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Putting Music Copyright Policy on a Free Market Footing

by

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On November 28, the House Subcommittee on Intellectual Property, Competition and the Internet is set to hold a hearing on the issue of copyright royalties and online music services. The focus of the hearing's testimony will be the so-called "Internet Radio Fairness Act of 2012" (H.R. 6480/S.3609).

Among other things, the bill would alter existing standards for setting licensing royalty rates paid by providers of Internet-based "webcasting" services for the public performance of digital sound recordings. At stake in this dispute over copyright royalty rate controls is the future course of online music services and the flow of billions of dollars in payments and revenues.

In sorting out a proper policy approach regarding music copyright licensing and royalties for webcasting – or for any medium – it's all too easy to get tangled up in the details and micro-minutiae of existing or proposed laws and regulations. Instead, the place to start is with a candid recognition: the existing music copyright licensing royalty regime runs counter to rule of law and free market principles. It arbitrarily discriminates among market players and imposes an onerous set of price controls.

Recourse to rule of law and free market principles explored in F.A. Hayek's *The Constitution of Liberty* sheds light on the defects of the existing music copyright

licensing royalty regime. Those principles also point the way to an ideal state of affairs consisting of a truly free market governed by a set of general rules. Any legislative reforms regarding music performances and services should be undertaken with the ultimate purpose of abolishing compulsory licensing and rate controls, be it immediately or incrementally. Bringing about a truly free market for music performances and services should be the overriding goal of Congress.

Hayek on the Rule of Law vs. Arbitrary Discrimination and Price Controls

In the Free State Foundation's new book, *Communications Law and Policy in the Digital Age*, FSF President Randolph May and I devoted a chapter to distilling the basic rule of law insights of the late economist F.A. Hayek and applying them to federal communications law and policy. We did so on the basis not only of Hayek's professed admiration for the U.S. Constitution and the congeniality of his insights to America's constitutional traditions, but also because Hayek's insights on the rule of law remain relevant to today's advanced technology markets. A Hayekian perspective is particularly helpful in bringing into sharper view the significant shortcomings of federal law and policy regarding music copyright licensing royalties.

In *The Constitution of Liberty*, Hayek discussed "the kinds of governmental measures which the rule of law excludes in principle because they cannot be achieved by merely enforcing general rules, but, of necessity, involve arbitrary discrimination between persons." Among the most significant anti-rule of law measures that concerned Hayek are "measures designed to control the access to different trades and occupations, the terms of sale, and the amounts to be produced or sold."

As Hayek elaborated:

> There are several reasons why all direct control of prices by government is irreconcilable with a functioning free system, whether the government actually fixes prices or merely lays down rules by which the permissible prices are to be determined. In the first place, it is impossible to fix prices according to long-term rules which will effectively guide production. Appropriate prices depend on circumstances which are constantly changing and must be continually adjusted to them. On the other hand, prices which are not fixed outright but determined by some rule (such as that they must be in a certain relation to cost) will not be the same for all sellers and, for this reason will prevent the market from functioning. A still more important consideration is that, with prices different from those that would form on a free market, demand and supply will not be equal, and if the price control is to be effective, some method must be found for deciding who is to be allowed to buy or sell. This would necessarily be discretionary and must consist of ad hoc decisions that discriminate between persons on essentially arbitrary grounds.

Music Copyright: Compulsory Licensing and Bureaucratic Ratemaking

With that Hayekian backdrop in mind, consider now the existing regime for music copyright licensing royalties. The federal Copyright Act recognizes that musical sound recordings are "performances" that entitle the holder of a song's copyright to royalty payment. When the copyright's holder and providers of music services cannot agree on royalty terms for performances, federal law imposes a compulsory licensing and rate-setting scheme. In other words, the government mandates that music copyright holders make their recordings publicly available, subject to a system of government price controls.

Congress created the Copyright Royalty Board to conduct ratemaking proceedings to establish sound recording copyright holder royalties. The Copyright Judges set royalty terms for traditional media such as CDs and vinyl, and also for digital streaming via the Internet, and for rates paid by satellite providers, non-commercial broadcasting, and certain cable providers.

