

# An Economic Perspective on Intellectual Property: The Case of Copyright

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*How to efficiently define intellectual property rights*

**T**his article will introduce the economic theory of property rights. It will then examine the characteristics of copyright protection in light of this theory.

A property right can be defined as a legally enforceable power to exclude others from using an object (Merges 1994). If you have a property right in A, the rights of use, possession and disposal of A are concentrated in you. Anyone else who wants one or all of these incidents of ownership of A has to make a voluntary bargain with you to obtain it.

A normative economic theory of property can track the establishment of property rights, and prescriptions about how to define such rights, with increases in benefits to society, thus providing a utilitarian justification for property rights.

For public policy purposes, economics can also alert the policymaker to the trade-offs involved in specifying property rights. How much weight is to be placed on each side of a trade-off depends on quantification of both sides of the trade-offs and the priorities of the policymaker.

## The Theory

Property rights benefit society in two ways: by allocating ownership and by encouraging production.

By performing a function of allocation, property rights facilitate social order. If it were possible for an unlimited number of individuals to use the same object simultaneously in any way they wished, there would be no need for the assignment of property to owners, which is a fundamental concept of property rights.

There are alternatives to not assigning objects to owners.

One is that people would be constantly fighting to hold on to their possessions. In the process they would be expending resources on private security measures such as locks and weapons (Epstein 1985).

Another alternative is that these objects belong to the

community. Holding 'personal property' in common ownership may entail very high transaction costs<sup>1</sup>.

The problem of transaction costs might be less serious in the case of land held in common, but there are other problems. Individuals would be more likely to use the land for their own private benefit rather than preserve it for the common good, because the cost of misusing or neglecting the land is spread among the co-owners.

Another characteristic of a property right is that all the incidents of ownership – use, possession and disposition – are concentrated in one owner. This avoids the possible high transaction costs of splitting the incidents of ownership between different people, such as the one entitled to sell the property, the one in exclusive possession and the potential buyer.

Property rights tend to ensure that objects go to those who value them most, where 'value' is measured by the amount of money someone is willing to pay for the object (Posner 1979).

This subjective 'value' is important because it is an indirect measure of well-being or happiness. Assigning objects to owners helps lower transactions costs and facilitates opportunities for trade, from which everyone benefits. Aside from informational problems, a trade will not occur unless both sides believe the exchange would increase their respective well-being, so a foregone opportunity for voluntary trade is likely to imply that the well-being of individuals is not as high as it could be.

Many of the goods we value are the products of human ingenuity. Under a property rights system, whoever makes an object owns it, if it is made using his initial entitlements and/or other objects secured through trade. Improving the value of our property – agricultural land

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<sup>1</sup> Transaction costs can be defined as the costs of transferring the incidents of ownership, which includes the costs of negotiating and arranging payments, etc.

or capital equipment, for example – allows us to appropriate this value through subsequent sale or further production. Thus property rights also provide an incentive to increase production and productivity.

Production and ownership benefits of property rights allow for greater marketing and production possibilities, including more elaborate coordination of production. The security of holdings alone is likely to free up the resources previously expended on private security and transaction costs. Thus the size of the ‘social pie’ representative of goods and services produced and consumed (another proxy for well-being) is likely to increase. It is unlikely that parties will be worse off than they were under the commons. If this is the case, some of the gains from the transition to property rights can in principle be redistributed to the ‘losers’ to ensure that they are better off – or at least no worse off – than before.

However, there are also drawbacks associated with property rights<sup>2</sup>.

The first is the cost of enforcing property rights. These may include paying the State to appropriately define, enforce and protect the boundaries of property via torts, criminal law, etc. The cost of determining whether a property right has been infringed is a component of this.

The second is the cost of transferring property rights, or transaction costs.

The third cost, rent-seeking costs, mostly arises with respect to pre-existing property such as unoccupied land. One example of a rent-seeking cost is the cost of farming land before it is profitable to do so, thus reducing the value of the land. This cost was incurred by the *Homesteading Act* in the US which was a way of allocating land based on priority of settlement. An efficient alternative to homesteading would be to auction off the land but this involves administrative costs.

### Copyright

Intellectual creations, unlike physical property, are non-rival goods. This means that they can be enjoyed by more than one person simultaneously without anyone interfering with anyone else’s enjoyment of that good.

