

Evaluating the Demsetzian Trend in Copyright Law

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Copyright law provides an excellent case study with which to evaluate Harold Demsetz's theory of property rights. Regardless of how one feels about the relationship between property and intellectual property, it is hard to escape the fact that intellectual property rights have expanded and grown more property-like and more privatized in recent decades. In this article, I critique the undeniable Demsetzian trend in copyright law and challenge some of the fundamental premises upon which rest the normative arguments for continued privatization and propertization of intellectual resources. First, I focus on the perceived benefits of internalizing externalities, arguing that externalities do not necessarily distort incentives or, more generally, the market allocation of resources. For many externalities, there is no efficiency benefit to internalization (whether accomplished by Pigouvian taxes/subsidies or property rights). In the end, the benefits of internalization must be carefully assessed rather than assumed. The view that increasing the degree of internalization through private property rights inevitably leads to increased incentives to invest in creation or distribution is not well-established in either theory or practice. Second, I focus on the frequently-invoked solution of efficient licensing and the "logic" that property rights should be extended "into every corner in which people derive enjoyment and value...[so that] signals of consumer preference [may] trigger and direct [producers'] investments" (Goldstein, 1994). I argue that a fundamental flaw in this logic undermines the efficient licensing hypothesis. Social demand for individuals' access to and use of copyright protected works often exceeds private demand. Purchasers'/licensees' willingness to pay reflects only their private demand and does not take into account value that others might realize as a result of their use. As I explain, many uses of copyrighted works generate value for third-parties. Finally, drawing from the first two points, I argue that, from a Coasean perspective, both externalities and property rights have symmetrical and reciprocal potentials to

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distort the market allocation of resources. A priori and devoid of context, one cannot say that the potential distortions caused by a property right, externality, or incremental change in a property right have a net positive or negative effect on social welfare.

1. INTRODUCTION

The information economy has risen to prominence in modern industrial economies and the value of intellectual resources has risen prominently as well. According to a recent study, the impact of the United States copyright industries on productivity and growth has dramatically increased over the past 25 years (Siwek, 2002). “In 1977, the last year before the 1976 Copyright Act took effect, [the core copyright industries (motion pictures, sound recordings, music publishing, print publishing, computer software, theater, advertising, radio, television, and cable broadcasting)] contributed approximately \$43 billion, or about 2.2 percent of GDP. From 1977 to 2001, the core copyright industries’ contribution to GDP grew at an average annual rate of 7 percent per year — a rate more than twice that of the GDP overall.” (Cohen et al., 2006; Siwek, 2002)¹ Along with the growing economic importance of the copyright industries, copyright law itself also has risen to prominence in law schools, law firms, corporations, educational institutions, governments, and the public consciousness (Landes & Posner, 2003; Epstein, 2001; Port 2006).

In his seminal article, *Toward a Theory of Property Rights*, Harold Demsetz (1967) famously observed that private property rights emerge and evolve as the value of resources increases and technology and new markets develop to capture that value. His article has been extremely influential both in explaining the emergence and shape of property rights in various societies and in providing a platform for making normative arguments about extending property rights. Demsetz’s work can be read fairly to suggest both a *descriptive thesis*—that private property rights in fact emerge to enable the internalization of externalities as the value of resources increases and technologies and markets emerge to make internalization less costly (more beneficial)—and a *normative thesis*—that the emergence of private property rights to enable the internalization of externalities is desirable (in an economic framework, social welfare maximizing) (Epstein, 2002:515-16). Copyright law is an ideal subject with which to explore both theses.

¹ In 2001, the U.S. copyright industries contributed 5.24% of U.S. GDP, or \$535.1 billion (Siwek, 2002:6). Remarkably, the U.S. copyright industries are a prominent sector in foreign trade, achieving approximately \$89 billion in foreign sales and exports in 2002, of which computer software accounts for approximately \$60 billion (Siwek, 2002: 9-10).

Copyright law provides an excellent confirmation of Demsetz's descriptive thesis. As entertainment, cultural, and software products have increased in economic value and relative importance within the economy as a whole (Cohen et al., 2006; Siwek, 2002), copyright law has evolved to enable rights holders to capture more economic value. While there have been countervailing forces in the past two decades—such as the emergence of digital technology and the Internet as a global communications and distribution system—the copyright system has grown more inclusive and both the core exclusive rights granted under the copyright system and supplemental rights granted by the Digital Millennium Copyright Act² and attainable via contract have grown stronger, enabling greater appropriation of economic value.³

As a matter of prediction, Demsetz's descriptive thesis hardly seems controversial (Carroll, 2005:914-17, 947-48). As the value of resources increases, private property will emerge, adapt, or evolve to better enable appropriation of value. Demsetz does not specify the process by which property rights evolve (Merrill, 2002:333). It is as if the dynamic being described is a natural process, as if the appropriation of value via private property rights is a “natural evolutionary endpoint.” (Frischmann & Lemley, 2007:264 n.21).⁴ Of course, it is not.

Here the descriptive and normative theses merge inappropriately. I do not mean to suggest that Demsetz necessarily meant to make a normative point at all.⁵ Still, much like the manner in which interpretations of Ronald Coase's scholarship have taken his original insights in unintended directions, Demsetz's property theory has likewise been extended to support normative arguments for increased propertization and privatization of valuable resources. In this essay, I critique these normative arguments as applied to copyright.

The evolution of copyright law in recent years should not be understood as the product of natural evolution toward a more efficient, social welfare enhancing state of affairs (not that anyone really thinks it has) (Carroll, 2005:956-57). As most scholars recognize, a better explanation of copyright's evolution is rooted in

² Digital Millennium Copyright Act, Pub. L. No. 105-304, 112 Stat. 2860 (1998).

³ See below Part 2.2.

⁴ See generally Levmore, 2002; Merrill, 2002:332; Banner, 2002:360. Compare Depoorter, 2004:¶48 (arguing “there actually is a degree of determinacy in the evolution of the laws of intellectual property”).

⁵ One commentator asked whether I intended to set up Demsetz as a straw man. That is not my intention at all. While it failed to take into account the process by which property rights evolve and the influence of politics and for that reason has been dubbed “naive,” (Eggertsson, 1990), Demsetz's property theory is descriptively powerful and prescient. I generally agree with his descriptive thesis but disagree with the normative spinoff, particularly in its emphasis on privatization of valuable resources.

public choice theory.⁶ That is, Demsetz's descriptive thesis best describes public choice dynamics, at least in the field of intellectual property. As the value of intellectual resources increases and new technologies and markets emerge, the pressure of special interests to create and extend private property rights likewise increases.⁷ Of course, that by no means suggests that acceding to such pressure is socially desirable.

To evaluate whether proceeding down the Demsetzian path is socially desirable, one must first appreciate the function of private property rights—at least, from Demsetz's point of view. Demsetz (1967) argued that the primary function of evolving private property rights is to internalize externalities. (The emphasis on this particular function implicitly leads to the normative thesis.) On this view, private property rights should emerge and evolve to replace commons and allow owners to capture newly created value because otherwise externalities—whether positive or negative—would lead to inefficient disruptions to the allocative efficiency of the market.⁸ Of course, as most economists recognize, not all externalities should be internalized (even if they could be). Accordingly, Demsetz was careful to say that property rights emerge to enable internalization of externalities only when the benefits of internalization exceed the costs. Yet as critics of law and economics regularly point out, the devil is in the details (*e.g.*, what costs and benefits count in cost-benefit analysis?). In a separate essay, *Spillovers*, Mark Lemley and I explain how the traditional law and economics explanation both fails to account for certain social costs of internalization and overstates the benefits of improving private investment incentives. We argue that spillovers (positive externalities) from innovation are “enormously significant to society” and need not be fully internalized through intellectual property rights (Frischmann & Lemley, 2007).

