

**DANGEROUS EXCEPTION: THE DETRIMENTAL EFFECTS OF INCLUDING
“FAIR USE” COPYRIGHT EXCEPTIONS IN FREE TRADE AGREEMENTS**

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Executive Summary

Copyright, appropriately bounded by exceptions and limitations, incentivizes creativity and innovation. As trade between individuals and firms in different jurisdictions has expanded, the importance of securing, at least, minimum copyright standards has similarly increased.

Over the course of the past fifty years, multilateral, regional and bilateral trade agreements have helped reduce barriers to trade between individuals and firms in the United States and those in other countries. Most of those agreements contain provisions establishing minimum standards of protection for copyright as well as a “three-step test” for exceptions to and limitations on the scope of copyright protections, as developed under the auspices of the Berne Convention. We argue that such provisions can enhance trade by improving the clarity of rights of creators and users – and thereby promote increased levels of creativity and innovation.

The United States is currently in the process of negotiating several major new agreements, including the Trans-Pacific Partnership (TPP). The successful conclusion of this agreement will be advanced by a Congressional grant of Trade Promotion Authority (TPA). Any new TPA bill must avoid specific language on exceptions and limitations which would mandate that our trading partners implement U.S.-style fair use exceptions to copyright or to permit trading partners to implement their own exceptions that don't comply with the three-step test. Such changes would ultimately be harmful to consumers both here and around the world. Moreover, because the United States' fair use rules may be incompatible with the legal systems in some jurisdictions, and in others might not be the most suitable form for exceptions and limitations, negotiators should not succumb to pressure to write a U.S.-style fair use exception into these international agreements.

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"No man but a blockhead ever wrote except for money"

– Samuel Johnson¹

Introduction

In the context of ongoing negotiations of the Trans Pacific Partnership (TPP) and deliberations over trade promotion authority (TPA), some organizations have been advocating for the inclusion of U.S.-style fair use exceptions and limitations to copyright. This brief looks at the evidence for and against mandating the adoption of a U.S.-style fair use exception and, in particular, at the implications of requiring countries to adopt such an exception in free trade agreements. It begins with a brief exploration of the relationship between copyright, creativity and economic development. It then considers the economics of copyright and fair use, applying these to a networked global marketplace. The brief concludes with an assessment of current debates around fair use exceptions in free trade agreements and TPA.

Copyright, Creativity and Economic Development

Creative industries tend to occur in clusters: think of Los Angeles (movies), Nashville (country music), New Orleans (jazz), the Bay Area (computers and software), and Milan (fashion). Research by Mercedes Delgado, Christian Ketels, Michael E. Porter, and Scott Stern shows that such industry clusters tend to increase rates of productivity growth, thereby generating more rapid economic growth.²

An important question for policy makers, then, is: what conditions underpin such clusters? An analysis of the emergence of the creative cluster of country music in Nashville by Mark Schultz and Alec Van Gelder highlights the importance of at least three factors: human capital (musicians, entrepreneurs),

¹ BOSWELL, LIFE OF JOHNSON, Vol. VI, chap. iii. (1776).

² Mercedes Delgado, Christian Ketels, Michael E. Porter, and Scott Stern, *The Determinants of National Competitiveness* (NBER Working Paper No. 18249, Jul. 2012), available at http://www.clustermapping.us/sites/default/files/files/resource/The_Determinants_of_National_Competitiveness.pdf

access to physical capital (recording technology), and a good legal environment (enforceable contracts, clearly defined and readily enforceable copyright).

The southern United States in general and Appalachia in particular has a strong musical tradition. Until the 1920s, musicians would typically play traditional songs and standards; there was relatively little original music being produced. Then, in 1927 Ralph Peer travelled to Bristol, TN, where he recorded a series of sessions featuring, among other artists, Jimmie Rodgers, the Carter Family, and the Stone-mans. The sessions were sponsored by Victor, which paid for the recording equipment and manufactured and distributed the records. But Victor did not require transfer of the copyright. Peer was paid a salary of only \$1 per year; his income came from licensing the copyright of original works, which he would purchase from the artists. Peer thus had a strong incentive to encourage artists to produce original work, since traditional songs are not protected by copyright and standards would usually entail paying copyright holders (unless they were out of copyright). Artists, in turn, were likewise incentivized to produce original works in order to sell the copyright to Peer.

Most of the music in the first set of recordings was in fact standard repertoire – the one significant exception being Jimmie Rodgers’ Blue Yodel. But artists quickly realized that it was more profitable to produce original works and began doing so. Meanwhile, other producers soon began copying Peer’s business model. Within a matter of years, a cluster had developed in Nashville around the musicians, producers, and a radio show (Grand Ole Opry) – and today the town is known as the capital of country music, with annual revenues to associated businesses in the billions of dollars.

In Nashville, the key innovation was Peer’s business model, which became the foundation of the entire music industry. That business model was underpinned by copyright. Indeed, it is quite possible that the country music industry, and even popular music more broadly, might never have flourished as it has – or at least would have taken a very different character – without the underpinning legal structure created by copyright law. Modern popular music would be a completely different animal without Berry Gordy’s Motown records and Jobet music publishing business, which were likewise founded on a combination of copyright, local talent and entrepreneurial vision – and which stimulated many copycats.

While copyright was essential to Peer’s – and Nashville’s – success, its emergence was not directly a result of innovations in copyright; rather, it resulted from the intersection of a solid existing copyright law with a strong local musical tradition, some particularly talented artists, and – crucially – the development of new, mobile recording technologies.

