amazon and Apple) and two innovations (retail innovation—online bookstores, and product innovation—e-books).

The main difference, however, is that Apple was not motivated to adopt the agency model because it was concerned that Amazon's discounting would hurt its sales (at the time it entered into the agency agreements Apple did not sell any e-book yet). Rather, it offered the agency model as a solution to what publishers perceived as "the Amazon problem"—a collective action problem that each of the publishers was unwilling to solve alone. By offering the publishers an alterative platform to Amazon, Apple hoped to induce the major publishers to offer their catalogues on the Apple bookstore with the launch of the iPad, and have them agree to retail prices that, while higher than those offered by Amazon, were still lower than those which the publishers preferred (Albanese 2013). Nevertheless, from the publishers' perspective, the story is remarkably similar to the turn of the 20th century case. The publishers believed that Amazon's discounting would undermine the book trade ability to sustain high retail prices, and undermine the viability of the brick-and-mortar retailers, which the publishers, for reasons that will become apparent below, sought to protect as long as possible (Albanese 2013; Thompson 2010, pp.364–65).

These cases are interesting not only for their antitrust aspects but for their copyright aspects as well. In *Bobbs-Merrill*, the Supreme Court avoided the antitrust questions and resolved the case on copyright grounds, by establishing the first-sale doctrine. Since RPM was the means to enforce the cartel, and copyright was supposed to be the means to enforce the RPM, the Court's decision could have destabilized the cartel, but apparently it did not. It took five more years, and another trip to the Supreme Court until the Court, in *Straus v. American Publishers' Ass'n*, outlawed the cartel.

C. THE PUZZLE

The horizontal aspects of *Bobbs-Merrill* and the alleged horizontal elements of the Apple case make them a relatively easy case from a purely doctrinal perspective. Yet those two incidents are far from unique or isolated. Rather, they reflect a much more common pattern. In fact, similar agreements between publishers and retailers to fix the retail prices of books have been a characteristic of the book trade in many countries for more than a century. In the UK, the Net Book Agreement existed for nearly the entire twentieth century, until its collapse in the mid 1990s (Thompson 2010, pp.50–52), and attempts to create such schemes began at least as early as 1829 (Feather 2006, p.100). In Australia, for several decades a "Statement of Terms" agreed between the Australian Booksellers Association and the British Publishers Association forbade price competition among booksellers. The booksellers set prices, and "British publishers were committed to withhold supply from booksellers who sold below the prices agreed by the cartel" (Curtain 1998). In 1972 the book trade hoped that the Restrictive Trade Practices Tribunal would endorse an RPM system, similar to the one that existed in Britain, but when the Tribunal refused to approve it, the RPM scheme and the Statement of Terms were abandoned (Curtain 1998).

Similar Resale Price Maintenance (RPM) arrangement—often bolstered by legislation—exist in Germany (Bittlingmayer, 1992) and many other European countries (Ringstad, 2004).

Yet from an economic perspective, the persistence of systemic efforts to fix the retail price of books—and now e-books—is puzzling. It is easy to see why publishers would be interested in fixing the *wholesale* prices of books, or why retailers might be interested in fixing the retail prices, and the literature on vertical restraints may explain why *individual* publishers might be interested in imposing vertical restraints on retailers. But arrangements that combine a wholesale cartel with a retail cartel are rather peculiar, and even more puzzling is the prevalence and endurance of such arrangements in the book trade.

D. TRADITIONAL EXPLANATIONS FOR RPM

The legal treatment of RPM and other forms of vertical restraints has been quite volatile. Antitrust law's attitude towards agreements imposing such restraints (e.g., between manufacturers and distributors) has seen remarkable changes throughout its history. Early antitrust law was as averse to vertical restraints as it was to horizontal restraints, and treated many agreements imposing vertical restraints, such as exclusive dealing, tying, and resale price maintenance, as *per se* illegal. Over time, however, antitrust scholarship began recognizing that vertical restrains are not necessarily anti-competitive, and may be used to enhance efficiency, prevent opportunism, and otherwise advance pro-competitive outcomes. Jurisprudence followed scholarship, and since the late 1960s, the Supreme Court has gradually abolished virtually all per se rules applying to vertical restraints. The last bastion fell in 2007 in *Leegin*, which overruled an almost century-old per se prohibition on RPM.