By assigning a property right to one owner and allowing that owner to dictate the conditions of its dissemination, intellectual property creates an artificial scarcity.

However, intellectual property is supposed to stimulate

the production of more intellectual creations. If so, it means that without intellectual property protection, much of the dissemination of intellectual creation would not be happening in the first place. You cannot disseminate something that does not exist, or would not exist without the guarantee of intellectual property rights.

Copyright generally gives intellectual property protection to artistic and literary creations, though it has also been applied to computer software. To qualify for copyright, a work must meet modest requirements, usually originality in a very general sense.

However, protection is also relatively modest. It enforces property rights by controlling the right to make copies of these works (using ‘copy’ in a generic sense to include staging a performance) such that a license, with payment of royalties, must be negotiated with the copyright holder before copying is allowed. There are

exceptions to this, such as fair use – for educational purposes, for example.

Copyright is said to apply to the copying of expression rather than ideas. Our economic perspective will illustrate how despite the inept phrasing – expression being just another idea, about how to convey an idea or ideas – this dichotomy captures a coherent policy balancing process. Furthermore, copyright does not prevent independent creation of the same work. Copyright is granted for a relatively long term, usually the

duration of the author’s life plus 50 years.

In a model by Landes and Posner (1989), the cost of producing a work which can be copyrighted – in this case, a book – can be broken down. There is the cost of creating the work – the author’s time and effort – and the cost of expression: the cost to the author of finding a publisher and the publisher’s cost of editing, publishing and distributing the resulting books. The analysis can be further simplified by ignoring the distinction between the costs to the author and publisher in the expression costs component.

The important difference between these two components is that the cost of creation does not vary, no matter how many copies of the work are created. Once the author has created the work, it can be incorporated into a book without any further cost to the author, or any other copier.

In the absence of copyright protection anyone can get

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<sup>2</sup> The following discussion is drawn from Friedman (1998: Ch.10)

hold of a work when it first appears and sell copies of it. In a perfectly competitive market, the price of copies of the work would be bid down to the marginal cost of copying – the cost of making an additional copy. One does not have to believe that a perfectly competitive market really exists in order to appreciate the strong likelihood that an author would not be fully compensated for the costs he or she has incurred. The model implies that only the ‘copying’ component but not the ‘creation’ component will be returned to the author.

Perhaps some authors may get pleasure from the act of creation, and so, do not need to be fully compensated. But this may not be true of all authors – copyright has implications for creators who may not possess artistic motives at all – so there will be underproduction of copyrightable works. Also note that we are talking about creation of works for dissemination. A may be willing to buy a story for \$10 but if that story is merely a manuscript in B’s desk drawer, then an opportunity for mutually beneficial exchange has been lost, because B might be afraid to publish the story without copyright protection.

Sceptics might ask why literature flourished before there was copyright. One answer is that we do not know if even more works would have been produced if copyright had existed. Another answer is that technology has constantly been changing.

The cost of copying is now lower than it has been in the past, and unauthorised copying is easier. Some argue that this renders copyright ineffective, but this is equivalent to arguing that the enforcement costs are higher so that the net benefits of establishing copyright are lower.

This argument is misleading – there is a stronger positive relationship between the benefits of copyright and the ease of copying technology than there is a positive relationship between the ease of copying and enforcement costs (Friedman 1991).

The enforcement costs of copyright might not be worth incurring if copying technology were so primitive that only a few copies a year of a book could be made, because one would be enforcing copyright merely to collect royalties from a few more copiers. The high cost of copying would serve as de facto copyright protection.

However it might be more worthwhile, not less, to enforce copyright if the ease of copying led to a rise in the number of unauthorised copiers who could be caught and forced to pay royalties. Recalling the Landes-Posner model, if improvements in copying technology reduced the cost of copying, this would also mean that the price of a copy of an author’s work would be reduced. This implies that the gap between this cost and the actual total cost of creation and expression would be wider, and thus the

‘underproduction’ problem would be even greater. This might explain why the need for copyright law has arisen, when it was not needed in the past.

### **The Ideas-Expression Dichotomy and Other Puzzles**

Independent creation of a work does not constitute copyright infringement. One reason that this loophole may not significantly undermine copyright protection is that the possibility of independent recreation of a work is quite negligible (Friedman 1998: Ch.11).