In this essay, I extend our analysis from *Spillovers* and our other work to explain why the “Demsetzian trend” in copyright law is normatively troubling.⁹ By “Demsetzian trend,” I refer to the evolution of copyright law from a “semicommons arrangement” towards a more complete private property

⁶ See, *e.g.*, Litman, 1987; Litman, 1989; Merges, 2000:1867-68; Carroll, 2005:916-18; see also Wyman, 2005 (suggesting that a positive theory of how property rights evolve is needed and that such a theory should be rooted in political theory). On public choice theory, see Farber & Frickey, 1991.

⁷ Of course, holders of existing rights have a greater incentive to enforce their existing rights as well. At times, it may be difficult to distinguish increased efforts to enforce existing rights, efforts to extend existing rights, and efforts to create new rights. There can be little doubt that all three dynamics have occurred in the copyright arena.

⁸ See below Part 3 (explaining this view of externalities and challenging it).

⁹ Both pieces were written during the same timeframe, and each borrows from and builds upon the other.

arrangement designed to better facilitate appropriation of value through private ordering (exclusion, control, and transaction). I argue that copyright in particular is the intellectual property system that ought to be the least private-property-like.

Copyright is a system designed to both internalize and promote externalities. While this view may seem in direct conflict with the view of copyright as a system designed to create incentives, it is not. Incentives and externalities simply are not mutually exclusive (Cohen, 1998:514); more of one does not necessarily lead to less of the other, and copyright law promotes both. As I explain below, the copyright system creates *semicommons*—a complex mix of private property rights and commons.¹⁰ As such, the copyright system is designed to be “leaky” to keep spillovers flowing, as it should be for both supply-side and demand-side reasons discussed below. As Demsetz might predict, technology and markets have evolved along with legal rights to plug in the holes—“perfect” the private property rights—and thereby enable owners to better appropriate surplus. As I argue below, this evolution is suboptimal and politically (rather than naturally) driven.

Saul Levmore (2002) suggested that the Demsetzian evolution of property rights often can be explained by an “optimistic” transaction cost story or a “pessimistic” public choice story (see also Levmore, 2003). For copyright, this is true. There is an optimistic story of dramatically reduced transactions costs due to technological advancements in distribution media, digital rights management, encryption and mass market shrinkwrap licenses. There is also a well-documented pessimistic public choice story of special interest lobbying and influence over the legislative process (Litman, 1987, 1989; Levmore, 2003:184-89). A careful examination of the premises underlying the optimistic story (i.e., the supposed causes for optimism) and the economic functions of the copyright system ultimately support a pessimistic assessment of the Demsetzian trend in copyright law.¹¹

¹⁰ According to Henry Smith (2000): “In a semicommons, a resource is owned and used in common for one major purpose, but, with respect to some other major purpose, individual economic units—individuals, families, or firms—have property rights to separate pieces of the commons. Most property mixes elements of common and private ownership, but one or the other dominates. A person has private rights to the moving spot of the highway that her vehicle occupies, but a highway is considered to be a ‘commons’ because that is its more significant aspect. Similarly, a parcel subject to an easement for emergency services is considered to be ‘private.’ In what I am calling a semicommons, both common and private uses are important and impact significantly on each other.” See also Heverly, 2003.

¹¹ To be clear, in this article, I do not evaluate the “pessimistic” public choice story, which is told in significant detail elsewhere (Litman, 1987, 1989). My objective is not to explain how copyright law has evolved but rather is to critique the normative case for increased privatization and propertization. Cf. Levmore, 2003:188-89 (distinguishing between the story told about how the law evolves and the normative assessment of resulting system of rights).

2. DEMSETZ AND COPYRIGHT

Copyright law provides an excellent case study with which to study and evaluate Demsetz's theory of property. Regardless of how one feels about the relationship between property and intellectual property,¹² it is hard to escape the fact that intellectual property rights have expanded and grown more property-like and more privatized in recent decades. There has been an undeniable Demsetzian trend in copyright law. To understand and evaluate this trend, the neoclassical law and economics account of private property rights is essential.¹³

2.1. THE NEOCLASSICAL LAW AND ECONOMICS THEORY OF PROPERTY

The most fundamental economic function of private property rights¹⁴ is to enable *the market* to work efficiently. Private property rights economize on both the costs of exclusion and transaction and thereby facilitate appropriation of surplus generated through the use of private resources. It is the improved capacity to appropriate surplus—whether through one's own private exclusive use or by transferring one's rights to another—that improves incentives to invest in the production, development, and management of property.¹⁵

According to neoclassical economic theory, *the market* is an economic system that relies on the price mechanism to efficiently coordinate productive activities and allocate resources to their most productive use. But the market

¹² There are considerable debates ongoing regarding the relationship between property and intellectual property as a matter of doctrine, rhetoric, metaphor, form and function, theory, and many other dimensions (see, e.g., Lemley, 2005a, 2005b; Duffy, 2005).

¹³ According to Neil Netanel (1996:312n.117), “[t]he inclusion of copyright within the post-Coasean neoclassical umbrella began with Harold Demsetz’s landmark essay setting forth the basic tenets of neoclassical property theory.”

¹⁴ I will refer to private property simply as property, and will not discuss common property or government property in this essay. To be clear, I disagree with Demsetz’s view that efficiency requires privatization of valuable resources, and as I have written extensively elsewhere, there is a strong case to be made in certain contexts that particular resources should be managed as commons or government property (Frischmann, 2005a). I do not take up a comparative analysis of different property regimes in this essay, however. My focus is on the normative case for internalizing externalities through private property rights. On the optimal mix of private and commons property, see, for example, Epstein, 1994.

¹⁵ “In general, the ownership of an asset consists of three elements: (1) the right to use the asset (*usus*), (2) the right to appropriate the returns from the asset (*usus fructus*), and (3) the right to change its form, substance, and location (*abusus*). This last element, which amounts to the right to bear the consequences from changes in the value of an asset, is perhaps the fundamental component of the right of ownership. It implies that the owner has the legal freedom to transfer all or some rights in the asset to others at a mutually agreed-upon price. The flexible right of transfer induces an owner to operate with an infinite planning horizon and, thus, to be concerned with the efficient allocation of resources over time.” (Libecap, 2003:145; see also Demsetz, 1998:145).

may fail for a variety of reasons. An important type of market failure concerns negative (positive) externalities—costs (benefits) realized by one person as a result of another person’s activity without compensation (payment). The perceived problem with externalities is that they generally are not fully factored into a person’s decision to engage in an activity and consequently may have a distorting effect on market coordination and allocation of resources (Cornes & Sandler, 1996:39-43; Meade, 1973:15; Arrow, 1970:67).¹⁶

For some time, most economists accepted Pigou’s view that the government ought to “intervene”¹⁷ via the tax or regulatory system and force externality-producing agents to fully account for their actions (Pigou, 1932). Thus, producers of negative (positive) externalities, such as pollution (education), should be taxed (subsidized) at a level that aligns private and social costs (benefits) (Cornes & Sandler, 1996:72-78).