The crucial insight is that imposing RPM may require some amount of market power, otherwise attempting to keep retail price higher would be futile—consumers would switch to cheaper substitutes. However, if the manufacturer possesses market power, it would normally be better off exercising its market power by raising the wholesale price, in which case RPM, which would result in a higher retail price, will decrease the quantity purchased from the manufacturer to below the profit-maximizing point. Therefore, with RPM the manufacturer has to set a lower wholesale price, effectively sharing some of the monopoly profit with the retailer. If the manufacturer is willing to sacrifice some of its profit, it may be a price that the monopolist is willing to pay in order to induce the retailer to provide something of value in return.

1. Pro-competitive explanations

A standard argument is that RPM is used to ensuring efficient promotional efforts by retailers. RPM offers a retailer a guarantee that its prices will not be undercut by another retailer, and that it will be able to sell the product at a sufficient margin so as to make it worth its while to invest in promotional efforts, without fearing free-riding on its investment by other retailers (Telser 1960). In the context of the e-books controversy, it has been suggested that the publishers would have preferred the agency model "to compensate Apple or other retailers for more extensive and broader promotion of their books, … . By offering Apple a retail margin sufficient to cover the costs of additional promotional efforts, publishers provide Apple an economic stake in such promotional efforts and facilitate more extensive promotion" (Manne & Rinehart 2012, p 19). This, the argument goes, was especially important in a case of a retailer like Apple, "which is largely unconcerned about profits from ebook sales (ebook sales generate only about .0005% of Apple's total revenues) [and] has little to gain from promotional activities devoted to the sale of ebooks beyond that sufficient to convey the basic information at the point of sale for its hardware that such content is available" (Manne & Rinehart 2012, p 19). While the concern about lack of interest in promoting e-books may or may not be true in the case of Apple, it does not explain why the publishers attempted to impose the agency model on Amazon, a retailer for whom the sale of books seems central to its business, and which has indeed developed a sophisticated system of reviews and recommendations to promote the sale of books.

Moreover, the "spectre of price deflation" (Thompson 2010, p.361) seems to be the main concern about Amazon's pricing under the wholesale model, not lack of promotional efforts. Nor does the free-riding explanation explain the prevalence of RPM in the traditional book trade, and more importantly, the systemic horizontal efforts to institute it. In fact, while an individual publisher might be interested in encouraging booksellers to promote its books and willing to share some of its monopoly rents with the retailer for that purpose, it is not clear why the publisher's decision to impose RPM would be dependent on similar decision by competing publishers. In fact, if RPM induces promotional efforts by booksellers, any publisher contemplating to impose it would hope that its competitors do not: the bookseller will promote the publisher's books and neglect the books of its competitors.

2. Anti-competitive explanations:

Besides pro-competitive explanations, RPM can has also generated some anti-competitive explanations.

Manufacturers' (publishers') cartel: fixing the retail prices makes prices transparent, and therefore makes it easier for the cartel members to detect cheating. If a retailer begins cutting prices, this will be immediately noticed, and may immediately suggest that one of the manufacturers cheated and cut the wholesale prices.

Another version: the manufacturers want to create a cartel, but they know that if retailers' margins are going to be too low, they will demand lower wholesale prices and the wholesale cartel will be more difficult to sustain. Fixing the prices at both levels thus stabilizes the wholesale level cartel.

While there is some evidence that in many cases the initiative to fix the retail prices of books came from publishers, there isn't much evidence that the various schemes have included the fixing of wholesale prices. Therefore, it seems that the RPM schemes are designed to achieve something more than simply supporting wholesale price-fixing.

Retailers' Cartel: The idea here is that fixing the retail prices is not in the best interest of the manufacturer, but powerful retailers collude and force the manufacturer to set the prices and enforce the retailers' cartel. It may be doubtful how strongly this explanation applies to the book trade, because it seems implausible that booksellers have been so persistently powerful, across time and in so many nations, to coerce publishers into adopting distribution schemes that do not serve the publishers' interests. It therefore seems more likely that RPM schemes served the joint interests of publishers and booksellers.

