

Know IP – The Stockholm Network’s Monthly IPR Journal Volume 3: Issue 8. November 2007

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Commentary

IP Economics: Market-based vs. Centrally Planned Solutions – Helen Disney and Dr. Meir P. Pugatch¹

Amazingly, six centuries have passed since the City State of Venice granted the first IPRs in 1474.² Six centuries have passed, yet the current criticism of the IP system seems to assume that new and unexpected circumstances render the system questionable.

We have already outlined in previous writings that such discussions and questions are far from being new or original.³ However, it is interesting to briefly contemplate the economic logic underlying the recent (intellectual) attacks on the IP system.

Broadly speaking, critics of the IP system (be they those who focus on the international architecture of IPRs, the relationship between IPRs and competition rules or the effects of IPRs on innovation) believe that the system has stopped serving its purpose. They argue that the monopolistic features of IPRs and their restrictive effect on access to existing knowledge are so negative that they outweigh any positive effect that IPRs may have on innovation and knowledge creation.

Consequently, these critics believe that the system of IPRs needs to be replaced by, or at least subordinated under, a more centrally planned and regulated system. It is often argued that such a system can effectively seek to determine the rate and direction of innovation via public or even governmental supervision, rather than by the private 'rent-seeking' firm.

This raises an interesting economic question: will a system that is based on centrally planned and managed mechanisms provide greater innovative output, as well as greater access to innovation than the IP system? Since we deal with theory, we do not presume to provide a clear-cut answer. But what we do want to emphasise is that economic theory suggests that such a system is likely to suffer from some serious problems that are likely to be much more severe than the IP system.

In order to discuss the above we need to return – briefly – to the basic problem that underlines the interest of society in the creation of knowledge and access to knowledge.

Market failure problems in the creation of innovative and inventive activities

In the absence of IPRs or any other institutional provisions for inventions, society may face two major problems when allocating resources for the production and distribution of new knowledge: free-riding and secrecy.

Free-riding creates a state of underproduction in innovative inventive efforts. In the absence of patents, for example, free-riding occurs when the inventor cannot prevent others from exploiting his invention free of charge. Consequently, free riding creates a disincentive for private entrepreneurs to engage in inventive activities, as they will not be able to receive commercial returns for their work.⁴ This problem has already been recognised and noted by Jeremy Bentham, who argued that, “without the assistance of the law, the inventor would almost always be driven out the market by his rival, who finding himself without any expense, in possession of a discovery which has cost the inventor much time and expense...(therefore) he who has no hope that he shall reap will not take the trouble to sow”.⁵

¹ Helen Disney is CEO of the Stockholm Network. Dr. Meir Perez Pugatch, Haifa University, is the Research Director of the Stockholm Network.

² Ladas, P. S. *Patents, Trademarks, and Related Rights: National and International Protection, vol. I*; Cambridge University Press; Cambridge, Massachusetts; 1975.

³ Pugatch, M.P., ed.; *The Intellectual Property Debate: Perspectives from Law, Economics and Political Economy*; Edward Elgar; Cheltenham, UK; September 2006.

⁴ Arrow, K; 'Economic Welfare and the Allocation of Resources for Invention' in *The Rate and Direction of Inventive Activity: Economic and Social Factors*; National Bureau of Economic Research; Princeton University Press; Princeton, New Jersey; 1962; pp. 609-626

⁵ Bentham, J.; 'A Manual of Political Economy' in *The Collected Works of Jeremy Bentham*; ed. J. Bowring, vol.III; Edinburgh; 1842

Lack of institutional arrangements for innovative activities also increases the tendency towards secrecy. Facing the problem of free-riding, entrepreneurs will aim to develop innovations and inventions that can be kept secret and that require a high level of know-how that cannot be easily copied (for example, a revolutionary process that would reduce production costs and that would be sold to only one company).¹

Ultimately, free-riding and secrecy generate considerable losses to society, as more innovations might have been released to society and used more efficiently if these problems could have been solved. Therefore, there is social merit in the creation of institutional provisions for inventions that will optimise both the allocation of resources towards innovative activities and the disclosure of innovations to society.