The recent resurgence of Zambia’s music industry, by contrast, *is* directly related to the introduction of stronger copyright protection. In the 1960s and 70s, Zambia’s capital Lusaka was a thriving music business hub. The relatively high cost of copying meant that even with weak copyright laws, musicians were able to make a good living recording music. But in the 1980s and early 1990s, cheap, imported pirated tapes killed the industry. Then, following the introduction of a new copyright law in 1994, entrepreneurs began to see – and seize – opportunity once more. In 1999, Chisho Folotoya founded Mondo Music Records, which – much as Ralph Peer had done in Tennessee and Berry Gordy had done in Detroit —

recorded local artists, encouraging them to write and play new songs. Others followed and there is now a thriving local music industry in Lusaka.

The lesson of these examples is fairly clear: creative industries thrive in environments that offer strong legal protections for original creative works. The business models and aggregations of talent that facilitate the creation and commercialization of creative works, and thus the development of self-reinforcing creative communities, are built on strong copyright protections. While, as we will discuss, there is also an important role for limited exceptions to strong copyrights, they must complement, rather than undermine, the fundamental protection of novel creative works.

Specialization, Trade and Copyright

The experiences of Nashville, Detroit and Lusaka demonstrate the importance of enabling individuals and firms to trade with one another, both within and between jurisdictions, to the emergence of creative clusters (and industrial clusters more generally). Trade enables specialization. Individuals and firms are able to focus on supplying those goods and services they are relatively better at producing (this is called “comparative advantage”). Trade also enhances competition, which stimulates innovation and creativity as competing firms seek to offer better products at lower prices.

But for trade to have these beneficial effects, buyers and sellers must be able to define clearly what is being traded and to enforce their rights to own the thing(s) being traded, as well as the terms of the trade. This is true both within and between jurisdictions.

Consider two countries, *S* and *C*, one of which, *S*, has good conditions for farming sheep, while the other, *C*, has good conditions for ranching cattle. If it is possible clearly to define and enforce rights of ownership to both cattle and sheep in both countries, and if transactions may be readily enforced in both countries, then farmers in country *S* will have incentives to produce extra sheep for sale to people in country *C*, while ranchers in country *C* will have incentives to produce extra sheep for sale to people in country *S*.

However, if animals and animal products cannot be owned in country *S*, then farmers in country *S* will have less incentive to breed sheep. At the same time, the inability to profit from the sale of cattle or cattle products in country *S* will reduce the incentive to produce cattle in country *C* — and innovation in cattle breeding, farming, transportation and other related activities will be reduced. Thus, the lack of ownership rights act as a barrier to trade.

In general, if it is not possible to readily to enforce ownership rights for certain kinds of goods in a particular jurisdiction, then there will be less incentive to produce such goods in that jurisdiction — and in other jurisdictions. In the case of creative goods, it is necessary for the ownership rights of the creative work to be recognized and enforceable in both the jurisdiction from which it is exported and that to which it is being imported, as well as for transactions involving the creative work to be legal (i.e. not subject to arbitrary content restrictions, etc.). If it is difficult to own creative works in country *N*, artists in *N* will have less incentive to generate new creative works. To a lesser extent the same will be true for

artists in countries where they are able to own their works, since they will profit less from the sale of their works in N.

That said, creative works that are distributed as copies differ from sheep and cows in at least one important respect: If a farmer sells a sheep or a cow that diminishes the total number of those animals owned by the farmer, but if an artist sells a copy of a creative work that does not diminish the total number of creative works owned by that artist. So, compare a cattle rancher and a musician: If the rancher owns 500 cattle and sells 100, he then has only 400; by contrast, if a musician produces 100 songs, she could sell one copy – or 100 million copies – of each of those songs and she would still have 100 songs.

On the one hand, this ability to sell many copies of the same creative work offers great opportunities for artists. On the other hand, it poses a challenge for them, since purchasers of a copy might try to sell or give away additional copies, thereby potentially diminishing the receipts of the person who produced the original work (since they are presumably less likely to sell the same work to the same purchaser).

Digital technologies have increased the scale of this conundrum by enabling essentially perfect copies to be made of almost any creative work. Meanwhile, the Internet enables such copies to be distributed to almost anyone, almost anywhere, almost instantly. Digital distribution thus both increases the potential market for creative works and increases the potential scale of the impact of non-permitted copying.

In an ideal world, artists might, when they sell a work, simply include a term in the contract of sale prohibiting the creation of additional copies of that work. In practice, however, there tend to be significant challenges involved in preventing unlicensed reproduction, not the least being the cost and difficulty of obtaining legal relief when copying involves a complex chain of individuals, some of whom have not been given notice of the original contract term. The high transaction costs associated with such a contract-based approach to protection of creative works offers one explanation for the property rights systems that have emerged and, in particular, for the systems of copyright that exist in most countries.

Copyright provides creative artists and those to whom they assign their work with exclusive rights to reproduce those works. Thus, any copy of a creative work that has not been expressly permitted by the owner of the copyright may be deemed illegitimate and the producer and/or holder of the copy may be held to have violated the copyright. Copyright works as a means of protecting creative works when individuals producing and distributing non-permitted copies of those works may be subject to legal sanction or otherwise prevented from engaging in such production and distribution.

The expansion of digital networks across borders, combined with weak copyright enforcement in some jurisdictions, poses a challenge to the traditional single-jurisdiction based copyright model. Specifically, it may be possible for a person in country P to access creative works produced in country P via an Internet connection to a site in country N that has no sanctions against persons distributing such works without permission. In such cases, the weak copyright protection in country N not only reduces the

supply of creative content in both N and P by reducing the number of legitimate purchases of content in N, but it also reduces the supply of creative content in P by enabling some people in P to access content from creative artists in P without payment.