It was Ronald Coase’s challenge to the “Pigovian tradition” that gave birth to the (neoclassical) economic theory of property rights. In his seminal article, *The Problem of Social Cost*, Coase (1960) gave credence to property rights as an alternative to government taxation or regulation as a means of dealing with externalities (De Meza, 1998:270, 270-73).¹⁸ Intending to directly challenge the Pigovian tradition, Coase first suggested that in a world without transaction costs, all that would be needed for the market to function properly are well-defined property rights. In such a world, regardless of how property rights are assigned, everyone who might be affected by the use of the resource to which the property right applies would bargain and (re)allocate rights in a manner that maximizes social welfare (Coase, 1960:19; De Meza, 1998:270). Of course, this theorem, sometimes referred to as the Coase Theorem (to Coase’s dismay),¹⁹

¹⁶ The term “externality” means many things and has been a contested concept in economics for many years (Papandreou, 1994:13-68). Arrow (1970) made clear the importance of understanding that the existence or nonexistence of externalities is a function of the relevant institutional setting, incentive structure, information, and other constraints on the decision making and exchange possibilities of relevant actors (Cornes & Sandler, 1996:39-43). According to Demsetz (1967:348), “every cost and benefit associated with social interdependencies is a potential externality.” Actual externalities exist where benefits or costs are not taken into account by interacting parties because “the cost of transacting in the rights between the parties (internalization) must exceed the gains from internalization.”

¹⁷ Elsewhere, I have argued that the traditional “government intervention into the market” analysis is incomplete and perhaps biased towards market-oriented solutions to public goods, governance, and other social problems (Frischmann, 2001, 2005b:159).

¹⁸ It is important to remember that Coase emphasized the need for comparative institutional analysis in the real world where transactions costs are rampant.

¹⁹ See Coase, 1991; Ellickson, 1989.

only holds in a frictionless world of zero transactions costs, *which is not the world we live in* (ironically, this is the point Coase intended to make!).²⁰

Coase mainly intended to emphasize the importance of taking into account transaction costs when (comparatively) evaluating institutional solutions to perceived market failures. Coase anticipated a role for government above and beyond defining and enforcing property rights, but he thought that role should be limited and evaluated contextually with a full understanding of the reciprocal nature of interdependent relationships²¹ and without a reflexive invocation of externalities to justify government action (Coase, 1960:18; De Meza, 1998:275; Buchanan & Stubblebine 1962:381).

Following Coase, Harold Demsetz (1967) further considered the role of “well-defined” property rights in alleviating market failures associated with the distortions caused by externalities. By definition (within economics), property rights are perfectly defined only in a world without externalities. In such a world, the range of “sanctioned behavioral relations among economic agents in the use of valuable resources” is completely and unambiguously delineated (Libecap, 2003:144; see also Demsetz, 1998). As Libecap (2003:145) explains, “In the limit, if property rights are so well defined that private and social net benefits are equalized in economic decisions, benefits and costs will be entirely borne by the owner,” and thus there will be no externalities. Of course, the real world is not only afflicted with transactions costs, but also is awash in imperfectly defined property rights and externalities (Frischmann & Lemley, 2007; Frischmann, 2005a:967; Epstein, 2002:520; Demsetz, 1998:144).

In his seminal article, *Toward a Theory of Property Rights*, Demsetz (1967) took a different approach than Coase and advanced a theory of property rights evolution where imperfectly defined property rights improve and evolve to meet societal demand for the internalization of externalities. Richard Epstein succinctly captures Demsetz’s three main points:

First, Demsetz articulated a theory that held that property rights are created to facilitate ‘the internalization of harmful and beneficial effects’ on the actor who makes the decisions, that is, the owner.

²⁰ See Coase, 1960, 1988; De Meza, 1998; Ellickson, 1989. On the analogy between transaction costs and friction, see Merges, 1997.

²¹ Coase believed externalities to be reciprocal in nature. He critiqued the notion that polluter A causes homeowner B to suffer a negative pollution externality and viewed the harm realized by B as jointly produced by both A and B because they engage in interdependent activities - manufacturing and homeownership (Coase, 1960; De Meza, 1998:273-74; Cornes & Sandler, 1996:79-80, 86; Buchanan & Stubblebine, 1962:381-82).

Second, Demsetz explained how property rights regimes evolved in response to changes in technology and demand, typically in the direction of greater privatization.

Third, Demsetz argued that this overall social trend was welcome because systems of private property generally outperform systems of common property, because when individuals internalize both the costs and benefits of their decisions they are more likely to advance the social interest while in pursuit of their own personal advantage. (Epstein, 2002:515-16)²²

Each of these points merits consideration. Here I summarize the points, beginning with the second. I revisit them in more detail below in my discussion of copyright law.

The second point is Demsetz's descriptive thesis—that private property rights in fact emerge to enable the internalization of externalities as the value of resources increases and technologies and markets emerge to make internalization less costly and/or more beneficial. According to Demsetz (1967), “[i]t is my thesis...that the emergence of new property rights takes place in response to the desires of the interacting persons for adjustment to new benefit-cost possibilities.” Essentially, private property rights are economically valuable and are subject to supply and demand. While this may seem rather straightforward in hindsight, it is the most famous and widely studied aspect of his paper. Demsetz illustrated his thesis by examining the development of property rights to land among Native American tribes. He also recognized the need for “extensive and detailed empirical work” to test his thesis, and much has been done with varied results. As I discuss below, copyright law evolution fits this thesis rather well.

The first and third points reflect a strong normative thesis—that private property rights should emerge and evolve to facilitate the internalization of externalities and private appropriation of value through exclusion, control, and market transactions. It is debatable whether Demsetz meant to make this normative argument, especially since he initially expressed his thesis in descriptive terms and has since described his original contribution as explanatory.²³ Nonetheless, the normative argument permeates Demsetz's article as well as property and intellectual property scholarship that build from his work, and it is this normative thesis that I will challenge in Part III below.

²² As noted above, I disagree with the notion that “systems of private property generally outperform systems of common property,” and have critiqued this argument elsewhere (Frischmann, 2005a).

²³ See Demsetz, 1967:350, 2002:655.

The normative thesis rests on a series of premises about the relationship between property rights, the market, and social welfare. I examine the premises below.²⁴ The basic idea is that if property owners are both fully encumbered with potential third party costs and entitled to appropriate completely potential third party benefits, their interests will align with the interests of society and they will make efficient (social welfare maximizing) decisions. For example, if land owners are forced to internalize the costs polluting the air or water might have on neighbors, they will pollute efficiently—they will pollute only to the extent that the total social benefits of doing so exceed the total social costs. If they also internalize completely the benefits of their activities, they will have the proper incentive to invest in maintaining and improving their property. Internalization is the “silver bullet” that aligns private and social welfare (Frischmann & Lemley, 2007; Lemley, 2005a:1040-43). On this theory, complete internalization renders the market a near perfect engine for social welfare maximization (assuming markets are competitive and putting aside other possible complications not associated with externalities).