But if IPRs are not the solution, what other arrangements can we offer?

An alternative reward system for innovators – a centrally planned system

Many of the discussions today about alternative models to IPRs propose a system that is based on centrally administered rewards for innovations, using public funds to remunerate innovators for their work. By attempting to break the link between inventions and market-oriented behaviour, these proposals seek to 'optimise' both the level of innovative and inventive activities and the distribution of knowledge to society.

Two aspects are particularly important in such a system. The first is concerned with government decisions regarding the value of the reward and the ways for granting it to the inventor. The second focuses on the need to finance the reward from the public purse.

With respect to the former, theory suggests that a government can reward the innovator either

before or after his invention is developed.² In cases where it is able to predict future inventions and to assess their social value, a government can 'auction' the right to invent. Using this method, and provided that a competitive industry exists, the government could pay the innovator based on the quantifiable social benefits. However, since innovations and inventions are extremely heterogeneous and vary in their actual and potential use, even when categorised, it would be very difficult (if not impossible) to come up with non-discretionary methods for rewarding inventors. Furthermore, the expected efficiency of such a system greatly depends on whether the reward is socially adequate. If it is too high, society will use too many resources in inventing, while if the reward is too low, there will be under-production of inventions. Polanyi, who discussed the merits of such a system, admitted that decisions regarding the grant of the reward would be prone to "corruption and arbitrary oppression which is never removed from the grant of public subsidies."³

In this respect, IPRs may be regarded as a much more efficient solution since they reduce discretionary decisions and are supposed to provide identical treatment to all inventions. For example, by adopting the system of patents, a government only needs to legally define the criteria to make a certain invention patentable, reducing considerably the risk of discretionary behaviour.

With regard to the second dimension - financing the reward - the government must collect additional tax in order to pay inventors from the public purse. Consequently, it will have to consider which method of taxation is the least expensive in terms of welfare losses.⁴ Even if the government is able come up with the optimal tax system for financing rewards, it will still have to face the political consequences of raising taxes.

¹ Pugatch, M.P.; *The International Political Economy of Intellectual Property Rights*; Edward Elgar; Cheltenham, UK; 2004

² Polanyi, M.; 'Patent Reform' in *Review of Economic Studies*, vol. 11; 1944; pp. 61-76

³ *Ibid.*, p. 68

⁴ Hindley, B. V.; *The Economic Theory of Patents, Copyrights, and Registered Industrial Designs: Background Study to the Report on Intellectual and Industrial Property*; Economic Council Of Canada; Ottawa; 1971

Here IPRs again can provide a better solution, as they allow the innovator to finance his invention by putting it on the market, i.e. it is based on the simple market principles of demand and supply.

Back to the market

IPRs are by no means an optimal solution. They have numerous problems, which are both systemic as well as technical. Yet, they are based on a very simple and powerful principle that assumes the way to solve market failures in the production of innovations is by granting private property rights on these innovations.

We should recall that for six centuries this solution has functioned well.

On the other hand, economic theory also suggests that the models often proposed as more modern, fair or fashionable more than IPRs and based on centrally-planned and administered systems may not be so attractive after all.

The flaws embedded in this system could potentially lead to more serious problems than critics of the IP system would care to admit.

We should be mindful that the choice is one between a bad system and good system – between a market-based system (IPRs) and a centrally-planned system. We feel that the former puts us on much safer ground.

