

Agenda

Advancing economics in business

Could 'fair compensation' be fairer to all? Finding an alternative to copyright levies

The majority of EU countries have a system of copyright levies on blank media and devices with storage capacity, such as MP3 players, mobile phones and recordable DVD players. Yet the rationale for, and implementation of, these regimes have been subject to a series of legal disputes and economic criticism in recent years, and some countries, including Spain, Finland and the Netherlands, have begun to look for change. Could an alternative system be less distortionary while still adequately compensating rights holders?

A number of EU countries have a private copying levy system that collects revenues from levies on blank media and certain devices with storage capacity and distributes them to rights holders of creative works. These revenues are intended to provide 'fair compensation' (as embedded in the EU Copyright Directive 2001/29/EC) to rights holders as a result of authorised private copying as permitted under the private copying exception. According to EU case law, and the *Padawan* decision by the European Court of Justice in particular,¹ the size of the levy ('fair compensation') should be equal to the 'harm' that rights holders suffer as a result of the private copying exception.

The rationale for, and the implementation of, copyright levies on hardware and media have been the subject of a number of legal disputes and public critique, with controversial, and sometimes uninformed, statements being made on the both sides of the debate. Given the controversy, at the beginning of 2012 the European Commission initiated a mediation process, which may be followed by a legislative action in 2013. At the same time, some Member States (Spain, Finland and the Netherlands) are already considering alternative compensation mechanisms.

On balance, there is evidence of a number of concerns with the current system.² In particular, the opponents of the levy system have noted that format-shifting (for example, copying a CD onto one's computer for private use) represents the way in which music is consumed, and that this useful functionality is already factored into the price of the original sale and may actually benefit right holders. Furthermore, the levies are only very imprecisely linked to private copying—not everyone uses their multi-purpose devices, such as computers,

tablets or mobile phones, for private copying, which in turn causes unintended re-distributional consequences.

There are also costs associated with the system. As a result of copyright levies, consumers pay higher prices for blank media and devices, manufacturers potentially suffer lower sales, incentives to innovate in licensing may be dampened, and payments to the creative community fluctuate with sales of hardware rather than sales of content. Given these problematic features of the current device/media-based levy system, the question is: are there fairer and economically more efficient remuneration mechanisms to ensure that the creative community is adequately compensated?

This article presents a framework that could be employed for an economic assessment of alternative regimes, aiming to provide insights to stakeholders in designing a compensation mechanism that is consistent with both economic efficiency and cultural objectives, and, crucially, achieving stakeholder buy-in and legitimacy.

Room for improvement

Aside from the question of what the 'right' amount of compensation is for private copying—quantifying the harm is itself a complex exercise—this article takes as given the need to raise a set amount of funds for rights holders and concentrates on examining the most efficient way of collecting this revenue.³ In order to assess whether an alternative regime would be an improvement on the status quo, the proposed regime would need to be tested against clearly defined criteria that are representative of public objectives. These criteria might include the following, although they are likely to differ across countries, based on policy-makers' differing objectives:

- **fair compensation**—rights holders should be rewarded adequately, including a fair/efficient distribution among them of any compensation;
- **limited market distortion**—allocative inefficiency manifested through higher prices and less output than would otherwise prevail ('deadweight loss') should be limited, also taking into account the implications of cross-border e-commerce;
- **licensing incentives**—there should be no dampening of incentives to engage in digital licensing, given the significant revenue potential that new platforms provide to rights holders and distributors;
- **stability**—rights holders and collective cultural funds should be provided with certainty and stability in the remuneration they receive, and developments should be 'future-proof'—ie, consistent with technological developments for years to come rather than something that is frequently revised;
- **innovation**—there should be no dampening of incentives to create innovative business models;
- **administrative burden**—the implementation and operation costs of the regime should be minimised, as should the costs of legal and other disputes;
- **wider tax policy and distributional implications**—the system must be otherwise in line with existing tax policy, including accounting for distributional effects and protecting vulnerable individuals (eg, in the relationship between the private copying remuneration system and VAT revenues to the state);
- **piracy**—there should be no increase in the incentives for piracy, and preferably a decrease.⁴