The problem of such “leakage” is increasing in proportion to the availability of bandwidth. Once confined primarily to music (which requires less bandwidth than video), it is increasingly a problem for movies as well. A 2013 study by David Price of NetNames found that “[t]he practise of infringement is tenacious and persistent. Despite some discrete instances of success in limiting infringement, the piracy universe not only persists in attracting more users year on year but hungrily consumes increasing amounts of bandwidth.”³ Specifically, Price found that:

- Worldwide, 432 million unique internet users explicitly sought infringing content during January 2013.
- Three key regions – North America, Europe, and Asia-Pacific – make up a majority of the internet world, comprising 82.6% of all internet users and 95.1% of all bandwidth consumed. Focusing on these regions, an analysis of all ecosystems of the internet commonly used to obtain infringing material (such as bittorrent, video streaming, cyberlockers, and other file sharing networks) found that:
 - Absolute infringing bandwidth use increased by 159.3% between 2010 and 2012, from 3,690 petabytes to 9,567 petabytes. This figure represents 23.8% of the total bandwidth used by all internet users, residential and commercial, in these three regions.
 - 327 million unique internet users explicitly sought infringing content during January 2013 in the three regions. This figure increased by 9.9% in the fifteen months from November 2011 and represents 25.9% of the total internet user population in these three regions (i.e., 1.26 billion internet users).
 - 13.9 billion page views were recorded on web sites focused on piracy in January 2013. This figure increased by 9.8% in the fifteen months from November 2011.

Copyright holders have sought to address the leakage problem through a combination of voluntary agreements with internet service providers (ISPs) and legislative intervention. In the United States, for example, the Center for Copyright Information worked with ISPs to create the Copyright Alert System, a notification system that identifies users attempting to download infringing content.⁴ The information

³ David Price, *Sizing the Piracy Universe*, NETNAMES (Sept. 2013), available at http://creativefuture.org/wp-content/uploads/2014/01/netnames-sizing_piracy_universe-FULLreport-sept2013.pdf.

⁴ CCI Provides First Copyright Alert System Progress Report Highlighting Initial Accomplishments, Center for Copyright Information (May 28, 2014), <http://www.copyrightinformation.org/press-release/cci-provides-first-copyright-alert-system-progress-report-highlighting-initial-accomplishments/>.

thereby gathered is then utilized in a selective way to issue increasingly stern notices to infringers. Following the fifth notice, ISPs may take “mitigation measures,” including bandwidth throttling. In France, the government created a new agency in 2009, known by its initials, HADOPI,⁵ which applied a similar graduated response, mandating increasingly severe restrictions on individuals sharing illegal files. An analysis by Brett Danaher, Michael D. Smith, Rahul Telang, and Siwen Chen found that HADOPI resulted in a significant (more than 20%) increase in sales of music on iTunes, suggesting that HADOPI changed the behavior of consumers, encouraging them to switch from illegal file sharing to legal purchases.⁶

Hollywood and Bollywood: A Tale of Two Copyright Regimes

Like Nashville, Hollywood’s creativity and innovation has been facilitated by entrepreneurs, in the form of producers and studios, who have channeled resources from investors – motivated by the prospect of making a profit. Initially, Hollywood’s revenue – and associated profits – came entirely from theatrical release of its movies. A combination of strong copyright protection, readily enforceable contracts with distributors and theaters, and relatively high copying costs, created the right incentives to invest in new movies and to develop increasingly sophisticated techniques for entertaining audiences.

Over time, new channels for distributing movies opened up, beginning with free-to-air broadcast TV, then videocassettes, then DVDs, then narrowcast, encrypted cable and satellite, and now streaming and downloading over broadband connections. While each of these new channels has in principle increased the potential size of the audience for movies, it has also increased the potential for piracy.

In the United States, legislators have responded to the threat of online piracy by enacting copyright protections through legislation such as the Digital Millennium Copyright Act (“DMCA”), the No Electronic Theft Act (“NET Act”), and the Technology, Education and Copyright Harmonization Act of 2002 (“TEACH Act”). The existence of such protections has enabled content owners to establish voluntary agreements with Internet service providers (ISPs) under which the ISP restricts access to copyright-protected content that is being shared without the permission of the copyright owner. Under the DMCA, for instance, copyright holders can use a take-down/put-back notice system to restrict access to infringing uses of their works while balancing the rights of digital users.

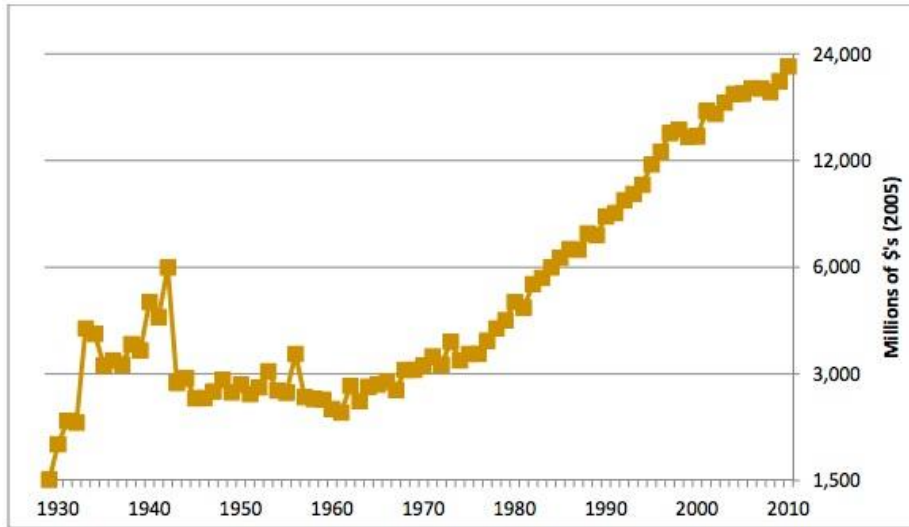
As a result, in the U.S. and other countries with strong copyright protection, most of these new distribution channels have so far generated additional revenue, enabling movie producers to invest increas-

⁵ HADOPI stands for Haute Autorité pour la Diffusion des Oeuvres et la Protection des Droits sur Internet (which translates as High Authority for the Dissemination of Works and the Protection of Rights on the Internet).