Not only does the government substitute bureaucratic rate rulings for marketplace bargaining for music content, it does so by applying varying rate standards to different services. While federal law requires the three Judges on the Copyright Board to "make determinations and adjustments of reasonable terms and rates of royalty payments," what "reasonable" means depends on the underlying technology of the services. When it comes to Internet-based webcasting of digital music content, the Copyright Judges apply the so-called "willing buyer/willing seller" standard. Under this standard, "reasonable" means payments that "most clearly represent the rates and terms that would have been negotiated in the marketplace between a willing buyer and a willing seller." Other services, however, are not subject to this "willing buyer/willing seller" standard. Cable and satellite providers, for instance, pay royalties based on Section 801(b) of the Copyright Act.

Under the 801(b) standard, rates are based on Copyright Judges' determinations as to what will maximize availability of creative works to the public; afford copyright holders a fair return and copyright users a fair income under existing economic conditions; reflect the roles of the copyright holders and users with respect to creative contribution, technological contribution, capital investment, cost, risk, and contribution to the opening of new markets; and minimize any disruptive impact on industry structures and practices. The 801(b) standard is effectively a ratemaking standard that results in copyright holder receiving less in royalty compensation from music services.

And not to be forgotten are AM/FM commercial radio broadcasters. They receive special protection under federal law and do not have to pay any royalties when they play musical sound recordings over-the-air.

Enter the Internet Radio Fairness Act

It's in this context of government compulsory licensing and price controls subject to varying standards for different services that the "Internet Radio Fairness Act of 2012" was introduced. The House Judiciary Subcommittee may soon be considering the bill. Among its provisions, the legislation would replace the willing buyer/willing seller standard for copyright royalties for webcasting with the 801(b) standard. Internet radio service Pandora has been particularly vociferous in its support of the bill. Incidentally, as a November article in the *New York Times* points out, Pandora's existing webcasting agreements with music copyright holders expires in 2015. And under the 801(b) standard, Pandora's negotiating position would be much stronger, likely resulting in Pandora paying significantly less for music performances.

In other words, Pandora appears motivated, at least in part, by concerns over arbitrary treatment. Federal law subjects it to a different ratemaking standard than other music services.

Indeed, there are ample reasons to be concerned over arbitrariness in the existing regime for music copyright licensing royalties. But even if putting webcasting under the 801(b) standard resolves the problem of arbitrariness for webcasters vis-à-vis those services currently subject to the 801(b) standard, the arbitrariness problem still remains. Remember, AM/FM commercial broadcasters are not subject to the compulsory licensing regime. And as a general matter, compulsory licensing schemes with government ratemaking result in an unavoidably arbitrary and disparate treatment between sellers and buyers. The problem of arbitrary discrimination will remain so long as music copyright holders are forced to the table in a compulsory licensing scheme.

A Way Forward to a Free Market under the Rule of Law

To put it in Hayekian terms, the existing regime for music copyright licensing royalties "lays down rules by which the permissible prices are to be determined" through ratemaking standards and Copyright Board determinations. Through compulsory licensing, the regime mandates that the producers (i.e., music copyright holders) be required to license their recordings in order to ensure that "the price control is to be effective."

The Internet Radio Fairness Act's provisions, wisely or not, operate entirely within a system in which a government bureaucracy, not market mechanisms, determines quantities and prices for services. But a commitment to the rule of law and free market principles would mean a complete overhaul of the existing regime for music copyright licensing royalties. Part and parcel of any legislative deliberations regarding reform to the existing music copyright royalties system should be concrete steps to eliminate compulsory licensing and ratemaking in order to finally transition to a free market for music in which copyright holders and users are all treated equally, regardless of the underlying technology involved.

Transition to a free market is particularly compelling in light of the abundance of market and technological alternatives available to consumers. New music media platforms and digital transmission capabilities now offer consumers a variety of listening choices, including CDs and vinyl, radio broadcasting, digital cable and satellite services, Internet-based webcasting subscriptions, or downloadable purchases through services like iTunes or Amazon. Given this rivalry in available services relying on different technologies and business models, the free market – and not bureaucratic boards – should be the mechanism for setting price points that meet consumer demand.

Congress should use the upcoming hearing to focus on real free market reform.

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