But there are obstacles to nirvana. (I discuss a few below.) In Demsetz’s writing, the primary obstacle appears to be the costs of internalization. Pigouvian taxes or subsidies are one way to force agents to internalize the costs of their activities, and, as Coase pointed out, such government actions may be unnecessary where property rights are sufficiently well defined to allow parties to transact over the distribution of costs and benefits—(external costs/benefits may be internalized within transactions among affected parties). In either case, administrative, enforcement, and transactions costs exist and may be prohibitive. Demsetz clearly recognizes that these costs matter and acknowledges that, at any given time, the costs of internalizing externalities may outweigh the benefits.

Yet over time, Demsetz maintains, property rights systems will evolve and mature (Demsetz, 1967:350; Epstein, 2002:516; Levmore, 2002:421). The costs of internalization²⁵ may fall due to technological developments, for example, and/or the benefits of internalization may increase as the value of the resource rises. As Saul Levmore (2002:421) describes, “the conventional story about the evolution or maturation of property rights,” which originates with Demsetz’s seminal article, “emphasizes that, with increases in value and economic activity,

²⁴ I discuss these premises in more detail below in Part 3.2.

²⁵ Hereinafter, I use “costs of internalization” to refer to the costs of internalization through private property rights. I recognize that depending on the context, externalities may be internalized more cheaply through a variety of other mechanisms (e.g., Pigouvian taxes). My focus is on private property rights, however.

property rights become secure, strong, well defined though malleable and divisible, and increasingly private.”

Increasing propertization and privatization of valuable resources is normatively attractive (and seemingly inevitable in a capitalist economy), according to Demsetzian theory, because of the superiority of the market as a mechanism for allocating resources, coordinating productive activities, and maximizing wealth (Demsetz, 2002, 1967; Netanel, 1996; Cohen, 1998).²⁶ It is this normative vision that I critique in Part 3 below.

2.2. THE DEMSETZIAN TREND IN COPYRIGHT LAW

Copyright law provides an excellent confirmation of Demsetz’s descriptive thesis. Copyright law has never been a system of well-defined property rights with the range of “sanctioned behavioral relations among economic agents in the use of valuable resources” completely and unambiguously delineated. Copyright law has been and still is designed to be leaky with fuzzy, context-specific doctrines and modes of analysis (for example, the application of idea-expression or fair use doctrine or copyright infringement analysis). Copyright law creates a semicommons arrangement—a complex mix of private rights and commons.²⁷ The commons component of copyright law avoids market or government allocation of resources for certain ranges of uses and for certain elements of a copyrighted work.²⁸

Copyright is a system designed to promote externalities, and it has done so since its inception.²⁹ To be clear, externalities arise when value realized by

²⁶ Julie Cohen (1998) critiqued the Lochnerian economic vision of “the relative superiority (as compared with copyright) of common law property and contract rules for protecting and disseminating digital works.” In many ways, this essay parallels and builds from Cohen’s critique.

²⁷ While many scholars refer to the commons component of copyright law as the public domain, I avoid that term here because of potential ambiguity derived from its many different meanings (see Samuelson, 2005, discussing over a dozen different conceptions of the public domain, how those conceptions overlap, and examining their role in copyright discourse). For purposes of this article, the commons component is essentially the absence of private property rights and not necessarily affirmative ownership rights in the form of public or common property.

²⁸ As I argue at length in my recent article on infrastructure and commons management (Frischmann, 2005a), this is the important allocative function of commons.

²⁹ Copyright promotes participation in productive activities that produce public goods (e.g., information) and nonmarket goods (e.g., education). For a discussion of the relationships between public goods, nonmarket goods, and externalities, see Frischmann, 2005a:964-67; see also Lemley, 2005a:1052 (“Indeed, part of the point of intellectual property is to promote uncompensated positive externalities, by ensuring that ideas and works that might otherwise be kept secret are widely disseminated.”); Loren, 1997:25-27 (arguing for a greater recognition of externality-producing uses as fair uses); Lessig, 2001, 2004; Ramello, 2005.

consumers, users and third parties is external to a creator's decision to produce the work and to any transactions involving the work. We might refer to these externalities as spillovers or more generically as the difference between private and social returns. For example, due to its limited duration, copyright has generated temporal externalities. A work that enters the public domain is free for public use, and the value derived from such use is external to the creator's decision to produce the work and to any transactions involving the work. Similarly, due to copyright's limited scope, copyright generates externalities that accrue to other creators, even competitors, as these entities can freely use various unprotected elements of a work, such as an idea, theme, or functional feature. Copyright's limited scope may also generate externalities in complementary technology markets (von Lohmann, 2005). Finally, copyright leads to the production of third-party externalities because of the nature of the intellectual processes people engage in when they create and when they consume different types of expression (Netanel, 1996; Frischmann 2005c) - creating and consuming creative expression of different types develops human capital, educates, and socializes in a manner that benefits participants (that is, creators and consumers) and nonparticipants.³⁰ These are just a few examples.

Within the Demsetzian framework, the existence of persistent externalities suggests persistent demand for property rights evolution to internalize and capture those externalities; such demand only increases as the value of the underlying resources increases. As a matter of fact, and not surprisingly, we have witnessed exactly such persistent demand in copyright.³¹

This persistent demand has led to what some have called the "Second Enclosure Movement" - the privatization and propertization of the intellectual commons (Boyle, 2003:33, 37n.12; Travis 2000). There are numerous accounts of copyright's evolution over the past few decades.³² Suffice it to say that, in

³⁰ While the utility to nonparticipants may be small or even trivial on a case-by-case or work-by-work basis, the aggregate gains to local communities and society on the whole may be substantial. See Frischmann, 2005a (discussing participation in activities that generate small scale but widespread positive externalities); see also Frischmann & Lemley, 2007; Frischmann, 2005b (discussing university research processes that develop human capital and research outputs).

³¹ It is not surprising that there has been persistent demand by copyright owners and various intermediaries that depend upon copyright to extract surplus. For a variety of collective action / public choice reasons, the public has not consciously questioned whether acceding to the pressure of industry is desirable. The basic lessons from public choice theory are on display in the copyright field. For example, we can expect that copyright will be extended too far because the benefits of increased propertization are concentrated and path dependency makes it quite difficult to roll back private rights.

³² Landes and Posner, 2003:406, conclude, "That there has been a trend toward greater protection of intellectual property cannot be doubted." Lemley, 2005a:1042, similarly observes,

accordance with Demsetz's descriptive thesis, copyright law and its complements, such as the DMCA, have evolved to enable rights holders to internalize externalities and appropriate more value as entertainment, cultural, and software products have increased in economic value and relative importance within the economy as a whole.

What are we to make of the Demsetzian trend in copyright law? Is the story an optimistic tale of diminishing transactions costs and more efficient markets or a pessimistic tale of special interest lobbying? What might we expect in the future? What might we wish for in the future? Continued progress in the same direction, or a change in direction?³³ Has copyright law evolved in a socially desirable manner? In this essay, I cannot answer these questions completely. As always, the actual tale is mixed, one of both optimism and pessimism, and, while subject to path dependency, the future remains open. Nonetheless, in the next Part, I offer a normative critique of the Demsetzian trend in copyright law.