⁶ Brett Danaher, Michael D. Smith, Rahul Telang, and Siwen Chen, *The Effect of Graduated Response Anti-Piracy Laws on Music Sales: Evidence from an Event Study in France*, (Working Paper, Jan. 21, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1989240. HADOPI has since been dissolved but most of its powers remain intact and have been transferred to the Conseil Supérieur de l’Audiovisuel (CSA).] See Bertrand Sautier, *HADOPI to disappear and the French graduated response system to be partially dropped*, IPKAT (Jul. 10, 2013), <http://ipkitten.blogspot.com/2013/07/hadopi-to-disappear-and-french.html>.

ingly large amounts in a wide range of movies, from mega-budget “blockbusters” to low-budget art-house films.

Figure 1: U.S. Real Movie Investment, 1930-2010⁷



However, in countries *without* strong copyright protection, these new distribution channels have had the opposite effect, reducing revenue. India’s highly prolific movie industry, based in Mumbai (Bombay) and nicknamed Bollywood, offers a stark contrast. Bollywood movies are nearly all low-budget affairs that stick to a simple formula: three hour long extravaganzas of music, dancing and domestic fantasies. The industry is sustained by theatrical presentations of movies.

Bollywood is forced to stick to its simple, low budget formula because the revenue from each movie is too low to justify a switch to higher budget movies — in part because of the availability of illegal copies and difficulties monetizing copyright. Thus, revenues to the Indian film industry were significantly reduced in the 1985-2000 period due to the widespread availability of bootlegged VCR tapes and re-transmitted video over cable.⁸

While the industry recovered somewhat in the early 2000s due to the popularity of multiplex theaters domestically and the growth of overseas’ audiences,⁹ recent technological trends have reversed this recovery. Piracy has killed the DVD market in India – and would kill the internet licensing market if broadband were more widespread – thereby undermining innovation and creativity in the Indian movie business. (The exceptions, which include movies such as *Kama Sutra* and *Monsoon Wedding*, prove the

⁷ Rachel Soloveichik, *Theatrical Releases as Capital Assets* 34, fig. 6 (Bureau of Economic Analysis, Jun. 3, 2011), available at <https://www.bea.gov/papers/pdf/Theatrical%20Movies%20as%20a%20Capital%20Asset.pdf>.

⁸ See Rahul Telang & Joel Waldfoegel, *Piracy and New Product Creation: A Bollywood Story* (Working Paper, Aug. 6, 2014), available at http://papers.ssm.com/sol3/papers.cfm?abstract_id=2478755.

⁹ See *id.* at 10-11.

rule, since these were specifically produced and marketed to overseas audiences where copyright protection is more secure.)

The impact of weak copyright enforcement is also evident in Switzerland – rare among developed countries in having no enforcement (civil or criminal) of copyright violations resulting from individual downloads of material (music, movies, software). A 2011 Swiss government report on the effects of this lack of enforceability showed that approximately one third of adults downloaded copyrighted music, movies and games without payment.¹⁰ The report notes that while such copyright violations have increased, the portion of disposable income spent on entertainment has remained constant, with the additional spending going on live concerts, cinema visits and merchandising. The report concluded that this justified making no change to the law, and the Swiss federal government agreed.

Unfortunately, this finding ignores the distributional impact of such a shift in spending patterns, and the consequences for investment in creative material. Most obviously, the result will be to reduce investment in recorded music and film and to shift it towards live music and merchandising. Such a shift tends to favor large existing brands (think: the Rolling Stones and Mickey Mouse) over newer and smaller brands. While such forms of creative output and distribution may be beneficial, there is no basis for the policy environment to tip the scales in their favor, when it is at least as likely that consumer welfare would be greater if creators and investors felt free to explore all media and modes of distribution rather than merely those favored by some policy advocates.

One useful comparison is the difference in value added by copyright industries in Australia versus New Zealand. Australia has long had stronger IP protection than its neighbor,¹¹ and in 2004, Australia updated its Copyright Act to more closely match that of the United States'.¹² While Australia has adopted a life plus 70 years regime with fair dealing exceptions and digital age protections, New Zealand has retained a life plus 50 years regime with fair dealing exceptions and has not yet adopted changes to extend protection to the Internet effectively. The legal differences in copyright between the two countries have had considerable impact on the value added by copyright industries. In Australia, copyright-based industries contributed over \$90 billion, or about 6%, of the nation's GDP in 2011.¹³ In New Zealand,

¹⁰ *Copyright infringement on the Internet: The existing legal framework is sufficient*, SWITZERLAND FEDERAL DEPARTMENT OF JUSTICE AND POLICE (Nov. 30, 2011), <http://www.ejpd.admin.ch/ejpd/de/home/aktuell/news/2011/2011-11-30.html>.

¹¹ *Australia and New Zealand*, OPENNET INITIATIVE (2007), available at <https://opennet.net/research/regions/australia-and-new-zealand>.

¹² Austrade, *The Australian–United States Free Trade Agreement*, <http://www.austrade.gov.au/AUSFTA8310/default.aspx>.

¹³ THE ECONOMIC CONTRIBUTION OF AUSTRALIA'S COPYRIGHT INDUSTRIES 1996-97 TO 2010-11, (Prepared for the Australian Copyright Council 2012), available at <http://www.copyright.org.au/pdf/PwC-Report-2012.pdf>.

though, the value added by copyright industries was just \$3.5 billion, or about 2%, of GDP in the same year.¹⁴ Piracy is more common in New Zealand, reducing the value of creation.