Having set out these criteria, several funding options could be assessed against them. The design of these options should recognise the objectives underlying the current device and media-based levy system: on the one hand, the levy system appears to intend to address the market failure of rights holders' inability to achieve sufficient remuneration through pricing of original copies—ie, the levy system serves as an imperfect substitute for licensing. On the other hand, in some countries more than in others, levies have become a source of funding for cultural initiatives in addition to the fact that a relatively high proportion of the levy revenue accrues to authors and composers (as opposed to, say, record labels). Correspondingly, with these objectives, alternative options can be broadly categorised into two groups: market-based schemes and variants of public funding.

Market-based schemes

In general, from an economic perspective, a first-best solution would be to achieve a well-functioning market that does not require any government intervention to correct its imperfections. In the case of private copying, such a system could be one where the price of the

content contains compensation for all legal usages. These licensing systems are not limited to traditional sales of content, possibly with variants of digital rights management, but include all fully licensed music distribution systems, including streaming and cloud services. For example, a consumer might pay extra for the mobile or tablet application of a streaming service, such as Spotify or Voddler, or pay for a right to use, on any device from a cloud (eg, Apple's iCloud Match), content that had already been purchased. Indeed, it appears of some importance to rights holders that, for example, cloud-based services are indeed licensable.

The key advantage of licensing is that it is non-distortionary and economically efficient. There is no additional tax on products that alters consumer behaviour. In economic terms, consumers have variable willingness to pay for the ability to consume their content over various platforms, and a fully functioning licensing system would serve as a tool to price-discriminate efficiently across consumers at different parts of the demand curve. Depending on 'how the pie is shared', distributors and various rights holders should each receive market-based remuneration from the sales, part of which reflects the value of private copying.

In the long term, a well-functioning digital content market with full licensing is incompatible with a system where remuneration is collected uniformly from the sales of devices and media. While the problematic incentives for licensing created by such a levy system are articulated elsewhere (most recently in the UK levy study by Professor Martin Kretschmer⁵), in simple terms, it would not be appropriate for collecting bodies to claim levies on devices that use licensed content. This conflict between device levies and licensing is particularly prevalent in the context of music, given that, in addition to 'traditional' à la carte download stores, cloud- and streaming-based services are available for, and increasingly embedded in or bundled with, devices sold.

That said, it may be difficult to address all acts of private copying through market-based licensing. Depending on its specific definition (which varies), private copying can cover acts such as private format-shifting, but also copying to 'close friends', copying CDs and films from a public library, or 'time-shifting' of audiovisual content on a recordable set-top box, for instance. Thus, there may indeed be harm to rights holders for which fair compensation is due. Also, if the current system were phased out and replaced by licensing, a further concern would be that the cultural initiatives that rely on levy-based funding would be unlikely to benefit from a fully market-based system. If this compensation cannot be fully addressed by licensing, and a hardware-based levy system is not optimal, is there a better alternative?

Public funding as a complement where markets fail?

Where licensing is not possible or is incompatible with policy objectives, the other main alternative to levies is public funding. The variants of this option include remuneration directly from the existing state budget; increasing the tax base and budgeting specifically for this purpose; a state-owned fund, which would have a clear mandate to remunerate rights holders for private copying; and funding private copying remuneration as part of media payment, lottery funds, or compensation sourced from part of VAT on music and/or hardware sales.