3. A NORMATIVE CRITIQUE OF THE DEMSETZIAN TREND

Many copyright scholars have both observed and critiqued the Demsetzian trend in copyright law.³⁴ Their critiques have questioned the wisdom of taking the copyright system too far in the direction of absolute property rights (See, e.g., Lemley, 2005a; Lessig, 2001, 2004; Boyle, 2003; Benkler, 1999, 2000; Cohen, 1998a, 2000; Netanel, 1996).³⁵ At the very core of many of these legal critiques is a fundamental challenge to over-reliance on economic theory and property theory. While legal commentators generally accept the utility of economic analysis to shed light on various tradeoffs being made within the complex intellectual property rights systems and to understand certain behaviors of those operating within the systems, they part ways with economics when it takes a normative spin and becomes prescriptive rather than descriptive. Even

"By virtually any measure, intellectual property rights have expanded dramatically in the last three decades." See also Lessig, 2001, 2004. On the political dynamics, see Litman, 1987, 1989.

³³ Saul Levmore (2002) suggests that the law may evolve from commons to private property and back again.

³⁴ Among legal scholars, economists, and many others that pay attention to copyright law's evolution, there has been a raging debate over the future of copyright. Debates have focused on many issues, ranging from the retroactive extension of copyright duration to whether contractual and technological means of exclusion and control might replace copyright altogether. In this Part, I do not seek to address any of these particular issues. Instead, my aim is to offer a broad normative critique of the Demsetzian trend in copyright law. For a similarly broad critique grounded in a normative commitment to fostering a democratic civil society through copyright, see Netanel, 1996.

³⁵ There are many more.

when accepting utilitarian explanations, justifications, or rationales for the existence of intellectual property and recognizing the economic importance of intellectual property rights, legal commentators often see the intellectual (property) systems as more than economic systems and appeal to various public policies and values that are not well explained or theorized within economic theory, often referred to by economists generically as non-economic or non-market values.³⁶ As a result, arguments in favor of a leaky copyright system are often viewed as simply non-economic or as (re)distributive.³⁷

Economists who have critiqued the Demsetzian trend in copyright law have tended to center their critiques on the social costs of inhibiting or retarding cumulative creativity, although some have also focused on the costs of administering the copyright system and transaction costs.³⁸ As Landes and Posner note, “Copyright’s effect on subsequent producers of intellectual property requires particular emphasis.” (Landes & Posner, 2003:66)³⁹ Creative or cultural works build off of each other and off of many things not subject to copyright. Copyright acts as a tax on the creative efforts of subsequent producers to finance the creative efforts of initial producers.⁴⁰ Increasing the scope and duration of copyright essentially increases the burden on the creative efforts of subsequent producers. While it is difficult, if not impossible, to identify the point at which copyright has gone too far, many economists have expressed skepticism of the current regime in terms of its excessive duration and expanding scope. (Brief of George A. Akerlof et al. as Amici Curiae in support of Petitioners, *Eldred v. Ashcroft*, 537 U.S. 186 (2003) (No. 01-618); Landes & Posner, 2003).

Yet those commentators optimistic about the Demsetzian trend counter both sets of arguments by reverting to Demsetz’s original formulation: Private property rights should emerge, evolve, and extend to enable internalization of externalities only when the benefits of doing so exceed the costs. The costs of internalization are the sum of costs for property rights administration and enforcement and contracting costs. If the costs of externalities are measured in

³⁶ In part, the positive economic functions of commons—or the public domain in copyright—seem underappreciated and perhaps misunderstood. One goal of this article and some of my other work is to develop a better understanding of how commons may improve allocative efficiency.

³⁷ Terry Fisher (1988) proposed a reconstruction of fair use that blends economic and non-economic considerations. Cf. *Merges*, 1997:115, 134-35 (arguing for express recognition of copyright’s redistributive features).

³⁸ See, e.g., Landes & Posner, 2003: 66; Brief of George A. Akerlof et al. as Amici Curiae in support of Petitioners, *Eldred v. Ashcroft*, 537 U.S. 186 (2003) (No. 01-618); see also Buchanan & Yoon, 2000.

³⁹ Landes and Posner (2003:67) provide a series of examples of the “borrowing” and “building on material from a prior body of works” that takes place regularly. And the “examples could be multiplied indefinitely.”

⁴⁰ Two classic explanations of the basic tradeoff are Landes & Posner, 1989; Breyer, 1970.

terms of the distortions they cause, the benefits of internalization are the improved allocation of resources due to the elimination of such market distortions. The notion that over time, private property rights should emerge, evolve, and extend to internalize externalities as the value of resources increases assumes distortions caused by externalities (imperfect property rights) are positively correlated to resource value. That is, as the value of a resource increases, the benefit (cost) of internalization (externalities) increases. With respect to arguments concerning first and second generation producers, there is a simple response: As long as transactions costs are manageable (low), a system of strong/absolute property rights would not inhibit all that much because parties would reallocate rights efficiently in licensing arrangements (Menell & Scotchmer, 2005:23-24; Bell, 1998:584; Hardy, 1996).⁴¹ Moreover, as Scott Keiff (2001) has argued, a system of strong/absolute property rights would force/enable parties to come to the table and coordinate where it is their interest to do so.

In this Part, I critique the Demsetzian trend in copyright law by challenging some of the fundamental premises upon which Demsetz's normative thesis rests. This critique fits somewhere in between the existing sets of critiques, advances them, and better responds to the counterarguments just noted. First, I focus on the perceived benefits of internalization and argue that externalities do not necessarily distort incentives or, more generally, the market allocation of resources. Second, I focus on the licensing solution and argue that purchasers'/licensees' willingness to pay for access and use rights will not adequately reflect social demand in market transactions. Finally, drawing from the first two points, I argue that, from a Coasean perspective, both externalities and property rights have symmetrical and reciprocal potentials to distort the market allocation of resources. *A priori*, one cannot say that the potential distortions caused by a property right, externality, or incremental change in a property right have a net positive or negative effect on social welfare.

The normative critique I offer here is but one piece of a complex puzzle. Unbundling the Demsetzian vision from copyright law's normative future begins with this challenge to the basic premises derived from neoclassical economic theory. In related work, I tackle other pieces of the puzzle. Ultimately, to complete the puzzle, it is necessary to develop a better understanding of the complex (economic) relationships between intellectual

⁴¹ See Cohen, 1998a:475-78 (summarizing arguments of Bell, Hardy and other neoclassical scholars) and 481-95, 519-23 (excellent summary and critique of "cybereconomists' claims about the presumptive efficiency of contract as a vehicle for allocating rights in digital works"); see also Cohen, 2000.

resources;⁴² intellectual systems of production, distribution, interaction, and relation;⁴³ and intellectual property rights.⁴⁴

3.1. THE PREMISES UPON WHICH DEMSETZ'S NORMATIVE THESIS RESTS

Demsetz's normative thesis—that it is socially desirable for private property rights to emerge and evolve to facilitate the internalization of externalities as the value of resources increases and/or the costs of internalization decrease—rests on the following premises:

- (1) Private property rights enable the internalization of externalities.
- (2) Externalities distort the allocation of resources by the market.
- (3) The market allocates resources efficiently.
- (4) Improving allocative efficiency improves social welfare.