Topic of the Month

Intellectual Property in China: No Quick Fix – Sukanya Natarajan¹

Since it joined the WTO, the climate of IP protection in China has constantly been in the spotlight. Not surprisingly, when the US recently announced an initiative to negotiate an anti-counterfeiting trade agreement (ACTA) along with its key trade partners, experts saw it as a

¹ Sukanya Natarajan is a research officer at the Stockholm Network

follow up to the recent WTO Dispute settlement mechanism motioned by the US against China.² The main aims of the two cases being brought are:

- To eliminate internal distribution barriers that prevents foreign publishers and producers of audio-visual products from getting legitimate products into the Chinese market. This activity has tended to enhance counterfeit products. The case also intends to examine other Chinese laws and regulations.³
- To challenge the quantitative thresholds which in Chinese criminal law must be met to obtain criminal conviction for copyright piracy and trademark counterfeiting, to ensure that rules for the disposal of counterfeit products seized by Chinese authorities be implemented and to address the denial of copyright protection for works ready to enter the market but awaiting censorship approval.⁴

The dispute resolution panel was established in the WTO on 25 September 2007 after a second request made by the USA to review China's protection and enforcement of intellectual property rights (IPRs).⁵ China blocked the request for a WTO panel on trade restrictions and copyright piracy of movies, music and books on 22 October 2007.⁶ Should the US renew its request at the next Dispute Settlement Body

²http://www.ustr.gov/Document_Library/Press_Releases/2007/October/Ambassador_Schwab_Announces_US_Will_Seek_New_Trade_Agreement_to_Fight_Fake_s.html 23/10/07

³http://www.ustr.gov/Document_Library/Press_Releases/2007/October/United_States_Requests_WTO_Panel_in_Case_Challenging_Chinese_Barriers_to_Market_Access_for_Products_of_Copyright-Intensive_Indus.html 11/10/2007

⁴http://www.wto.org/english/news_e/news07_e/dsb_2_5sep07_e.htm

⁵http://www.wto.org/english/news_e/news07_e/dsb_2_5sep07_e.htm

⁶ According to WTO regulations, the request for an expert panel on a certain dispute can be blocked only once. If the request is made for a second time, a panel will automatically be set up.

meeting on 19 November 2007, a new panel will be automatically established.¹ If the US wins the case, it would be allowed to impose economic sanctions on Chinese products.

Responding to this, Wang Ziqiang, spokesperson for China's National Copyright Administration (NCA) refuted the U.S. government's complaint that China's market access restrictions on films, books and audio-visual products had led to rampant piracy, saying that the accusation "does not bear serious scrutiny". He also maintained that China strongly opposed US attempts to establish a panel in the dispute settlement body of the WTO.²

The European trade commissioner, Peter Mandelson, in a document filled with hard-hitting criticism of what he terms the "Chinese juggernaut," argued that the EU should align policy more closely with Washington and be more ready to take cases against China to the World Trade Organization.³

In a four-page letter to the European Commission president, José Manuel Barroso, Mandelson highlights the widening trade gap, arguing that the European Union is "sitting on a policy time bomb". The letter reveals increasing impatience in Europe over state subsidies to Chinese exporters, Beijing's failure to crack down on the abuse of intellectual property rights and limited access to China's massive domestic market.

More than 81% of counterfeit products seized in US ports in 2006 originated in China.⁴ Though China has a growing legitimate software sector and has increased seizures of copied goods, the US and EU are pressing Beijing to eliminate rules that allow some pirates to avoid prosecution and to punish those convicted with imprisonment rather than fines. Chinese scholars such as Wang

et al state that despite heavy criticism of the US policy, raising the dispute has had a beneficial impact on China's reform of intellectual property law.⁵

In April 2007, China's Supreme People's Court lowered the threshold for prosecuting manufacturers and vendors of counterfeit intellectual property products. The new rules state that anyone who manufactures 500 or more counterfeit copies (i.e. discs) of computer software, music, movies, TV shows and other audio-video products can be prosecuted and face a prison term of up to three years. The new regulations replace the 2004 rules, which had a 1,000 disc threshold.⁶ Even in their tighter form, though, these rules are not enough to fight counterfeiting. Instead of trying to defend its current policy, China could stand to gain substantially if it were to strengthen its intellectual property protections.