Public funding is ultimately raised through taxation—paid by consumers and companies—as are any other compensation mechanisms such as device-based copyright levies. In this sense, any form of (non-lump-sum) taxation has some distortion on the economy. However, levies on products may not be the most efficient way of raising funds. Indeed, there is a large literature on the theory of optimal taxation (see the box below). In general, a salient finding of this literature is that, if taxes cannot be targeted to address a negative externality (as a ‘Pigouvian tax’ would do⁶), it is more efficient to collect the desired revenues through uniform taxation. A device or media levy cannot, in practice, be targeted at specific users who, first of all, privately copy their content, or do not use licensed services. Hence, the system may disproportionately burden consumers and manufacturers of hardware without having any significant relationship with private copying behaviour.

Public funding also has the advantage that it more effectively meets the key criteria outlined earlier.

- It would provide stability in payments to rights holders, since their remuneration would no longer depend on variable sales of hardware—or, indeed, resolutions of continuing legal disputes.
- The system is likely to have a simpler administrative burden, since it can form part of the current tax system. There would be some administration in, for example, determining the amount collected, but the current administration and reporting costs to manufacturers, importers and vendors could be avoided.
- The public funding schemes would be unlikely to distort licensing incentives because the duplication of charges for private copying (ie, both the licence and the levy) would be reduced or removed altogether.
- It would not create any distortions beyond those already embodied in the tax system.
- It would allow greater targeting for equity reasons, since it is easier to control the progressive nature of the income tax system than is the case with commodity taxes.

Where licensing is not possible, some form of tax collection and redistribution is the main way of compensating rights holders for harm from private copying. The current system of levies has several problems, and using general taxation to complement licensing could be an alternative, but imperfect, solution. However, it may well be an improvement on levies, for reasons of administrative simplicity,

What can be learned from the theory of optimal taxation?

Taxes can impose welfare losses on society by increasing prices and reducing quantities sold. The sum of these costs is almost always greater than the revenue raised—ie, there is typically a deadweight loss from taxation. Hence, a key goal of tax design is to minimise this loss where possible. There is a substantial literature on the theory of optimal taxation. While much of it inevitably relies on theoretical results, there are several relevant lessons for the design of alternatives to copyright levies.

- Lump-sum taxes are generally the most efficient form of taxation (since they do not alter any marginal incentives). However, in practice, such taxes are rarely implemented due to equity concerns that the tax falls equally on the rich and poor.
- Given that lump-sum taxes may not be politically desirable, marginal taxes on commodities, labour or capital are typically used instead. In terms of

commodity taxes, Atkinson and Stiglitz (1976)¹ have shown that (where taxes cannot be linked to externalities) it is optimal to tax all goods at the same rate—put another way, special taxes on certain goods (such as copyright levies) are sub-optimal. The intuition for this is that whatever the optimal distribution of post-tax income across individuals, the disincentive effects of achieving it are minimised if individuals’ consumption choices are undistorted.

- The design of a tax system depends on the equity concerns of the government. The level of progressiveness of the system can be controlled to a greater extent when taxes are raised from income and/or wealth rather than commodities, given that commodity taxes only indirectly target certain groups.
- Taxation involves administration and compliance costs. All else being equal, it is optimal to seek to limit such costs.

Note: ¹ Atkinson, A. and Stiglitz, J. (1976), ‘The Design of Tax Structure: Direct versus Indirect Taxation’, *Journal of Public Economics*, 6, pp. 55–75.

non-distortionary impacts in consumption decisions, less conflict with licensing initiatives, and fewer distributional implications (insofar as the general taxation is progressive in a given country).

Beyond harm?

Furthermore, if alternatives are considered, it is important to recognise what the current levy regime is actually intending to achieve. So far this article has focused on regimes that would meet the requirement of fair compensation for rights holders. However, it is also worth noting that most collecting societies spend at least some proportion of their revenues on collective cultural purposes rather than direct transfer to rights holders. In particular, copyright levies are used for cultural purposes, such as new, and less commercial, production of audiovisual and music content.

This suggests that a broader approach to determining the level of remuneration might focus not on the harm suffered by rights holders as a result of authorised private copying, but on the socially optimal level of funding for rights holders, taking into account harm and cultural purposes.