Assume, for purposes of argument, that the first and last premises are valid. Leaving aside the fourth premise, let me say a word on the first. The first premise rests on the notion that private property rights economize on the costs of exclusion, control, and transaction and thereby facilitate appropriation of surplus that might otherwise be external. Private property rights do not always enable the internalization of externalities. In the real world at least, there are externalities that cannot realistically be internalized because of collective action problems, imperfect information, transaction costs, and the diffuseness of their distribution.⁴⁵ I address my arguments to situations where a case for internalization can be made within the neoclassical economic framework.⁴⁶ My critique is focused on the second and third premises.

⁴² "Intellectual resources" refers broadly to products of the mind.

⁴³ "Intellectual systems" refers broadly to the social systems by which human beings generate, distribute, interact with, and relate to intellectual resources. There are many overlapping (sub)systems that operate within market and non-market contexts.

⁴⁴ Compare Cohen (1998a:496), which states, "Determining the optimal degree of author/owner control of digital content requires careful consideration of what system of entitlements would be most effective given the public-good nature of creative and informational works and the unpredictable pathways of creative progress."

⁴⁵ Take education as an example. It would be impossible to fully internalize the externalities from education. Education is generally deemed a merit good for which government subsidization is necessary (Musgrave, 1959:13-14; Rogers & Ruchlin, 1971:3-7).

⁴⁶ In addition, Coase's basic insight bears repeating: private property rights are one possible means for internalizing externalities; the case for private property rights must be evaluated contextually, with an eye on transaction costs, and in comparison with other institutional means, including Pigouvian

My basic contentions are that (1) externalities do not necessarily or generally distort the allocation of resources by the market; (2) the market may fail to allocate resources efficiently in cases where consumers' willingness to pay understates societal demand; and (3) (a) even where externalities distort market allocation, such distortions may be social welfare enhancing; or conversely, (b) extending property rights to internalize externalities may distort market allocation in a manner detrimental to social welfare.

3.2. EXTERNALITIES DO NOT NECESSARILY OR GENERALLY DISTORT THE ALLOCATION OF RESOURCES BY THE MARKET

Externalities are ubiquitous in society, and in a wide variety of contexts, externalities are simultaneously valuable to society and yet irrelevant to incentives to invest in the activities that lead to their production (Buchanan & Stubblebine, 1962; Haddock, 2004).⁴⁷ As Mark Lemley and I explain in *Spillovers*:

My decision to plant an attractive flower bed benefits my neighbors and people who happen to stroll by. Your decision to educate your children well, making them into productive, taxpaying, law-abiding members of society, benefits the people who buy the goods they will produce, the people who will receive the government benefits their taxes fund, and the people they might otherwise have robbed. Dan Bricklin's invention of a computer spreadsheet benefited not just his customers, who paid for the privilege, but their customers, who used spreadsheets; Bricklin's competitors, who built on his idea; and all the people who got products somewhat cheaper because the business from which they bought ran more efficiently by using a computer spreadsheet.

Spillover benefits aren't intentionally provided. We don't plant flowers to benefit our neighbors, you don't educate your children in order to give the government more money, and Dan Bricklin certainly didn't develop the spreadsheet in order to benefit the competitors his invention would eventually attract. These benefits are not the result of altruism. Instead, they are incidental "extras"— they spill over to others as a result of decisions you and we and Bricklin made for our own purposes. While seemingly insignificant to us, spillovers turn out to be enormously significant to society. We are all incidental beneficiaries,

taxation or subsidies as well as other forms of property ownership (e.g., common or government ownership). Comparative institutional analysis, however, is beyond the scope of this essay.

⁴⁷ See also Frischmann, 2005a (discussing the role of infrastructural resources in supporting widespread participation in activities that generate externalities).

each and every day. Spillovers “are a ubiquitous boon for society” because we share a common environment, live in communities, and interact with one another. (Frischmann & Lemley, 2007:258-59)

Economically rational individuals⁴⁸ and firms⁴⁹ invest resources and choose activities based on anticipated private returns. From the supply side, the market can be viewed as a disaggregated collection of individuals and firms seeking to maximize their (private) returns subject to their (private) risk tolerances, discount rates and the like. As such, the market allocates resources to uses that foreseeably generate appropriable returns (Frischmann, 2005a). The greater the prospect for appropriable returns, the greater the “pull” on resources.

A simple view of externalities suggests that externalities distort the allocation of resources because there are benefits or costs not being taken into account by the relevant actors; if those benefits or costs were internalized and thus taken into account, the actors would behave differently, for example, by reallocating their resources and efforts to other activities or by adjusting the intensity of their resource allocation and efforts.⁵⁰ This simple view is misleading.

In an important article, *Externalities*, James Buchanan and William Stubblebine (1962) differentiate relevant and irrelevant externalities on the basis of the impact that the external costs or benefits have on decision making by relevant agents. Simply put, relevant externalities are those costs and benefits for which internalization would lead to a change in behavior (resource allocation);⁵¹ irrelevant externalities are those costs and benefits for which internalization would not lead to a change in behavior (resource allocation). Buchanan and Stubblebine suggest that many externalities are in fact irrelevant and thus fail to justify intervention on efficiency grounds. That is, internalizing irrelevant

⁴⁸ For purposes of exposition, I leave aside a variety of issues concerning individual rationality, such as bounded rationality, cognitive biases, and so on.

⁴⁹ For purposes of exposition, I leave aside a variety of issues concerning the firm, such as firm size, ownership structure, and so on.

⁵⁰ Suppose the expected private rate of return on a research project is 15% and the social rate of return is 30%. The 15% difference reflects spillovers from research. The incentive to invest in this research project is shaped in part by the expected private rate of return. The simple idea behind internalizing externalities through private property rights is that stronger property rights will enable appropriation of spillover benefits, reducing the wedge between private and social rates of return and increasing the attractiveness of this research project. As Mark Lemley and I explain in *Spillovers*, however, this view is both too simple and misleading. See Frischmann & Lemley, 2007:276-79 (explaining why we do not need to fully internalize externalities to have sufficient incentives to invest in research). See generally Lemley, 2005a.

⁵¹ Relevant externalities have an effect on resource allocation decisions. We might label the effect a distortion but only relative to some baseline, such as fully internalized costs and benefits.

externalities will not change resource allocation, and thus, there is no efficiency benefit to internalization.

In *Spillovers*, Mark Lemley and I examine the perplexing puzzle of socially significant externalities that regularly flow from innovation (Frischmann & Lemley, 2007). Many econometric studies have found significant spillovers from private research and development (“R&D”).⁵² On the simple view of externalities, this would appear to reflect a significant cause for concern and demand for internalization. Yet it turns out that spillovers from R&D investments do not necessarily or generally undermine incentives to invest and, counter-intuitively, in some cases “actually drive further innovation.” (Frischmann & Lemley, 2007:268).

Inventors do not need to capture the full social value of their inventions in order to have sufficient incentive to create. Society needs merely to give them enough incentive to cover the fixed costs of creation that their imitators will not face. Any greater return is at best a mere wealth transfer and at worst wasteful—it doesn’t encourage any more innovation in the field, and it may actually interfere with downstream innovation and distort behavior in the market. [See below.] Thus, while we need some ex ante incentive to innovate, we don’t need (and don’t particularly want) full internalization of the benefits of an invention. As long as we get enough incentive, the fact that other benefits aren’t captured by the innovator doesn’t impose any real cost on innovation, and may even contribute to innovation. (Frischmann & Lemley, 2007: 276).