These examples show how would-be creators in countries with weak copyright protection suffer because of the lack of ability to benefit from investments in human capital. And the economy suffers because of this reduced investment in human capital, lower levels of creativity and less knowledge-sharing. Most importantly, this in turn reduces choices for consumers, who do not get to enjoy new content.

International Agreements

The benefits of trade are not merely theoretical: empirical evidence overwhelmingly finds that trade leads to economic growth.¹⁵ However, as already noted, for trade to take place it must be possible to own the items being traded. For most forms of creative content, the high transaction costs of relying solely upon contract means that ownership is better protected by a system of copyright. But many countries only offer weak copyright protection, which is thus an effective barrier to trade, harming both creators and users of content in those countries and elsewhere.

Recognizing the importance of copyright for promoting creativity and collaboration across borders, governments have developed a series of agreements that establish minimum standards of protection and enforcement of copyright. Among the earliest of these was the Berne Convention of 1886, under which creative works produced in all signatory countries are automatically protected for defined minimum terms of copyright. Other international agreements include the Buenos Aires Convention (1910), the Universal Copyright Convention (1952), and more recently the TRIPS agreement (1994), the WIPO Copyright Treaty (1996) and the WIPO Performances and Phonograms Treaty (1996) as well as provisions in numerous bilateral and regional free trade agreements (FTAs).

One important problem these international conventions partly overcome is the tendency within any particular country for governments, responding to the wishes of politically influential local interest groups, to protect local artists while providing less or no protection to foreign artists. The prospect of national treatment effectively ensures that interest groups representing local copyright holders, in particular, see the benefits of granting copyright protection to foreign artists.

However, there remain powerful interests in many countries that benefit from weak copyright, ranging from self-described “consumer advocates” to local businesses that profit from illegal content distribution. These interests have continued to challenge the implementation of the various treaties, push for

¹⁴ *Creative Industries add \$3.5 billion to NZ's GDP & WeCreate.org.nz formed to Champion the Creative Sector*, WECREATE, <http://www.wecreate.org.nz/427/>.

¹⁵ See, e.g., Matthias Busse and Jens Koeniger, *Trade and Economic Growth: A re-examination of the empirical evidence* 123 (Hamburg Institute of International Economics Research Paper 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2009939.

the elaboration of wider exceptions and other changes that would weaken the effectiveness of the copyright provisions.

The U.S. has recognized that IP reinforces its comparative advantage and, as such, it is a major proponent of strengthening the international copyright system through NAFTA, TRIPS, the WIPO Internet Treaties and various bilateral and other regional FTAs. Apart from the WIPO treaties, all these agreements were ancillary to larger trade agreements. By linking stronger copyright to agreements that reduced other trade barriers, negotiators were able to establish penalties for breach of conditions, thereby increasing the incentive for governments to implement the copyright components.

The U.S. is currently in the process of negotiating several new trade agreements, including the Trans Pacific Partnership (TPP). This agreement, if concluded, offers potentially significant increases in trade and associated benefits to consumers and producers of all kinds. A 2011 analysis conducted for the East-West Center by Peter Petri, Michael Plummer and Fan Zhai estimates that TPP alone would generate more than \$80 billion in annual benefits to the U.S. economy by 2025.¹⁶

An important factor enabling U.S. negotiators to conclude past trade agreements was the granting by Congress of "Trade Promotion Authority" (TPA). Originally established in 1974, TPA enables the executive to enter into negotiations with clear guidelines as to trade policy priorities and objectives. The resulting agreements were subject to an up or down vote in Congress, without amendment and without the possibility of a filibuster. TPA was extended to cover the negotiations to the end of the "Uruguay round" of world trade talks in 1994. In 2002, Congress granted TPA to George W. Bush, whose administration negotiated a series of bilateral agreements, but it expired in 2007. If this administration is to be able to conclude TPP, it behooves Congress to enact TPA once again. As the legislation that sets out the negotiating objectives for the U.S. trade agenda, it is important that the objectives for intellectual property are robust if the U.S. is going to continue to leverage free trade agreements to advance its comparative advantage.

Copyright Exceptions: The Law and Economics of Fair Use

While avoiding the potentially prohibitive transaction costs associated with attempting to enforce terms limiting copying through contractual chains offers an explanation for the existence of copyright, so transaction costs may also inhibit the creation of some socially beneficial uses of copyrighted material.

For example, there will be some instances in which copyright owners would in principle be willing to license their works to users (including producers of derivative works) but in which the costs of creating,

¹⁶ Peter A. Petri, Michael G. Plummer, and Fan Zhai, *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment* 41, table 12 (East West Center Working Paper No. 119, Oct. 24, 2011), available at http://www.usitc.gov/research_and_analysis/documents/petri-plummer-zhai%20EWC%20TPP%20WP%20oct11.pdf. (Figures here have been adjusted for inflation using a CPI deflator. The original estimate of economic benefits to the U.S. was \$70.8 billion.)

monitoring and enforcing such licenses precludes their creation. Under such circumstances, it makes sense to allow limited licenses by law to otherwise copyrighted content at a zero price.¹⁷

In addition, there may be situations where copyright owners would not license their works at any price because of the nature of the intended derivative use – even though that derivative use results in substantial net benefits to society when the use is permitted. An example is parody. In such cases, a presumptive rule is adopted permitting the use.