There are, indeed, robust economic and non-economic reasons for public intervention and funding of such initiatives. Policy-makers may choose to fund cultural activities for social or political reasons—in economic terms, there are sound reasons to support creation that has wider benefits to society, even if it is not commercially viable. The ‘long tail’ income distribution characterising content industries indicates that a small fraction of rights holders earn the vast majority of the revenues generated, and new or niche creations might not receive sufficient remuneration from sales and broadcasting (with which the distribution of copyright levies is also typically tied).

However, even abstracting from these issues, there may be pure economic reasons to fund culture, since it has some aspects in common with public goods. Digital content can be reproduced at a near-zero marginal cost and has the characteristic that consumption of it (eg, listening to music) does not reduce the amount available for another (non-rival) user.⁷ The absence of rivalry is one of the key characteristics of public goods. It represents the market failure that some users may attempt to ‘free-ride’ on the provision of this good (eg, engage in piracy), and hence fair remuneration is not provided to rights holders and the good is underprovided. This tends to lead to public funding

for public goods in order to ensure that the socially optimal level of the good is provided.

Cultural funding can be at risk if it is predicated on the existence of ‘harm’ from private copying and/or reliant on the sales of devices. Put another way, public funding of new creation may well make (economic) sense, and will be required, even in the not-so-distant future when new forms of content consumption become more widespread and private copying is likely to diminish.

Striking the balance between legitimacy, practicality and economic underpinning

The current system of copyright levies on devices does not fit well with the Digital Age and is not conducive to more market-based licensing. Insofar as these services play an important role in providing consumers with innovative services, providing rights holders and distributors with new revenue streams, and helping to combat piracy, it is important that the private copying remuneration does not become a ‘substitute’ and a structural barrier to digital licensing.

However, the issues with the current system do not necessarily mean that rights holders are not entitled to funding, in the form of either compensation or a subsidy. There is likely to be harm to rights holders that cannot be dealt with by market-based licensing, and, as a separate issue, there are objectives that could be deemed important from a cultural point of view that currently rely on levy revenue.

In all, if the objective is to achieve long-term legitimacy and end the disputes between parties that could benefit significantly from each other, neither continuing with the existing regime nor removing it altogether without any explicit alternative may be appropriate. Countries are currently engaging in debate about reform to the levy system, and it is likely to take some time before new, permanent regimes that suit all stakeholders are put in place. Earlier in 2012, Spain replaced its levy system temporarily with state subsidy from the general budget. At first sight, this new Spanish model seems like a pragmatic approach—compensation for rights holders is achieved with a system that is less likely to be disputed. However, using tax revenues to fund public cultural objectives and complement market-based remuneration can also make economic sense.

¹ European Court of Justice (2010), 'Judgment of the Court (Third Chamber) of 21 October 2010 (reference for a preliminary ruling from the Audiencia Provincial de Barcelona – Spain) – PADAWAN SL v Sociedad General de Autores y Editores (SGAE)', case (C–467-08), October.

² See, for example, Oxera (2011), 'Is there a Case for Copyright Levies? An Economic Impact Analysis', prepared for Nokia, April.

³ It is recognised that there may be some endogeneity here, in that the amount of *net* harm may depend on the remuneration mechanism chosen.

⁴ Oxera (2011), 'Competing with "Free"? The Damages of Music Piracy', *Agenda*, October.

⁵ Kretschmer, M. (2011), 'Private Copying and Fair Compensation: An Empirical Study of Copyright Levies in Europe', independent report commissioned by the Intellectual Property Office, October, pp. 68–9.

⁶ This is a tax on a product or good to correct for the negative externalities that it causes.

⁷ Fang, H. and Norman, P. (2010), 'Optimal Provision of Multiple Excludable Public Goods', *American Economic Journal: Microeconomics*, 2:4, pp. 1–37.

If you have any questions regarding the issues raised in this article, please contact the editor, Leonardo Mautino: tel +44 (0) 1865 253 000 or email l_mautino@oxera.com

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