E. BOOKS AND THE DURAPOLIST PROBLEM

I would propose that the various RPM arrangements reflect the book industry's solution to the durable monopoly problem (or following Orbach (2004), the "Durapolist" problem).

The standard economics of copyright emphasizes the large gap between the high fixed cost of creation and the very low marginal cost of reproduction. Copyright, then, is supposed to encourage creativity by protecting the publisher from competing unauthorized copies. Copyright, however, might be effective in preventing competition from identical copied books (and somewhat effective in protecting the publisher from "substantially similar" competing books), but it is ineffective in protecting publishers from competing, yet non-infringing, books (Katz, 2013).

This means that notwithstanding copyright, sustaining supra-competitive prices is a challenge because every new book has to compete at least with numerous other *new* titles in the same genre, as well as with numerous *old* books that are often just as good as new titles (think about all the great classic and non-classic novels that you have never read and probably never will).

What exacerbates this challenge is the fact that a book is a durable good, in the sense that typically a consumer buys it only once and reading it does not consume it. This suggests, following Coase (1972), that notwithstanding its copyright, the publisher, in effect, is in price competition with itself over time, and that without a workable strategy that allows it to commit to higher prices, the price of books might drop towards marginal cost rapidly.

In 1972 Ronald Coase conjectured that a durable good monopolist might not be able to exercise its market power even if it controlled the entire market. Orbach uses the following example to explain the point. Consider a hypothetical light-bulb durapolist, who can sell bulbs that last ten years or bulbs that last one year.

> When introducing the long-lived technology of ten-year light bulbs, the durapolist adopts an optimal plan of charging the monopoly price in order to maximize profits. Under this optimal plan, only consumers who are willing to pay the monopoly price ("*high-valuation consumers*") purchase bulbs, while other potential consumers continue to use substitutes, such as candles and oil lamps. Consumers, however, are not easily fooled. They realize that if the durapolist maintains the monopoly price, it

> will exhaust the market of high-valuation consumers and will seek ways to secure a flow of income. They anticipate, therefore, that upon satisfying the demand of high-valuation consumers, the durapolist will offer its merchandise to consumers who cannot afford, or are not willing to pay, the monopoly price ("*low-valuation consumers*"). For a small discount, some of these consumers would purchase bulbs. The durapolist, consumers believe, will set a new price according to the demand of the low-valuation consumers, such that its profits will be maximized. Again, not all consumers will buy bulbs, and, after saturating the market, the durapolist will continually readjust its price to expand its business to consumers with even lower valuations (Orbach 2004, p.72).

Thus, the durapolist faces a commitment problem: consumers anticipate that the durapolist will not sustain its higher prices and may hold their purchases until prices drop to the competitive level. As a result, "despite the durapolist's hold on the market, durability creates expectations that prices will fall and predisposes consumers to postpone purchases until prices are close to the competitive level" (Orbach 2004, p.73). To avoid this outcome, the durapolist may try to adopt various strategies designed to credibly commit itself to higher prices. For example, it may choose to make its product less durable (for example, selling light bulbs that last one year instead of ten years). If the product is less durable, early high-valuation shoppers may return to the market before the demand of their high-valuation peers is saturated (Orbach 2004, p.74).

F. BOOKS AS DURABLE GOODS

The Coase Conjecture offers an explanation for the historic tendency to fix the retail prices of books through horizontal means, and for the publishers' anxiety over e-books in general, and Amazon's pricing in particular. This part shows how the various historic RPM schemes for books were designed to generate credible commitments to high book prices. It will further demonstrate how committing to such a strategy was easier in the analog era, when the industry relied on printed books and brick-and-mortar bookstores, but has become more difficult when printed books are sold online, and might be impossible with e-books. But first it may be useful to explain why books are durable, because this may not always seem straightforward.

