Introduction to the session 'The Economics of Digital Goods' by Ruth Towse

It is my privilege to introduce Prof. Paul Belleflamme, who is Professor of Economics currently at the Aix-Marseille School of Economics on leave from the Catholic University Louvain in Belgium. His main research area is in theoretical industrial organization and he specialises in economics of innovation in the digital economy. He is the author of many books and articles in this area and runs the IPdigITblog. His expertise is widely recognised in the economics profession and beyond and we are very glad indeed to welcome him to the Launch of the CREATe Copyright and Innovation network and to deliver the Keynote talk The Economics of Digital Goods.

This simple title belies the considerable complexity of the underlying theory and I can reassure you that his exposition will be both straightforward and profound. Before giving him the floor, I would like to say a couple of words about the field of industrial organization, in which Paul specialises and its relation to copyright. I should say that most of what I know about it was gleaned from his excellent textbook on the subject with some difficulty on my part but very rewarding and worthwhile. At bottom, industrial organization is concerned with how markets work in terms of the relation of firms in an industry and therefore it is about competition or the tendency to monopoly. It forms the basis of economics of regulation related to competition issues and it is in that context that the question of IP and copyright law arises. The structure of markets in the creative industries and how they change with new technologies is necessary for understanding the role of copyright and how appropriate it is today in the digital economy. Understanding the economics of digital goods is therefore essential.

We are honoured to have Paul to guide us though the complexities.

A Future for the Creative Economy report – summarized a wide ranging discussion between economists specialising in industrial organisation applied to the creative and media industries. Remarkable consistency of opinion on the ability of markets to adapt to digital technologies.

Economists have asked themselves the question: do we need new economics to understand the new economy? The answer, inevitably, is both yes and no! No because we are talking about the way markets and the price system works to coordinate supply and demand and Yes – we do need new ways of thinking because markets and pricing of digital goods are very different. What makes these markets so different is streaming and platforms. Streaming means people no longer buy the good for a price: instead they rent it as part of a huge bundle of similar (and previously competing) goods – the whole catalogue of songs and films instead of choosing one at a time. Platforms, as Paul points out, are 'the inescapable intermediaries between content producers and end users'. They are not marketplaces for creative goods: they are reselling music and films etc for which they have obtained the rights.

Pricing is very different with new business models for digital. In the creative industries where copyright is so prevalent, royalties are no longer based on sales but on advertising revenue or subscription fees. Obviously, subscription fees for an ephemeral use are lower than if you buy a DVD and reuse it as often as you want. So creators' royalties are based in lower prices, albeit with the expectation of higher usage. But the title is just one of a huge bundle. The role of price as a signal to the producer is muffled by the business model of the platform, not that of the record label or the film company.

Nevertheless, the evidence shows that output of creative goods is increasing and is easily accessible both legally and illegally, for free and for payment. Abundance creates its own problem of consumer choice. Consumers' attention is limited and that gives rise to recommender systems and the use of algorithms, which in turn lead to network effects. Networks effects create loopbacks which in my view lead to greater concentration of winners and superstardom in what are already winner-takes-all-markets in the creative industries. The long tail story of niche markets has no doubt materialised with self-publishing and distribution via social media but it is dominated by winners and big intermediaries. Unmediated content makes choice even more difficult and consumers fall back on buying bundles of goods making demand less focussed and again, blunting price signals.

At this point I'd like to introduce my colleague Prof Morten Hviid, from University of East Anglia and CREATe. Morten is an economist working in law and economics at the ESRC Centre for Competition Policy. He has recently authored Working papers on the effects of digitization in the music and publishing industries, which deal inter alia with self-publishing.

A Future for the Creative Economy: a discussion between economists

- **Ruth Towse** (ruth.towse@gmail.com)

In summer 2016, three CREATe events took place in which economists working in the areas of culture, media and industrial organization were invited to exchange views on the transformative impact of digitization and the internet on the creative economy and to reflect on the implications of emerging trends for the future of the cultural production industries and copyright.[1]

The rise of digital platforms has transformed the possibilities for the supply, demand and finance of creative products (ranging from art, archives, broadcasts and books to live music and theatrical performances). Products of the creative industries which embody copyright works are now are universally capable of being made available in digital form, while some also remain in 'analogue' form. With discussions taking place on the future of copyright law and how to reform it to meet these developments, it is important to link the economic literature to thinking about the future shape of markets for copyright works in the creative industries and the implications for law-making.

Topics such as platform pricing, network effects, long tail, price discrimination and customization clearly apply to markets for creative goods and the discussion reported here was between some of the leading economists researching them. There is a perceived need for economists to 'translate' their theories and the hope is that this research could be discussed more widely with stakeholders. Accordingly, the aim of this paper is to report on those discussions and disseminate the conclusions.

Economists agree!

There was considerable agreement on the part of the economists who took part about the changes to the creative economy wrought by digitization and the internet. There is undoubtedly a greater supply of creative goods and services which are cheap and easily accessible to consumers (fulfilling aims of media and cultural policy and copyright to promote diversity and accessibility). In economic terms, this enhances welfare. On the supply side, however, there are concerns about finance for the primary creation of cultural goods and the increasing concentration of their distribution in the hands of entities that have little investment in their production or even interest in them. While the former incumbent firms in the creative economy, such as record labels, have lost out to the providers of services using new technologies, new incumbent players are present, whose role (if any) in incentivising creativity is, however, different.

