

Regulatory Piracy

By Kent Lassman

By now, the battle between the recording industry and music down-loaders has become well known. Headlines constantly remind us of the impact that technology can have on the marketplace as the industry tracks down those engaged in unauthorized use of copyrighted material. The controversy has no easy solution, and the statutory nature of copyright law has only added to the confusion. Less conspicuous, but just as important, is a form of piracy in the guise of governments forcing companies to modify their products or share their technologies with competitors. Justified as consumer protection, such regulatory piracy often harms the consumers it purports to help. More often than not, it provides a bounty to firms having difficulty competing in an open marketplace while dampening the drive for innovation.

For many firms “intellectual property” is an integral component of the business. These firms face high fixed costs when creating new products, with heavy investments in research and development. Once developed, however, additional copies can be made for virtually nothing. Consider, for example, the multimillion dollar price tag of making a Hollywood blockbuster compared to the ability to churn out limitless bootleg copies for less than a dollar on the streets of Shanghai. If others are allowed to reproduce the original work, there is little incentive for the initial investment. The Internet and file-sharing technologies have made the situation even more difficult to manage.

Recognizing this important link between incentives and innovation, the U.S. Constitution

allows Congress the ability to provide “inventors and authors” limited monopolies on the works that they create. In economics, this emphasizes the importance of dynamic efficiency rather than just examining static efficiency. Simply put, static efficiency examines the use of resources at any given point in time, with efficiency defined as prices that are driven to per unit cost. Dynamic efficiency, on the other hand, addresses the need to find new and innovative ways to combine resources over time in a way that maximizes consumer welfare.

Protecting intellectual property rights allows firms to recoup their initial investments and earn a rate of return, which promotes dynamic efficiency, something described in the Constitution as a need to “promote the useful arts.” Constructive government action plays a part by battling piracy; but markets also play a role. As intellectual property rights become vulnerable, new technologies are developed to thwart additional pirating. As an example, new RFID technologies are emerging to protect DVDs. This game of cat-and-mouse seeks to balance the character of intellectual property with fair use by consumers.

There has always been a tension. Some government policies are at odds with dynamic efficiency and the problem is more acute with the

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deployment of digital technologies. Rather than protect intellectual property, these policies sacrifice dynamic efficiency to uphold some notion of static efficiency that seeks to redesign how existing markets are structured. These policies are akin to piracy, for they often demand dominant firms share their intellectual property or modify the products they have developed. It is a twist on the common perception of pirate but the analogy holds. Economic bounty is taken from some – under the threat of extreme punishment – for the use by others.

These issues often emerge in the field of antitrust, and it is becoming a larger issue on a global scale. This can be seen in Europe where France, Germany, and several other nations have challenged iPod to license its technology so songs

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can play on other players. In addition, the European Union has been in an ongoing battle with Microsoft, calling on the software manufacturer to restrict the features on its operating system, and make more of its code available for competitors developing software products.

Similar battles have played out in the United States. But importantly, there is a fundamental distinction in the application of antitrust laws. In the United States, the antitrust adage is to “protect competition, not competitors.” Policy goals seek to improve consumer welfare through a dynamic and open market. In Europe and elsewhere, protecting consumers often yields to more proactive and invasive policies of managed competition. Dominant firms may be taken to task by their rivals, which, in the high-tech community, often means handing over intellectual property. Other than the government endorsement, there is little to distinguish this behavior from selling bootleg copies of the latest *Harry Potter* out of the trunk of a car. In both instances, the incentive to innovate suffers as the potential to recoup investments becomes less certain.