For example, the Oxford Dictionary of Economics defines the term "Consumer Durables" as "Long-lived goods bought for final consumption. Their services are expected to be enjoyed over a period longer than that (usually a year) used in national income accounting. Examples are private cars, boats, and domestic items such as furniture and appliances. Footwear and clothing are not normally treated as consumer durables, although they are frequently made to last for several years. House purchase is normally treated as an investment and not as spending on a consumer durable" (Black 2009). According to Orbach, "[a] durable good (or durable) is a long-lasting good that can be used repeatedly. A non-durable good, otherwise known as a perishable good (or perishable), cannot be used more than once even if it has a long shelf life" (Orbach 2004, p.69).

While some books, such as encyclopedias or other reference books, fit those definitions without any difficulty, fiction and non-fiction books do not, at least not immediately. Typically, these kinds of books are purchased with the expectation of being read once, and in this sense they are enjoyable for a short period, even shorter than typical footwear or clothing. Yet, for the current purposes, the crucial point about a book is that it is not perishable and is not consumable. The book, as a medium, is long lasting, and can be enjoyed over an incredibly long period without much depreciation, and the book, as content, is as durable as a good can be. As long as a medium in which the content can be fixed exists, the book, as content, a non-rivalrous good, can be reproduced and then read without ever being consumed. Therefore, from the demand side, while a book may typically be read only once, reading it does not consume it, and the purchaser may continue to enjoy it as long as he wishes, or can lend, give it away or resell it for others to be reused. From the supply side, the combination of non-rivalry of consumption and low marginal costs means that as long as there is demand, it may be difficult for a publisher to commit not to supply it: it may always be tempting to increase supply once high-valuation demand has been saturated.

Together, books present publishers with the classic problems of durapolists: the fact that a typical buyer buys a book only once means that it may become difficult for the publisher to resist the temptation of lowering the price, and the fact that a book is typically read only once means that used books might be easily available, accelerating the drop in the price of new books. With these observations in mind, let us consider some features of the book trade and how they can be viewed as means for countering what otherwise might have been—from a publisher's perspective—a durapolist's nightmare.

G. COMMITMENT STRATEGIES IN THE BOOK TRADE

In essence, the business model for the distribution of trade books was based on making new books available at high prices for limited times, and then making them unavailable.[2] Some of these strategies were made possible thanks to mere technological constraints; others required adopting appropriate distribution practices, which the law sometimes allowed and sometimes discouraged.

1. Technological constraints

While discussions of the economics copyright often describe the production of books as entailing a high fixed cost of creating the first copy and a very low marginal cost of multiplying additional copies thereafter, the reality of printed books is somewhat different. Printing requires type-setting and other setup costs, and after the first batch has been printed, increasing production requires incurring these setup costs again. Therefore, in addition to the fixed and sunk cost of producing the first copy (writing the manuscript, editing it, etc.), printing a new edition entails incurring new sunk costs. After the first edition has been printed and sold, printing a new edition requires incurring those fixed costs again, and the publisher may be reluctant to incur those costs unless it can expect sufficient demand for the new edition. From the buyers' perspective, this means that waiting until the price drops might be a risky bet for high-valuation consumers. If they don't buy the book when it is available, it may take a long time until a second edition may be available, if at all. Thus, the technological constraints of printing help convincing

[2] Except on special order, through libraries, or as second-hand. The first option may not be available at a reasonable price and within reasonable time, the second may be highly inconvenient, and the third may be highly unreliable, or inconvenient, or costly.

buyers that production will be limited.[3]

Brick-and-mortar bookstores have limited shelf space, and they necessarily can stock only a limited number of books. As Thompson, citing Epstein, explains, “In bookselling as in any retail business, inventory and rent are a trade-off. The more you pay for one, the less you can spend on the other” (Thompson 2010, pp.34–35). Consumers cannot expect that every book ever printed will be always available at the bookstore. The combined effect of these two constraints (the *typesetting constraint* and the *shelf-space constraint*) is that consumers know that if they don’t buy the book at a high price today, the book may not be available tomorrow, and it may be uncertain if and when a new edition is released.[4]

While the typesetting and shelf-space constraints may help in committing to high book prices, they may not be sufficient. Several factors complicate the matter.