Most jurisdictions permit such exceptions and limitations on copyright protection, either specifically or under a broader rubric of “fair use.” For those instances where the barrier to voluntary licensing is the result of the costs of creating and enforcing a license exceeding the expected value of the license, the appropriate boundary of such exceptions is clear. But in practice, laws permitting such exceptions don’t always map well onto this transaction cost dividing line, in part because the dividing line is constantly shifting due to technological changes and legal systems are relatively slow to adapt. Nevertheless, where such laws are generally constrained by a strong rule of law, some form of judicial review, and economically literate judges, the benefits of such exceptions exceed their costs.¹⁸

The difficulty is that the same technologies that facilitate legitimate licensing may also facilitate illegitimate copying and trafficking. Opposition to the latter is not the same thing as opposition to the former, and it is disingenuous to suggest otherwise. But an appropriate stance against piracy — which would benefit creators, legitimate distributors and users alike — does entail appropriate restraints on copyright exceptions, including fair use. In opposing expansive interpretations of fair use and in adopting self-help mechanisms, creators are not challenging widespread access to legitimate copies.

Technologies such as DVRs and MP3 players that predominantly enable users to shift the time, location and/or format of consumption may increase the value of the creative work to the consumer and hence the creator. But there is also a risk that they will be used for illegal distribution of works, reducing in-

¹⁷ Still other circumstances arise in which the law creates compulsory licenses at a statutorily defined rate, permitting some compensation for creators while avoiding the need to negotiate other contract terms.

¹⁸ The U.S. approach to fair use considers the following four factors:

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.

¹⁷ U.S.C. § 107 (2006).

Over decades of development, U.S. fair use law, especially the market value prong, has come to fairly closely mimic the transaction cost model of fair use. The core disputes over fair use in the U.S. center on new technologies, on technologies with both fair and infringing uses – where the application of the law of fair use, if applied improperly, drives a wedge between creators and the law because it authorizes uses that the creator would not approve. The market value test has, in many cases, recognized this tension and operated to minimize fair use’s application where it would deter contracting that would otherwise likely occur.

come to the creator – since it is almost impossible for the creator to appropriate that value.¹⁹ To the extent that the value added by the technologies may be appropriated by creators, it is in the interests of the creator to permit their use – and to develop technologies that minimize infringing uses. But if the infringing use dominates – as was clearly the case with Napster, for example – then it is in the creators and society’s interest for the use to be prohibited.²⁰

Economist George Barker notes that an important effect of the expansion of the digital economy has been to reduce the cost of communication and exchange between copyright holders and potential users.²¹ These reduced transaction costs in turn increase the value delivered by content creators (in part by increasing the amount of content available, in part by delivering content to a larger number of users) and the value derived by users from that content (for the same reasons). To the extent that the digital economy thereby enables agreements between creators and users for applications that might otherwise be subject to fair use or fair dealing exceptions, the expansion of the digital economy obviates the need for some such exceptions. In short, the scope of exceptions should be decreasing, not increasing, as technology lowers the costs of contracting.

In jurisdictions that have well-developed jurisprudence on exceptions to copyright, courts may be expected to take account of the changing technological environment by appropriately changing the boundaries. This is likely to be easier where the exceptions take the form of a more general “fair use” rubric, since such a standard tends to offer more room for judicial discretion. Nonetheless, as the United Kingdom’s Hargreaves Review noted in 2011, the economic benefits of fair use “have sometimes been overstated.”²² This was one reason why Hargreaves concluded that the U.K. should not shift to a fair use system.

As digital distribution and the Internet have reduced transaction costs, the boundaries of exceptions should, logically, contract, not expand. Indeed, it is possible that the existence of fair use exceptions may inhibit the development of mechanisms for simple, low-cost agreements between owners and users of content – with consequences beyond the material that is subject to the exceptions.

Understanding the Law of Fair Use in a Digital, International World

The U.S. has entered into many agreements in the past 20 years that have permitted such exceptions to and limitations on copyright protection. But these exceptions and limitations are not boundless –

¹⁹ Benjamin Klein, et al., *The Economics of Copyright “Fair Use” in a Networked World*, 92 AM. ECON. ASS’N PAPERS & PROCEEDINGS 205, 208 (2002).

²⁰ Ibid.

²¹ See George R. Barker, *Agreed Use and Fair Use: The Economic Effects of Fair Use and Other Copyright Exceptions* (Paper Presented to the 2013 Annual Congress of the Society for Economic Research on Copyright Issues, Jul. 9, 2013), available at <http://www.serci.org/2013/barker.pdf>.

²² Ian Hargreaves, *Digital Opportunity: A Review of Intellectual Property and Growth* 45 (May 2011), available at <http://www.ipo.gov.uk/ipreview-finalreport.pdf>.

otherwise they would undermine the purpose of establishing copyright protection in the first place. Indeed, all trade agreements entered into by the U.S. since 1994 require exceptions and limitations to copyright protection to conform to the same global standard: the three-step test, established under the auspices of the TRIPs.²³ According to that standard:

Members shall confine limitations or exceptions to exclusive rights to

1. ***certain special cases, which***
2. ***do not conflict with a normal exploitation of the work and***
3. ***do not unreasonably prejudice the legitimate interests of the right holder.***²⁴

This three-step test provides a workable standard for balancing copyright protections with other public interests. Most important, it sets flexible (but by no means infinite) boundaries, so, rather than squeezing every jurisdiction into the same box, it accommodates a wide range of exceptions and limitations to copyright protection, ranging from the U.S.'s fair use approach and the fair dealing exception in other common law jurisdictions to the various statutory exceptions adopted in civil law jurisdictions.