Instead of denouncing the WTO panel as a Western attack, China should begin improving its enforcement strategies in tackling piracy, counterfeiting and the general intellectual property regime. Fostering the growth of intellectual property will not only benefit the world's most populous country, but also its trade partners all over the world.

Experts' Corner

Incentives to Innovate- discussing the balancing test – Yannis S. Katsoulacos⁷

A few weeks ago, the European Court of First Instance (CFI) delivered its response to Microsoft's appeal on the *Microsoft (MS) vs. Commission* Decision of 24th March 2004. The

¹<http://www.reuters.com/article/entertainmentNews/idUSL2248842220071022>

²http://news.xinhuanet.com/english/2007-04/17/content_5988076.htm

³<http://www.iht.com/articles/2007/10/17/business/trade.php>

⁴<http://www.chinapost.com.tw/news/archives/business/2007113/99885.htm>

⁵ Wang et al, "Recent WTO disputes involving the protection and enforcement of Intellectual Property Rights in China: Legal and Political analysis", *Copyright China Policy Institute*, August 2007, China House.

⁶http://news.xinhuanet.com/english/2007-04/17/content_5988076.htm

⁷ Professor of Economics, Athens University of Economics and Business; Member of the Hellenic Competition Commission, 1995 – 2005.

CFI concurred with the Commission on all substantive issues. A very contentious aspect of the decision, due to its very high precedential value, is that relating to the question of Intellectual Property Rights (IPRs).

Microsoft's refusal to share IP-protected interoperability information for Windows with its competitors, according to the Commission, hampered the ability of other firms to create products that worked with Windows. The Commission argued that this will have adverse effects on innovation and ultimately on consumers, and ordered the compulsory licensing of this technology.

Economic theory unequivocally suggests that it is acceptable to 'Refuse to Supply Technological Information' (RSTI) protected by intellectual property law. This protection has been established to encourage companies to invest in R&D. Most companies would be reluctant to do so if they had to reveal the fruits of their efforts to their competitors for free or for a negligible sum. In only just a very small number of past cases have European or American courts found a refusal to license practice to be abusive - and then only under "exceptional circumstances."

In order to reach its conclusions, the Commission adopted a new decision rule (or legal standard) which is based on "essential facility" type arguments, and on arguments related to Microsoft's incentives and ability to leverage its market power in the PC operating system market to foreclose competitors in the workgroup server OS market. The most novel aspect of this rule constitutes a new "incentives to innovate balancing test" on the basis of which it rejects Microsoft's objective justification to refuse to supply interoperability information, on the grounds that it exercised its IPRs, arguing that *objective justification* requires a showing (by Microsoft) that the RSTI does not result in a reduction of the incentives to innovate in the whole industry (including Microsoft). The Commission indeed argued that even Microsoft's incentives to innovate would increase by compulsory licensing of the information - as well as the incentives of its competitors in the market under investigation. However, the Commission's economic arguments are not sound: it can easily

be shown that Microsoft's incentives to innovate could diminish and the Commission certainly does not show beyond reasonable doubt that innovation in the markets under consideration as a whole will be enhanced.¹ In short, the new rule may well increase the cost of decision errors when assessing RSTI practices.²

Further, the Commission's argument is inadequate as it fails to take into account the implications of its balancing test when applied more generally. As Prof. Whinston (not a noted pro-Microsoft commentator) has suggested in the US case, it is a mistake to justify a restriction on a dominant firm's practices on the grounds that this will raise overall incentives to invest, since the same restriction applied to *all dominant software firms* would likely make entry easier but reduce overall incentives by reducing the rewards of success.³ Also, through the introduction of this new test, the decision leaves open the possibility that IPRs, often earned after having sunk substantial costs into R&D, will be questioned by competition authorities, increasing uncertainty in R&D investment returns. This increase in legal uncertainty will reduce innovative effort.⁴

Whilst the leveraging and foreclosure arguments proposed by the Commission stand on firmer ground, they could only be potentially considered as sufficient for a ruling that a RSTI practice is abusive if it was shown that the practice cannot be objectively justified. This is something that the Commission failed to do. Furthermore, they have a number of very serious shortcomings. Firstly, they rely on the phenomenon of 'tipping', which

¹ See for example Leveque; "Innovation, Leveraging and Essential Facilities: Interoperability licensing in the EU Microsoft case", *World Competition*, Vol. 28, Issue 1; 2005.