The segment of the intellectual commons which an author appropriates in writing a book and claiming copyright for the ‘expression’ in that book is fairly negligible compared with what is left for potential and future authors to use. Despite the prolific works of Stephen King, it is unlikely that people will run out of horror books to write, much less other kinds of books.

This is relevant to the ideas-expression dichotomy described in the previous section because this dichotomy ensures that the intellectual commons for potential authors to create future works is not depleted.

This rule aims to protect the greater good; all parties are better off if there is a limit to the amount of the intellectual commons that each can claim. Broad claims – often characterised as ideas – which would deplete the intellectual commons, are usually disqualified from copyright protection.

The individualist anarchist Benjamin Tucker argued against the ideas-expression dichotomy on the basis that an expression was simply an idea about how to express an idea (McElroy 1995). Though this characterisation is apt, it does not demolish the coherency of the implicit policy test which judges sometimes use in deciding what constitutes an expression. It is alright to protect an author’s claim to an ‘expression’ but not an ‘idea’ because an ‘expression’ by definition occupies a narrower expanse of the intellectual commons. Thus, by claiming ownership of a particular ‘expression’, the author is not significantly depleting the pool of possible ideas for other authors to draw on and turn into ‘expressions’.

What judges are doing in applying this test is defining the scope or boundaries of an author’s claim to his portion of the intellectual commons on the basis of his work.

It might be worrying that the common law is defining this boundary on what is essentially a trial-and-error basis, with a lot of discretion subject to earlier doctrine. But that is how the common law developed doctrines of property rights and elaborations on the idea of property rights such as torts and contract.

Given that the probability of more than one person writing the same book or composing the same music is

fairly low, why not assign a perpetual term to copyright?

Firstly, enforcing intellectual property boundaries is relatively more costly than enforcing the boundaries of physical property. In addition to litigation and administrative costs, costs are incurred in monitoring trespasses onto claims (Friedman 1998: Ch.11).

Drawing clear boundaries around an intellectual creation is more difficult than drawing boundaries around physical property. This difficulty adds an element of legal uncertainty for authors and inventors who, after all, depend on the same intellectual commons as those who may infringe their copyright. It may be inconvenient for authors to have to determine at every stage of creation whether their intended act infringes on someone else's property rights.

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It is relatively easy to detect a copyright infringement in most cases, particularly when there has been verbatim reproduction. The personal nature of artistic and literary creations protected by copyright might lead one to think that disputes about infringement would be easy to settle – even in marginal cases where there has been general appropriation of expression, such as the same plot line, or similar characters or setting.

However with perpetual copyright the number of such marginal cases turning up for litigation would be significantly higher. The longer this perpetual system was in place, the more cases there would be. Ultimately we might end up with horrendous transaction costs involved in tracing the evolution of one's ideas and contacting the copyright holder. Both literature and the arts borrow from many different sources.

In addition to all this, the costs of creating a new work are reduced with each work that passes into the public domain, because a creator would pay fewer royalties for prior works borrowed in the process of creation (Landes and Posner 1989). This cost would be less important for a creative genius but would be relevant to the average creator.

Bearing all the above considerations in mind, it is likely

that potential authors and inventors would reject the notion of perpetual copyright.

### Conclusion

This essay has attempted to demonstrate that the considerations by which economists might evaluate the social utility of traditional property rights apply equally to intellectual property rights, with a particular focus on copyright. More importantly, these considerations yield a reasonably coherent argument for establishing property rights for intellectual creations, based upon the implicit criteria of overall well-being of individuals.

Using the economic perspective, major features of copyright doctrine can be plausibly explained. Positive and normative concerns are necessarily tied up in this narrative. This is because copyright legislation and common law as it has developed has been reasonably efficient in developing the institution of intellectual property for society's needs. Thus the recommendations which a utilitarian approach would have yielded have been duplicated – whether consciously through statute, or unconsciously evolved through common law.

I have not attempted an explanation of every aspect of copyright doctrine. But hopefully the ones presented here can give a basic idea of how the features of intellectual property can be fine-tuned using the versatile economic perspective of exploring the trade-offs involved in property rights, in order to yield greater benefits to society.

*Policy*

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