Recently, some groups have promoted the idea that U.S. style fair use language should be incorporated in international treaties, requiring all signatory countries to adopt the same legal standard that governs such exceptions in the U.S.²⁵ Given the effectiveness of fair use in the U.S., this is a seductive idea. Unfortunately, however, "fair use" is a concept particular to the United States and a handful of other countries.²⁶ The fair dealing exceptions in the U.K, Canada, Australia, New Zealand, Singapore and South Africa are narrower, though in some cases the lines between the concepts have become blurred.²⁷ But in common law countries both fair use and fair dealing, while now part of statutory law, can be traced to the common law exception of Fairness Abridgement established in the 1740 case of *Gyles v. Wilcox*.²⁸

²³ See, e.g., Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), available at http://www.wto.org/english/tratop_e/trips_e/t_agm3_e.htm; Berne Convention for the Protection of Literary and Artistic Works (as amended on Sept. 28, 1979), available at http://www.wipo.int/treaties/en/text.jsp?file_id=283693; WIPO Copyright Treaty (adopted in Geneva on Dec. 20, 1996), available at http://www.wipo.int/treaties/en/text.jsp?file_id=295157; WIPO Performances and Phonograph Treaty (adopted in Geneva on Dec. 20, 1996), available at http://www.wipo.int/treaties/en/text.jsp?file_id=295578.

²⁴ TRIPs Art. 13 (emphasis added).

²⁵ See, e.g., Electronic Frontier Foundation, *The Three-Step Test*, available at https://www EFF.org/files/filenode/Three-Step%20Test_FNL.pdf.

²⁶ See JONATHAN BAND & JONATHAN GERAFTI, *THE FAIR USE/FAIR DEALING HANDBOOK* (March 2013), available at <http://infojustice.org/wp-content/uploads/2013/03/band-and-gerafi-2013.pdf> (countries that have adopted "fair use" policies include Bangladesh, Israel, Philippines, Poland, South Korea, Sri Lanka, Taiwan, Uganda, United States).

²⁷ See *id.* at 1 ("Although fair use is generally considered to be more flexible and open-ended than fair dealing, this, as discussed above, is no longer the case in many Commonwealth countries.").

²⁸ *Gyles v. Wilcox*, 26 Eng. Rep. 489, 490 (1740) (Ch.) ("[A]bridgments may with great propriety be called a new book, because not only the paper and print, but the invention, learning, and judgment of the author is [shown] in them....").

As such, in common law countries the interpretation of the statutes derives from more than two and a half centuries of case law.

In the United States, rules on “fair abridgement” were largely defined by the 1841 decision in *Folsom v. Marsh*,²⁹ in which Justice Story, sitting as a circuit judge, ruled that a 353 page excerpt of George Washington’s letters from a twelve volume biography was an infringement because the excessive quotation would unduly reduce demand for the original work.³⁰ The law of “fair use” came into its own in the early 20th century beginning with the 1903 case of *Bloom & Hamlin v. Nixon*, where small parts of a song were used in a parody.³¹ For the first half of the 20th century the uncodified fair use doctrine was the main defense to infringement, as Congress had yet to create any statutory copyright exceptions.³² Fair use was finally codified as part of the 1976 Copyright Act.³³

Since that time, fair use law has continued to develop as courts have fleshed out its meaning.³⁴ Changes in technology have driven many legal changes in this area, as innovators and established technologies battled over what counted as infringement and fair use. The clarification of legal boundaries through *ex post* adjudication by courts has the advantage of enabling developments to be based on the facts of each case, building some “fairness” into the development of fair use in accordance with society’s evolving customs and technological sophistication.

Other countries that have attempted to adopt U.S.-style fair use by legislation have not had that long history of developed norms. For example, in 2007, the Israeli Parliament passed a new Copyright Act, Article 19 of which is closely modeled on Section 107 of the U.S. Copyright Act.³⁵ Moving from a regime of “fair dealing” with just a few enumerated exceptions to a more open-ended regime of “fair use” based upon the four factors that govern fair use in the U.S. (but without any jurisprudence to give them definition) has led to a short-term increase in uncertainty. Israeli courts have not had many cases yet before them, so it is not apparent whether Israel’s jurisprudence will track the United States’.³⁶

²⁹ *Folsom v. Marsh*, 9 F. Cas. 342 (C.C.D. Mass. 1841) (No. 4901).

³⁰ *Id.* at 349.

³¹ *Bloom & Hamlin v. Nixon*, 5125 F. 977 (C.C.E.D. Pa. 1903).

³² On the history of copyright and fair use before it was codified, see ALAN LATMAN, FAIR USE OF COPYRIGHTED WORKS, STUDY NO. 14, COPYRIGHT LAW DIVISION, STUDIES PREPARED FOR THE SUBCOMM. ON PATENTS, TRADEMARKS & COPYRIGHTS, S. COMM. ON THE JUDICIARY, 86TH CONG. 3, 7-18 Comm. Print 1960), available at <http://www.copyright.gov/history/studies/study14.pdf>.

³³ See 17 U.S.C. § 107 (2012).

³⁴ See, e.g., Rich Stim, *Summaries of Fair Use Cases*, in COPYRIGHT & FAIR USE STANFORD UNIVERSITY LIBRARIES (last accessed Sept. 4, 2014), <http://fairuse.stanford.edu/overview/fair-use/cases/> (cases cited therein).

³⁵ See Tony Greenman, *Fair Use Under Israel’s New Copyright Act*, COPYRIGHT & PARTNERS, <http://www.tglaw.co.il/en/article.php?id=109>.

³⁶ While Israel’s Supreme Court did apply the four factors of U.S. law under its previous “fair dealing” statute in *Geva v. Walt Disney Corp.*, CA 2687/92, 48(1) PD 251 (1993), the court has only had a few cases on copyright since that time. See *id.*

Given the importance of case law in the development of fair use and fair dealing and the lack of an equivalent body of case law in civil law jurisdictions, the adoption of “fair use” in such jurisdictions is likely to face significant challenges and create significant costs. Initially, there would be enormous legal uncertainty, as in Israel, with two divergent effects. First, many of those who would otherwise have used copyrighted material under the previous system of exceptions might choose not to do so for fear of being in breach of an unclear rule that might be interpreted narrowly by a court. Second, some of those who would not have used copyrighted material (without license) under the previous system will choose to do so in the expectation that, if challenged, their use will be upheld in court. Parsing out these effects, it seems likely that the former group will comprise a majority of less well known, less wealthy individuals and firms, while the latter group will be dominated by wealthier individuals and firms who are able to afford the legal fees to test the system.