² See Ahlborn, Evans and Padilla; "The Logic and Limits of the "Exceptional Circumstances Test" in Magill and IMS Health"; *Fordham International Law Journal*; 2005

³ Whinston, MD; "Exclusivity and Tying in US vs. Microsoft: What we Know and Don't Know"; *The Journal of Economic Perspectives* Vol. 15, No.2; 2001; p. 79.

⁴ See also Killick, J; "IMS and Microsoft Judged in the Cold Light of IMS"; *The Competition Law Review*, Vol. 1, Issue 2, Dec. 2004.

cannot be disputed as a theoretical possibility, but significant economic questions remain unanswered as to whether and when it occurs in practice. Secondly, even if one is convinced that as a result of the RSTI practice ‘tipping’ in favour of Microsoft will take place in the workgroup server OS market, meaning that the latter will acquire a dominant or even monopoly position in this market, this is not sufficient for showing that consumers will be harmed as a result. More concretely, the Commission’s arguments in no way establish or document a significant and likely harm to consumers from Microsoft’s RSTI practice.

In conclusion, the precedent set by the Commission’s decision is likely to lead to a higher number of decision errors by competition authorities, to increase administrability costs, to increase deterrence costs - as more companies will be deterred from adopting benign RSTI practices – and ultimately to reduce incentives for innovation in Europe.¹

New and Notable

Postgraduate Research Grants In the Field of Pharmaceutical Intellectual Property Rights.

A Joint Collaboration between the Stockholm Network, Queen Mary Intellectual Property Research Institute and Maastricht University, Faculty of Law

The Stockholm Network, together with the Queen Mary Intellectual Property Research Institute (QMIPRI), University of London, and the Faculty of Law, Maastricht University, are delighted to announce the inauguration of a postgraduate research grants programme for students in the field of pharmaceutical Intellectual

Property Rights (IPR). From November this year we will be accepting applications for these awards.

For this academic year, 2007-2008, there will be six grants awarded – three per institution. The awards are only open to postgraduate students attending either QMIPRI or Maastricht University and writing in the field of IPR.

The purpose of these grants is to, firstly, provide outstanding postgraduate students a platform to showcase their research, secondly, to award a prize sum of \$US 9,000 per winner, and finally, to encourage further academic research in IPR.

Applications should take the form of a research paper with an upper word limit of 5,000 and a personal statement no longer than 750 words. The personal statement is an opportunity for candidates to outline their past achievements and plans for future research and will be of particular importance to those just beginning their research. The personal statement is a vital part of the grant application and candidates should treat it as such. Further selection criteria are as follows:

- research papers must seek to address the issue of IPRs within a pharmaceutical context;
- the papers should seek to provide a constructive and practical discussion on what often seems an acrimonious debate on the relationship between IPR and pharmaceuticals;
- the papers should look at policy solutions based on the existing IP system;
- papers should be as evidenced-based as possible;
- papers should be no longer than 5,000 words and can form either part of a wider project, such as a doctorate or Master’s thesis, or be free-standing pieces of work;

The judging panel will consist of academic representatives from the Stockholm Network, QMIPRI and Maastricht University. The deadline for submission of applications is April 1st 2008, winners will be announced by the end of May 2008 and an award ceremony will be held in June.

