Summary
Economic Reflections on Napster

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Economic Questions raised by Napster

- Are property rights allocated efficiently or fairly?
- How are the basic economics of copyright, the internet and network industries related? (Lecture 3) Lessig’s Law
- What sorts of market structures promote innovation? (Lecture 4) Lessig’s Markets
- Has the market been designed for the benefit of incumbents? (Lecture 5) Lessig’s Architecture
- How can the market power of incumbents be regulated? (Lecture 6) Lessig’s Norms
- What corporate strategies could incumbent firms play faced with innovation in liberalised markets? (Lecture 7)
Lessons for Napster
(from Economic Theory)

- Efficiency and ‘Distribution’ trade-offs exist. That is why we have limited life copyright and patent systems. Higher producer surplus now with higher consumer surplus in the future and possibly higher consumer surplus now.
- Evidence on the negative effect of illegal copying is limited. Not clear that legitimate music effected adversely by previous forms of copying.
- Simple calculations suggest that benefit of illegal copying is large relative to value added of record industry and equipment industry is much bigger than music industry. This implies that consumer and producer surplus higher with copying.
- Experience, overload, switching costs and network externalities are important aspects of the internet. None constitute a new economics of the internet.
- Napster is an alternative distribution network. We must trade-off the benefits of the new network with the efficient use of the existing network and incentives for future network innovation.
- What do record companies do? Firms must have a core competence which justifies economically and socially their continued existence and legal protection.

Unpacking the economics of the Napster case

- **Competition** - what are the benefits of this even if it means loss of existing networks and new fixed costs?
- **Market design** - who gets to design the market rules and what effects will this have on the outcome?
- **Regulation** - given that there may be monopoly power, how do we determine a fair price for products?
- **Company strategy** - in the face of a radical change in market conditions how should incumbent companies respond?
Lessons for Napster
(from the Wireless Wonderland)

- Governments should have a pre-disposition towards competition as this produces unexpected technological advances.
- Common standards which increase size of the market but do not favour incumbents should be encouraged.
- New entrants founded by bright young individuals should be encouraged as this has positive externalities for whole economy.
- As Lessig suggests in *Code* both *markets* and *culture* are important parts of economic the environment in Finland.

...Defending incumbents in network industries should have an economic health warning!

Lessons for Napster
(from Californian Electricity)

- Markets are designed and do not exist by accident.
- Incumbents have undue influence.
- Incumbents getting may get it wrong for themselves.
- Governments (and committees) are bad at technicalities of markets.
- Ensuring worthwhile investment crucial.
- Trading collapses if market is badly designed. This has enormous costs.
Lessons for Napster
(from UK regulation)

- Trade-off between adequate return to incumbents for developing/maintaining network and fair prices lies at the heart of public policy towards distribution networks (including music distribution).
- Regulatory bodies can and do regulate prices on the basis of cost and rate of return. Any regulatory system must maintain pressure on incumbents to reduce costs, innovate or yield market share to innovators.
- Comparators (such as Napster) play an important demonstration effect and have value to society for that reason. Caution should be exercised in letting incumbents take-over new entrants (or each other) and hence the number of comparators.
- Levies can be added to the price of monopoly services to support innovation, e.g. to support artists if we think they are being damaged by Napster.

Lessons for Napster
(from corporate strategy)

- Cost Leadership
  - Drive down costs of music distribution.
- Product Differentiation
  - Improve quality of conventionally distributed music.
- Focus
  - Concentrate on high willingness to pay yuppie market.
- Customer Solutions
  - Offer range of music appreciation services: internet, CD, cassette etc.
- Lock-in Strategy
  - Seek better security for recordings to prevent copying.
- Strategic Alliances
  - Team up with Internet distributors.
Class Debate

- Debate: What strategies can/should record companies adopt in the face of technological disruption?
  - Group 1: Is Hollywood Failing to See the Big Picture?
  - Group 2: A Case of Piracy Overkill?
  - Group 3: Is the threat of online piracy receding?
  - Group 4: Suing Your Customers: A Winning Business Strategy?
  - Group 5: What Price Online Music?
  - Group 6: Trying to Sell CDs by Adding Extras

- Each group to prepare a one slide (2 minute) argument.

Coursework Hand-in Details

- To Paula Tyler at JIMS (A1.07).