As suggested implicitly by Buchanan and Stubblebine (1962), in many cases, investments will be made with equivalent intensity in settings with and without (some) externalities. In such cases, intervention to increase internalization (through additional property rights or Pigouvian taxes/subsidies) cannot be justified on efficiency grounds.⁵³ Innovation spillovers provide an excellent example of Buchanan and Stubblebine’s essential point. Copyright does as well.

⁵² We cite to various studies in *Spillovers*.

⁵³ The point is the presence of externalities does not demand *more* property, taxes or subsidies. This does not mean that *some* property, taxes or subsidies is not justified, however, to provide sufficient incentives to invest in the first place.

Copyright is a system designed to generate both incentives and externalities.⁵⁴ The supply side incentives that copyright affects extend beyond the initial investment in creation to investments in development and dissemination of content. Like traditional property rights, copyright economizes on the costs of exclusion, control, and transaction with respect to certain uses of expression and to certain sets of relationships between creators, disseminators, and consumers; copyright thereby enables rights holders to appropriate some of the surplus generated by their investments in creation, development, and dissemination. In this manner, copyright is designed to generate incentives.

Yet, as discussed previously, copyright also is designed to be “leaky” to generate externalities and preclude rights holders from exercising too much control or appropriating too much of the surplus. As with spillovers from R&D investments, spillovers from investments in creation, development, and dissemination of expressive works do not necessarily or generally undermine incentives to invest.

Keep in mind that I do not intend to attack or defend any particular degree of internalization in this section. My point here is simply to challenge the second premise underlying Demsetz’s normative argument and argue that externalities do not necessarily or generally distort the allocation of resources by the market. Of course, in some cases for certain classes of works, more (less) internalization may lead to more (less) investment. Yet the reverse is also true. That is, in some (other) cases for certain classes of works, less (more) internalization may lead to more (less) investment (Frischmann & Lemley, 2007). In the end, the benefits of internalization must be carefully assessed rather than assumed. The view that increasing the degree of internalization through private property rights inevitably leads to increased incentives to invest in creation or distribution is not well-established in either theory or practice (Frischmann & Lemley, 2007; Lemley, 2005a; Lunney, 2002:1017; Fisher, 1988:1700-01; Akerlof et al., 2003:5-10).

⁵⁴ Giovanni Ramello (2005:3) explains this point as follows: “[T]he main function of intellectual property is...to cause information to be created and disclosed, thereby facilitating a more complex dynamic connected with the special attributes of knowledge. In a sense, the existence of information externalities is the statutory goal of intellectual property: because information is a public good, the likelihood of opportunistic behaviour within this context is amplified and thus IPRs should address this problem. In the absence of specific property rights, any information will inevitably be followed by its near-immediate imitation, without any remuneration for the creator. The function of IPRs, and the specific economic incentives to creators they provide, is to curtail such occurrences and so avoid underproduction of the market oriented information, though only through a limited form of appropriability, which should therefore also assure a sufficiently broad spillover effect.” See also Ramello, 2005:4, which states, “The laws for the protection of intellectual property are (or ought to be) designed to properly solve the trade-off between the privatisation of information and the preservation of information externalities.”

3.3. THE MARKET MAY FAIL TO ALLOCATE RESOURCES EFFICIENTLY IN CASES WHERE CONSUMERS' WILLINGNESS TO PAY UNDERSTATES SOCIETAL DEMAND⁵⁵

The previous section explained that externalities do not necessarily disrupt the market allocation of resources. The analysis focused on the supply side—specifically, on private incentives to invest in creation, development, and dissemination—and showed how the benefits of internalization may be overstated. This section focuses on the demand side.

According to neoclassical economic theory, *the market* is an economic system that relies on the price mechanism to efficiently coordinate productive activities and allocate resources to their most productive use. From the demand-side, the market is generally seen as an efficient system for aggregating, processing, and responding to information about what people want. The market system works rather well in responding to consumer preferences measured by consumers' willingness to pay for goods and services. As Demsetz (1970) argued in *The Private Production of Public Goods*,⁵⁶ the price mechanism provides a signal to producers about where to direct their investments. Extending Demsetz's point to copyright, Paul Goldstein (1994:178-89) argued: "The logic of property rights dictates their extension into every corner in which people derive enjoyment and value from literary and artistic works. To stop short of these ends would deprive producers of the signals of consumer preference that trigger and direct their investments."

This logic applies not only with respect to the preferences of passive consumers. It is also fundamental to licensing by subsequent producers (active users). That is, productive users of (elements of) copyright protected works manifest their private demand (willingness to pay) in licensing transactions. Commentators optimistic of the Demsetzian trend in copyright law have relied in part on the argument that as transaction costs fall, efficient licensing should prevail and minimize concerns over deadweight loss (Menell & Scotchmer, 2005:23-24; Bell, 1998; Hardy, 1996).

There is a fundamental flaw in this logic that has received insufficient attention.⁵⁷ Simply put, the demand signaling function of the price mechanism

⁵⁵ There are many reasons why the market may fail to allocate resources efficiently. In this section, I discuss one particular demand-side reason that is not well understood or reflected within economic theories of property and intellectual property (see Frischmann & Lemley, 2007; Frischmann, 2005a).

⁵⁶ See also Demsetz, 1969.

⁵⁷ A number of legal scholars have touched on the idea that users of copyrighted material are not always optimal purchasers of access and use rights (Cohen, 2000:15; 1998:547; Loren, 1997:51-53; Lemley, 1997:1056).

does not necessarily work well when purchasers/licensees use a resource as an input to produce public goods (e.g., information) and merit/nonmarket goods (e.g., education) (Frischmann, 2005a).⁵⁸ Purchasers'/licensees' willingness to pay reflects their private demand—that is, the value that they expect to realize—and accordingly does not take into account value that others might realize as a result of their use. Many uses of copyrighted works generate value for non-users, however. A wide variety of socially valued productive activities—e.g., education, community development, democratic discourse, political participation—depend critically upon widespread access to and use of the expressive works subject to copyright. The “ancillary” social value generated by use of works to participate in these types of activities is difficult to quantify but nonetheless well recognized as reflected in our society’s long standing normative commitments (Bates, 1988:77). As a general matter, it is reasonable to conclude that social demand for access to and use of copyright protected works exceeds private demand, at least for a sufficient numbers of works to merit rejection of the nirvana-like combination of absolute property rights and efficient licensing.⁵⁹

3.4. EXTERNALITY-INDUCED VS. PROPERTY-INDUCED DISTORTIONS

My final contention flows from the first two. Even where externalities distort market allocation, such distortions may be social welfare enhancing; or conversely, extending property rights to internalize externalities may distort market allocation in a manner detrimental to social welfare.

Property rights distort resource allocation in the same way (although perhaps in the opposite, or at least a different, direction) as externalities.⁶⁰ When relevant, both externalities and property rights impact (distort) the market allocation of resources; when irrelevant, neither does. *A priori*, one simply

⁵⁸ Infrastructural resources represent a subset of resources for which these arguments are especially strong (see Frischmann, 2005a), but the limitations on the efficacy of the price mechanism apply more broadly and can be extended to situations where productive (re)use of a resource generates relevant spillovers.