First, the success of new books is notoriously unpredictable, and books are susceptible to fads. The publisher, then, faces a dilemma: if demand is higher than expected and exceeds the number of copies printed, it may be difficult to increase production quickly at a reasonable cost. This suggests that it may be wise to print more than what the publisher expects to sell at the target price. However, if the demand for the new book is lower than expected and too many books are printed than those that can be sold at the target high price, it may be tempting to reduce the price quickly, making a commitment to high prices less credible.

The shelf-space constraint also has its downside. For the bookseller, a new book the demand for which is lower than expected, quickly becomes a liability. Keeping it on the

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[3] This is similar to the example of an artist who commits to limited production of a lithograph by destroying the plates (Bulow, 1982).

[4] Bulow suggested that “an author may be able to establish that he will not put out a low-cost edition (paperback) for at least a year after the hardcover comes out. However, it may be difficult to convince anyone that a paperback will never come out” (Bulow, 1982; 326). Nevertheless, the expected availability of cheaper paperback editions is merely a variation of the strategy, whereby instead of one opportunity to buy the book there are two. But there is no guarantee that the book will always remain available.

shelf creates an increasing opportunity cost, as it prevents another (and still promising) new book from being stocked. To clear the space the bookseller may wish to reduce its retail price. Moreover, stocking a new book is a high risk, especially if the publisher charges a high wholesale price. Thus, the higher is the wholesale price of a book, the greater is the risk that if it is not sold the bookseller will lose money, and the greater is the bookseller's incentive to offer discounts when sales begin to falter.

Under a standard wholesale model, this means that the bookseller will be reluctant to pay high wholesale prices for new releases, or to stock any new releases before it clears its earlier inventory. It also means that consumers may anticipate a decline in prices and withhold their purchases of new books, which would further accelerate booksellers' discounting, and exert downward pressure on wholesale prices. The result might be rapid downward spiraling of prices toward marginal cost.

Two factors may further aggravate this situation: one, the reusability of books, and the other, competition among booksellers and among publishers. The reusability of books means that other than the über-enthusiastic readers, all other readers may be willing to wait until prices decline, or until they can borrow the book or purchase a used copy. To earn a profit from them, prices of new books would have to decline rapidly. Competition among booksellers means that a bookseller who starts discounting when sales begin to falter might quickly force other sellers to cut their prices too, lest they be left with unsold inventory, leading to greater downward pressure on wholesale prices. Thus, competition among publishers means that publishers will find it more difficult to commit to high wholesale prices. Even though books are differentiated products, especially in the eyes of readers, for a booksellers they are much more fungible. It would make little sense for a bookseller to incur the risk of stocking a new book with a high wholesale price, when another publisher is willing to supply a close enough substitute at a lower price.

This may explain the rise of industry-wide RPM schemes.

H. Early 20th Century RPM schemes in the US and the UK

On February 13, 1901 the American Publishers' Association adopted a plan "to correct some of the evils connected with the cutting of prices on copyright books." They agreed that "all copyrighted books first issued by them … shall be published at net prices, …" and recommended that "the retail price of a net book, marked 'Net,' be printed on a paper wrapper covering the book", and that booksellers would receive a discount on net copyrighted books of twenty-five per cent. They agreed "that the members of the association agree that such net copyrighted books and all other of their books shall be sold by them to those booksellers only who will maintain the retail price of such net copyrighted books for one year, and to those booksellers and jobbers only who will sell their books further to no one known to them to cut such net prices, or whose name has been given to them by the association as one who cuts such prices, or who fails to abide by such fair and reasonable rules and regulations as may be established by local associations as hereinafter provided." And they further agreed that "after the expiration of a year from the publication of any such net copyrighted book dealers shall not be held to the above restrictions, and may sell such book at a cut price; but if, on learning of such action, the publisher shall desire to buy back at purchase price the copies then remaining in the dealers' hands, they must be so resold to him on demand."[5]

Concurrently, the American Booksellers' Association was formed and adopted its own resolution, acknowledging that "the American Publishers' Association has adopted a net price system and entered into an agreement for its maintenance, by which the members of said association will cut off the supply of all their books, net, copyrighted, or otherwise, to any dealer who fails to maintain the net price of any or all books published under the net price system, and resolving that "the American Booksellers' Association, in convention assembled, accept the said net price system, with the distinct understanding that it is the intention of the American Publishers' Association to include fiction under the net price system as rapidly as possible; and … that all members of the American Booksellers' Association shall give to each of the members of the American Publishers' Association, and to all publishers who co-operate with them in the maintenance of the net price system, our most cordial support; and that to this end we agree not to buy, not to