The Stockholm Network is the leading pan-European think tank and market-oriented network, with over 130 affiliated think tanks in 40

¹ See Katsoulacos and Ulph “On the Optimal Design of Competition Policy Procedures”; mimeo; Athens University of Economics and Business, 2007, for a discussion of the optimal choice of legal standards that takes into account apart from decision errors also indirect (deterrence) effects. Under publications in www.cresse.info

European countries. The Stockholm Network Intellectual Property and Competition Programme was established in January 2005. It aims to achieve four key objectives: to make the field of intellectual property more mainstream and accessible to the general public, to increase the interaction between specialists focusing on different aspects of intellectual property rights, to encourage discussion, as well as debates, on different burning IP issues.

For further enquiries and information please contact project coordinator David Torstensson of the Stockholm Network on telephone number +44 (0)20 7354 8888 or via email: david@stockholm-network.org

Free Use or Fair Use? by David Torstensson, Rena Sasaki and Dr Meir Pugatch

Today the internet – and companies operating as internet mediators – finds itself at the centre of a contemporary legal and philosophical conflict over the protection of intellectual property rights. The *Viacom v YouTube* case is only the latest in a long list of court cases. This report seeks to analyse the current legal and philosophical disputes between internet mediators and content creators with regards to the protection of intellectual property on the internet, and to put this dispute within a wider context and debate over the protection of intellectual property.

<http://www.stockholm-network.org/publications/list.php>

Stockholm Network ‘Five Minutes’ DVD – Quick Guide to Pharmaceutical Intellectual Property Rights.

In a bid to demystify the issues surrounding pharmaceutical intellectual property rights (IPRs) the Stockholm Network is launching its first ever DVD: ‘Five Minutes: Stockholm Network Briefings on Pharmaceutical Intellectual Property Rights’.

‘Five Minutes’ is a simple yet focused guide to some of the most important debates surrounding

pharmaceutical IPRs and addresses the misconceptions surrounding it. The DVD is aimed at busy policy makers, journalists and anyone who would like to get a better understanding of the field of intellectual property.

In order to maximise the DVD’s impact, the Stockholm Network has made the 7 topics it covers, into slots of no more than 5 minutes each.

It is hoped this approach will make the often dense and demanding subject of IPR more comprehensible for a whole new audience. “This DVD is part of a wider drive by the Stockholm Network to promote the message that intellectual property affects everybody’s lives in a myriad of ways - from the availability of AIDS medication in developing countries to what we listen to our iPods”, explains Dr Meir Pugatch, Director of Research for the Stockholm Network.

‘Five Minutes’ covers the following topics:

- Data Exclusivity
- Evergreening and incremental innovation
- The uses and abuses of compulsory licensing
- The Trips Agreement and its flexibilities
- Counterfeiting of medicines
- The debate over patents and access to medicines
- Research and development in the Pharmaceutical Industry
-

To view the ‘Five Minute’ DVD, please go to: <http://www.stockholm-network.org/publications/videos.php>

News Flashes

Top Stories in the World of IP and Competition

Growth in R&D around the world has increased over the past year, according to a report released by the UK government. The US continued to pull away from the rest of the world, while China and India also recorded sharp increases.

http://www.ft.com/cms/s/0/4246da8a-9080-11dc-a6f2-0000779fd2ac.s01=1,stream=FTSynd.html?nclick_check=1

The usually staid world of professional cricket became embroiled in a major IP controversy this week, with many of the world's leading media organisations, including Reuters and News International, threatening to boycott covering the upcoming series between Australia and Sri Lanka. Cricket Australia, the national governing body, is claiming IPRs over all photos, data, and text relating to the games, something that could hypothetically allow them to censor reporting.

<http://sport.guardian.co.uk/cricket/story/0,,2206093,00.html>

The head of the World Intellectual Property Organisation has decided to step down a year early, following a scandal. Kamil Idris is accused of signing papers with a false birth date when he joined the agency, making him appear nine years younger than he was. His successor will be appointed in 2008. Idris denies any wrongdoing.

<http://www.washingtonpost.com/wp-dyn/content/article/2007/11/15/AR2007111500638.html>