⁵⁹ I recognize that I have argued the case against absolute private property rights without providing a roadmap for drawing doctrinal lines within copyright law that would lead to the optimal semicommons. That is a project for another day. Nonetheless, it is worth noting that economic considerations set forth above may be integral to emerging analytic frameworks for copyright that move beyond the access-incentive paradigm and focus more explicitly on the socially valued, externality-producing activities that commons may support (see, e.g., Madison, 2004; Cohen, 1998; Fisher, 1988).

⁶⁰ As Landes & Posner (2003: 58), recognize, “Copyright, however, causes its own distortions in the market for expressive works.”

cannot say that the distortion caused by a property right (or an incremental change in a property right) has a positive or negative effect on social welfare.

This is quite evident in the copyright field (and intellectual property generally)⁶¹ where there are many complementary and cumulative markets. Imagine an imperfect (leaky) property right applies to a resource R exchanged in market A, and consequently an externality arises in Market B—e.g., if producers in the latter market use an unprotected element of R without compensation. The standard economic argument for internalizing the externality by perfecting the property rights in R rests on the notion that doing so would force (enable) producers in Market B (A) to transact, which would eliminate externality-induced distortions. On the supply-side, increased appropriation of surplus would lead to improved incentives to produce R; on the demand-side, making users pay for access would (i) provide a demand signal (*i.e.*, users' willingness to pay) to producers of R and thereby guide investment decisions and (ii) introduce a constraint on consumption and thereby prevent overconsumption of R. Yet, as I have shown, both the supply and demand side arguments do not hold universally. On one hand, incentives may not improve,⁶² and on the other, making users pay for access may provide an inaccurate signal of social demand and may lead to underconsumption. Perfecting the property rights in R and enabling/forcing transactions has its own distortionary effects on the allocation of resources. Whether or not the effects are a net positive or negative for society depends on the context (and one's choice of baseline) and cannot be determined *a priori* or on the basis of theory alone.

Remember Coase's basic point: Avoid reflexive invocation of externalities to justify government intervention in the form of taxation, regulation, or subsidies. Often, such intervention is unnecessary because affected parties will be able to work things out privately. In the end, one must approach perceived cases of market failure cautiously and engage in comparative institutional analysis.

My basic point is the same. Avoid reflexive invocation of externalities to justify propertization and privatization. The processes by which property rights

⁶¹ An important distinction between most resources subject to (ordinary) property and resources subject to intellectual property is that the former resources tend to be rivalrously consumed while the latter are nonrivalrously consumed. Property rights manage scarcity while intellectual property rights create scarcity in order to create the prospect of market power and incentives to invest; the distorting effect of strong intellectual property raises concerns over market power and the misallocation (diversion) of resources that generally do not arise as a direct consequence of granting and enforcing ordinary property rights.

⁶² Moreover, as Glynn Lunney (1996) argues, making copyright too strong may draw too many resources into the production of expressive works at the expense of other more beneficial productive activities.

evolve almost always involve “government intervention” in one form or another, and often, such intervention is unnecessary and may lead to welfare reducing distortions. As Buchanan and Stubblebine (1962) observed, externalities are often irrelevant to investment decisions and not worth internalizing. As copyright law demonstrates, some externality-producing activities are worth encouraging.

4. CONCLUSION

Copyright law is designed to generate incentives and externalities. Copyright grants private property rights and thereby facilitates appropriation of some value by economizing on the costs of exclusion, control, and transaction with respect to certain uses of expression and with respect to certain sets of relationships between creators, disseminators, and consumers. In this role, copyrights improves the operation of the market mechanism and, in a sense, uses it as a means for achieving a broader set of economic and social ends.

Copyright encourages and sustains participation in intellectually productive activities that both generate and use expressive works to communicate, entertain, teach, and engage us in many different ways. Many of these activities—e.g., education, community development, democratic discourse, political participation—generate socially valuable yet often irrelevant⁶³ spillovers. Through a variety of leaks and limitations on the private rights granted, copyright sustains common access to and use of resources needed to participate in these activities. Reframing copyright in this manner helps bridge the gap between economic and “noneconomic” theories of intellectual property and begins to lay the foundation for a different way of conceptualizing and evolving copyright law.

The Demsetzian argument that all externalities should be internalized provided the costs of doing so are manageable is closely connected to the Lochnerian argument that surplus or profit potential is itself property (Cohen 1998a:506-11). As Julie Cohen (1998a:509-10) argued, “[t]he scope of such a property right can only expand ... more often than not at the expense of third parties whose current practices or privileges, because not considered ‘property,’ are not perceived as obstacles.” The expansionary, Demsetzian trend in copyright is normatively troubling precisely because copyright must take into account, promote, and ultimately sustain a wide range of third party practices valued by society (Cohen, 1998a, 2006; Frischmann, 2005a; Madison, 2004).

⁶³ Irrelevant in the Buchanan and Stubblebine sense.

Perhaps the “delicate balance” struck by copyright need not and should not be understood solely in terms of access versus incentives. Both access and incentives are incomplete and indeed malleable concepts. Instead, the balance might better be understood more broadly in terms of (1) allocating private and public (common) rights, (2) promoting and internalizing externalities, and (3) promoting commercially-valued and socially-valued activities. Copyright cannot and should not be comprised of fully private or fully public rights. To best serve its economic and social objectives (to promote Progress, broadly conceived), copyright must be somewhat but not completely leaky.

Leakiness is desirable in a copyright system, not only for (re)distributional considerations as some have argued (Merges, 1997), but importantly, to promote allocative efficiency (cf. Fisher, 1988:1695). Plugging the leaks by increasing copyright duration, shrinking fair use, extending copyright to ideas, and so on, may have superficial appeal as intellectual resources increase in value and the costs of managing rights with technology and contract decrease, but, as I have shown, there are strong economic reasons to question the Demsetzian impulse in copyright law.

To be clear, my preferred alternative⁶⁴ to a pure private property rights system is not a government allocation system but rather is a semicommons arrangement. Copyright works well as a form of (partial) private property right so long as it remains leaky. My primary concern in this essay is with the persistent, largely successful efforts to plug in copyright’s holes and “perfect” (or complete) the private property rights granted by the copyright system. Copyright mixes private rights with commons in a manner that avoids market or government allocation of resources for certain ranges of uses and for certain aspects of a copyrighted work. And this, as I argue at length in my recent article on infrastructure and commons management, is the important allocative function of commons; to some degree, commons management avoids reliance on either government or the market to choose among resource users that produce private, public, and merit/nonmarket goods. Semicommons can be an attractive and viable allocation system for nonrival resources, such as intellectual resources, provided that we can overcome supply-side problems and create sufficient incentives to provide the resource in the first place. And copyright can do this without becoming “perfect” (or complete) private property rights.

⁶⁴ I thank Gary Libecap for reviewing an early draft and offering a poignant and very helpful comment, which I will paraphrase: What is the alternative? You must evaluate and compare property/market based systems with an alternative allocation system, such as government allocation, which has its own set of problems. See also Demsetz, 1969:1 (critiquing the so-called nirvana approach in favor of a comparative institution approach). In future work building from this paper, I would like to further explore the semicommons design of copyright.

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