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keep in stock, nor to offer for sale, after due notification, the books of any publisher who declines to support the net price system. ..."[6]

The American scheme was more or less identical to the British scheme, the Net Books Agreement, which was adopted a year earlier. Although in 1962 the NBA was approved under the Restrictive Trade Practices Act, 1956, it eventually collapsed in the 1990s. Dillons, which began as an academic bookseller in London had grown to become a national bookstore chain and began discounting. Subsequently, some publishers withdrew from the NBA, the Office of Fair Trading decided to review the NBA, and finally in 1997 the Restrictive Trade Practices Court ruled that the NBA was illegal (Thompson 2010, pp.51–52).

These schemes deviated from a traditional wholesale model, whereby a bookseller buys a book at a wholesale price set by the publisher and then is free to resell it at whatever price it chooses, and bears the risk of unsold inventory, and they enabled publishers and booksellers to make credible commitments to high prices by relying on the typesetting and shelf-space constraints. The key features of the scheme are: (a) eliminating any price competition between booksellers, by prohibiting discounting for one year after publication; (b) a commitment by publishers not to supply books to discounting booksellers; (c) a commitment by booksellers not to buy books from publishers who do not abide by the rules and not to supply books to recalcitrant booksellers; and finally (d) a *call* option given to publishers to "buy back at purchase [wholesale] price the copies then remaining in the dealers' hands" a year after publication. This option, which would later transform into a *put* option given to booksellers to return all unsold books to the publisher, reduces the risk of stocking unsold books significantly, and allows the bookseller to care less about a higher wholesale price and a fixed retail price.

The result of this scheme was that publishers could credibly commit to high prices for new books, because it secured booksellers cooperation with it. This scheme ensured that new books will only be available for a short period after their publication and sold at a

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high price.

The Supreme Court's holdings in 1908 and 1913 (and *Dr. Miles* condemnation of RPM as a per se violation of the antitrust laws in 1911) might have been expected to undermine the price fixing system, but apparently, its basic structure endured. American antitrust law never prohibited manufacturers from advertising suggested retail prices, so publishers could continue printing books with a suggested retail price. They could still negotiate with booksellers a wholesale price that is calculated on the basis of the suggested retail price minus a discount, and, following the *Colgate* doctrine, they could still decide not to supply books to discounters or reduce the discount available to them, as long as they did that unilaterally. And finally, they could still assume the risk of unsold inventories by allowing booksellers to return unsold books. What they could not do is impose RPM. However, weaker ability to ensure compliance with a big stick might only meant that publisher had to induce compliance with a more enticing carrot, which they did by increasing the booksellers' discount to fifty per cent and by changing the ability to return unsold books from a call option exercisable by the publisher within a year after publication into a put option exercisable by the bookseller anytime. While booksellers were free to discount as much as they want, they had fewer incentives to do so.

1. Where there are bookshelves there will be books

Theoretically, used books could still threaten the ability to commit to high prices. But the logistics of large-scale organized trade in used books might have limited the scope of this threat. Interestingly, however, publishers adopted some measures to discourage the secondary market of used books. An interesting anecdote is a campaign to encourage outfitting American homes with bookshelves.

As Striphas writes, "Today accumulating printed books and shelving them in one's home may seem like mundane facts of life, at least among those economically enfranchised enough to do so. In the first decades of the twentieth century, however, those activities couldn't be assumed and needed to be learned" (Striphas 2009, p.27). Therefore, several major New York book publishers embarked on a campaign to persuade architects, contractors, and decorators to equip American homes with shelves to store books. The campaign strategist, Edward L. Bernays, reasoned that "Where there are bookshelves … there will be books" (Striphas 2009, p.27). Gradually, books were meant not only to be read, but also to be accumulated and displayed, to signify their owner's material, social, and cultural success.