More generally, the wholesale importation of “fair use” into other jurisdictions without appropriate restraints may not result in a simple extension of the restrained and clearly elaborated fair use principles that exist in the U.S., but, rather, something completely different, possibly even a system untethered from economics and established legal precedents. In some jurisdictions, it might have the effect of fundamentally undermining incentives to create and trade content, ultimately harming not only producers of such works but also users — surely the very opposite of the intended effect. In many instances the “user” is also a “creator” and as such may wish to benefit from the sale of work that, while derived from previous content, may nevertheless itself be protected by copyright. The introduction of very broad “fair use” provisions might act to actually discourage the creation of many derivative works that the provisions are ostensibly intended to enable.

For these reasons, no U.S. free trade agreement currently *requires* signatories to implement fair use laws. The Korea-U.S. Free Trade Agreement *permits* fair use when it conforms to the three-step test,³⁷ but this is both the furthest any existing agreement goes and is an appropriately restrained statement. Indeed, such language is fully consistent with prior U.S. free trade agreements, none of which include the permissive fair use footnote. This is because the Korea footnote is simply an affirmation of what is already fully possible in other trade agreements. As such, it is deemed by some as superfluous. Importantly, however, fair use in the Korea agreement is restrained by application of the three-step test

³⁷ See US-Korea Free Trade Agreement, Chapter 18, 8 n. 11 *available at* http://www.ustr.gov/sites/default/files/uploads/agreements/fta/korus/asset_upload_file273_12717.pdf (“Each Party shall confine limitations or exceptions to the rights described in paragraph 1 to certain special cases that do not conflict with a normal exploitation of the work, performance, or phonogram, and do not unreasonably prejudice the legitimate interests of the right holder. For greater certainty, each Party may adopt or maintain limitations or exceptions to the rights described in paragraph 1 for fair use, as long as any such limitation or exception is confined as stated in the previous sentence.”).

which has likely helped ensure that Korea's implementation of fair use does not suffer unduly from the problems adumbrated above.³⁸

There is a world of difference between *permitting* fair use and *requiring* it. Out of the 166 members of the Berne convention, only a handful of countries have adopted a version of fair use. It seems fair to presume, then, that the majority of jurisdictions have *chosen not* to adopt such rules. In light of these facts, it makes sense for the U.S. to continue to pursue the path adopted in trade agreements such as Peru or Australia or the Korea FTA. In all cases, fair use is permitted and compliance with the three step test is required.

The contemporary debate over fair use

As noted above, we begin from the reasonable starting point that copyright is important for incentivizing creation and that the key to an effective system of exceptions and limitations is how well the system mediates the boundary between piracy and presumptive, unlicensed use. Note that this tradeoff does not pit owners against creators (as some activists claim), but evaluates fair use on the basis of how well it maximizes joint economic value.

The costs and benefits of fair use exceptions are to a significant degree dependent on the legal and technological sophistication of the particular jurisdiction. Where copying is more difficult and the negotiation and enforcement of legal agreements more expensive, fair use exceptions likely offer greater benefits and impose fewer costs. Where copying is easier and agreements less expensive, fair use exceptions offer fewer benefits and impose greater costs. A one-size-fits-all fair use policy would therefore likely be excessively restrictive in some countries and excessively lax in others.

The governments of the UK, Canada and Australia have recently held inquiries into copyright reform that considered the question of fair use exceptions. The UK and Canadian inquiries rejected the case for expanding fair use, while the Australian inquiry supported expansion. We do not seek to presume to know what is best for any of these jurisdictions, each of which are highly developed common law countries with centuries of case law pertaining to fair abridgement and fair dealing. However, it is worth noting that there is a risk that even in such circumstances the introduction of fair use exceptions may deter the development of better alternatives. In reference to the high transaction costs that inhibit some potential licensing arrangements, the UK inquiry noted that:

It is widely acknowledged that the solution to these difficulties lies in the very technologies that created the problem. Just as digital technologies provide new and exciting ways of using content, they offer a means of transforming the efficiency of licensing.³⁹

³⁸ See Ben Challis, *How will South Korea Implement Fair Use?*, THE 1709 BLOG (Feb. 23, 2013), <http://the1709blog.blogspot.com/2013/02/how-will-south-korea-implement-fair-use.html>.

³⁹ Hargreaves, *supra* note 22, at 30.

The inquiry goes on to discuss the potential for digital exchanges to act as means of enabling rights holders to make agreements with users. But in jurisdictions with broad fair use exceptions, the incentive to develop such exchanges will be diminished.

In addition, U.S.-style fair use rules, which emerged in the context of a common law legal system, are – as the UK inquiry noted – likely not well suited for civil law jurisdictions. Given the mix of legal regimes in TPP countries, as well as other countries with whom the U.S. might at some stage develop new FTAs, it is highly likely that the introduction of U.S. style fair use rules would be misinterpreted in at least some civil law jurisdictions and could result in excessively lax copyright protection, undermining incentives to create and innovate. Further, mandating the inclusion of fair use in trade agreements through TPA legislation would, in essence, force the U.S. to ignore the legal regimes of its trading partners and weaken the protection of copyright in trade agreements, again undermining the incentive to create and innovate.

Conclusion

The United States is currently in the process of negotiating several major new trade agreements, including TPP. The successful conclusion of this agreement will be advanced by a Congressional grant of TPA. On the basis of the foregoing analysis, it would not be appropriate to *require* trading partners to implement U.S.-style fair use exceptions and limitations to copyright, since fair use may be incompatible with the legal system in some jurisdictions and in others might not be the most suitable form of implementation exceptions and limitations.

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