The shift in control of distribution into the hands of online service providers– a new form of specialization – gives rise to concern over two features: one, the ever-increasing oligopoly, even monopoly, power of the online platforms due to network and scale effects inherent in the technology, but also reflecting consumers' behaviour; and second, the break of the link between creation and production and distribution, which affects revenues to creators and intermediaries. These features have implications for copyright as an incentive mechanism, and also for competition authorities.

[1] For the full discussion and resources, see http://www.create.ac.uk/a-future-for-the-creative-economy/

The growth of cultural supply has increased due to two basic features of the digital creative economy: one is the considerable reduction on the cost of producing, promoting and distributing creative goods and services, and the other is the access that digitization and the internet offer to creators to self-publish and promote their work. Intrinsic motivation of creators and performers has flourished in these conditions, raising questions on the one hand about the quality of unmediated output and on the other, about how sustainable the model is. Online quality evaluation is now provided by aggregators and social media rather than by intermediaries acting as both gate-keepers and financiers. The issue of quality and cultural diversity is a minefield for economists and one that is avoided in copyright law, for which 'originality' rather than quality is the criterion. However, quality is noted as a concern. Some evidence suggests that those creators who achieve success online may turn to the traditional gate-keepers for finance and services of production and distribution, increasing winner-takes-all tendencies to concentration in these markets. Another aspect on the supply side is the sharing of expertise in product development between different contributors with no commercial incentive in mind (another type of intrinsic motivation). The role of copyright in these aspects of supply requires further research.

It remains to be seen whether markets for content become more or less dominated by superstar and winner-takes-all effects. Economists tend to believe they will, based on the analysis of markets in the creative industries and consumers' switching costs. On the other hand, new entrants and multi-homing of content on several platforms can counteract the effects of concentration. Research so far has not been conclusive on the long tail. Excess supply of content may be said to be inefficient but radical uncertainty of the success of experience goods counters that claim and justifies many 'draws from the urn'. Commercially unsuccessful investment in innovation and creativity is, after all, inherent in capitalism. In the digital creative economy a question is who is doing that investment – creators or distributors or even users?

For economists one of the most significant changes on the supply side has been to business models as licensing takes over from sales, resulting in the development of two-sided, even multi-sided, markets. So far the main action has been competition between freemium and subscription models, with several types of the latter, such as 'a la carte' and 'all you can eat'. In both, content is bundled, increasing consumer choice while at the same time blunting the incentives to creators, who are paid a uniform (low) royalty. Bundling may act as a deterrent to new entrants, especially if contracts with producers are exclusive, but has proved attractive to consumers. Two-sided markets in which advertisers play a significant role in financing distribution, with 'poorer' consumers tolerating the 'bad' of advertising to obtain the goods they wish to access, are becoming vulnerable to developments such as adblockers that reduce the incentive to this form of finance.

Summary

The economic aspects of the effect of the switch to platforms on the production and consumption of creative content can be summed up as:

- eduction in costs and prices, including zero prices;

- the effect of networks and scale economies on the economic organization of production, including at the level of initial content creation, and on the structure of markets;
- the effects on content creation due to the enhanced role of distributors businesses, especially those not involved in the creative process;
- changes to pricing models as platform pricing and non-price competition that are increasingly complex;
- consumers' embrace of social media and willingness to 'pay' with data on their choices;
- implications for competition authorities and for cultural and copyright policy-makers of possible increasing concentration of supply of creative goods and services.

Conclusion

Overall, the implication for copyright of the economic analysis of digitization and the internet in the creative economy is that, on balance, there is no case for increasing the copyright standard on welfare grounds - the basis of the economic case for copyright. The reduction in costs of producing and distributing content and the increased benefits to both consumers and producers of network effects undermine claims for greater protection. However, new features of internet trade, such as the role of customization present a different challenge to copyright as well as to privacy and freedom of expression.

Perhaps predictably, economists differ as to the ability of market forces alone to bring about an overall improvement in welfare from ongoing innovation and adjustment in the creative economy in the medium to long run. Some have greater faith than others in the ability of market incentives and innovation to overcome perceived negative effects of digitization and the internet but those who incline more to intervention through competition, copyright and cultural policies also recognize that the dynamic effects of technological and business model innovation make the effects of intervention difficult to gauge. Nevertheless there was considerable agreement about trends in the creative economy and their economic interpretation.

So what can we say about the future of the creative economy? Judging by the economic criterion of overall dynamic welfare, it is 'rosy'. Consumers are better off due to lower prices and vastly increased supply of creative content and there is innovation and change; creativity by non-professional, non-commercially-minded individuals is available to all with access to a computer and broadband. Producers are under pressure from market forces to innovate in all sorts of ways, whether through prices or non-price services, including quality evaluation – all trends that are necessary for growth in a market economy. Non-profit cultural organisations also benefit from these changes by being able to reach much wider audiences. The lingering concern is about the incentives to long term content creation and its quality.