The change in consumers' conceptions of books could have had two salutary effects on the book trade. If the value of buying a book lies not only in its literary enjoyment but also in its ability to signify the owner's social significance, the willingness to pay for books may increase. In addition, the change in books' consumption function strengthens their durability: they are meant not only to be read, but also to be kept and displayed, and they are less likely to be resold in the secondary market of used books. Thus, the campaign to equip homes with bookshelves might have been part of a strategy to limit the supply of cheap used books.

I. FAST FORWARD A CENTURY

The growth of the large retail bookstore chains changed some aspects of the system, but did not alter its fundamentals, but the rise of Amazon in the 1990s led to significant changes. Amazon did not face the same physical constraints on shelf-space that brick-and-mortar bookstores face, and more importantly, competing on price and making as many books available as possible, were essential elements of its strategy (Thompson 2010). Amazon's rapid growth and its resulting bargaining power against publishers made commitment to high prices more difficult, but as long as printed books are concerned, the fixed costs associated with printing each edition may have enabled some commitment to high prices.[7]

[7] A related change was the emergence of online secondhand retailers, such as Biblio, AbeBooks, or Alibris, which was a matter of growing concern for publishers (Thompson, 2010; 44). This concern is consistent with Waldman's observation regarding the effect of secondhand markets on durable good monopolists (Waldman, 1997).

J. e-Books: Publishers' Nightmare?

The rise of the e-book, however, signals a dramatic and fundamental change, and threatens to undermine the trade's fundamentals. In essence, the distribution of e-books does not face the same constraints that facilitated commitment to high prices of printed books. Since e-books do not have to be printed in limited editions, the marginal cost of an additional copy is continuously close to zero. This means that there are no physical constraints on the available quantity at the production stage, and credibly committing to a limited quantity becomes more difficult: when books are digitized, every title on the backlist can be as easily available as the titles on the front list. In addition, since e-books do not have to be stored, shelved, or transported from one place to another, there are no shelf-space limitations or other retail-level constraints on quantity similar to those that exist in physical bookstores. As a result, as long as there is demand, it can be supplied instantly. Therefore, a distribution model based on limited availability of high-price copies is unlikely to be sustainable for digital books.

These insights may explain some of the recent developments in the book and e-books trade: from publishers' reluctance to embrace e-books, to their angst over Amazon's pricing of e-books. Indeed, their attempt to impose the "agency model" might be explained as an attempt to recreate a distribution system for e-books that resembles that of printed books, or at least as an attempt to stall the demise of their existing business model in the hope of figuring out another model before others overtake them.

These insights may also explain publishers' objections to projects of mass digitization of books, and to proposals to revive orphan works. While the vision of easy access to all books ever written has sparked the imagination of many, it might be the nightmare of an industry whose profitability has traditionally depended on making only a small selection of books available, and only for short periods.

K. Legal and Policy Implications

Several interesting legal implications arise from of these findings. For example, if commitment to supra-competitive prices of e-books becomes impossible, prices might be set at (or close to) marginal cost even if copyright is enforced perfectly and all piracy is eliminated. This interesting result may suggest that focusing on preventing unauthorized reproduction by legal or technological means might be completely futile, and further suggest that copyright itself might be futile. Alternatively, it may suggest that copyright might still be useful if it can serve as a basis for other business models, not those based on distribution of copies, but on providing convenient access to different sorts of "libraries".[8]

These insights might also have important implications for competition law and policy. Horizontal agreements to fix the retail prices of books are highly suspect from a competition law perspective, and where overt book RPM schemes were permitted, they have often been justified on cultural rather than economic grounds. But this paper's hypothesis may invite revisiting these positions. If RPM is indeed necessary for sustaining investment in the production of new books, and if it cannot be sustained without horizontal components, then competition law might have to rethink its position, and book RPM schemes might actually be defended on economic, rather than cultural grounds.

Note, however, that such a conclusion depends on two non-trivial conditions: the first, that RPM is indeed *necessary* for sustaining investment in the production of new books, and that in addition, that sustaining such RPM schemes *requires* horizontal coordination among publishers and booksellers. Observing that such horizontal schemes have been quite common, or that some of the main players in the industry have relied on them, does not mean that they are indeed essential.

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