

**Before the Permanent Subcommittee On Investigations  
Committee On Governmental Affairs  
United States Senate**

**STATEMENT ON  
PRIVACY & PIRACY: THE PARADOX OF ILLEGAL FILE SHARING ON  
PEER-TO-PEER NETWORKS AND THE IMPACT OF TECHNOLOGY ON THE  
ENTERTAINMENT INDUSTRY**

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My name is James V. DeLong. I am Senior Fellow and Director of the Center for the Study of Digital Property at The Progress & Freedom Foundation in Washington, D.C.

PFF is a market-oriented think tank that analyzes the digital revolution and its implications for public policy. For more information about us, a copy of our Mission Statement is attached to at the end of this Statement.

It is a pleasure to be here today to talk about intellectual property, Peer-to-Peer (P2P) file sharing, and private and public responses. The Digital Age has the potential to foster the creation of an immense quantity and variety of intellectual riches of all kinds – music, books, journals, software, movies, video. Whether this potential is fulfilled depends largely on whether appropriate property rights and markets are developed and enforced, so this issue meshes neatly with the issues of regulatory policy and the protection of markets that PFF has addressed during its decade of existence.

I will focus first on a question that receives too little attention, in my view. It is: What is the true interest of consumers in this controversy?

Much of what I read on the issue of intellectual property generally, including much that is written by “consumer representatives,” treats the issue as a zero sum conflict between creators of intellectual property on the one hand and consumers on the other. Such work

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often talks about the need to “balance” the interests of the two groups. The underlying assumption seems to be that the consumer interest lies in getting creative work for free – indeed, it is often portrayed as virtually a *right* to get things for free -- and that society grudgingly chip away at this consumer interest so as to give producers some incentive to produce.

This view of the world is erroneous – as a matter of economics, morality, and law.

The true interest of consumers is in having a strong system of intellectual property rights and well-functioning markets that makes available a wide variety of products and that enables consumers to vote with their payments to influence what is produced. The only question worthy of consideration by Congress is what it can do to help us ensure that such a market system exists.

Let me use three thought experiments designed to illustrate the absurdity of the “information ought to be free” line of argument, and the reasons why it seems obvious that the true interest of consumers is in property rights and markets.

First, consider an information service here in Washington called *TechDaily*. I am sure most people at this hearing are familiar with it. It is an e-newsletter issued twice a day that covers developments in the tech world. It is comprehensive, well-written, thoughtful. It is accessed by password and it not cheap, in absolute terms, but my organization’s site license is spread over several of us so my access to it costs a couple of bucks a day, which is a true bargain.

Now, suppose a “consumer representative” decides, after “balancing the consumers’ interest” against that of the producer, that *TechDaily* charges too much. After all, the marginal cost of adding me, or any other individual, to the distribution list is zero. So every day this “consumer representative” cuts-and-pastes the newsletter and blasts it out to the world at large. Of course, *TechDaily* soon goes out of business. Or it is forced to revert to the pre-Internet mode of operation, in which it is printed up each night on flimsy pastel paper (to discourage photocopying) and hand-delivered in the wee hours of the morning, thus becoming both less timely and more expensive.

I am the consumer here. On what possible theory can the “consumer representative” who caused this carnage call himself my friend?

To extend this thought experiment further, suppose *TechDaily* wants to stop this practice. Should the “consumer representative” be able to claim that to allow the company to ascertain his identity is a violation of his right to privacy on the Internet? Suppose that such a privacy claim were upheld; the losers would include not just *TechDaily*, its investors, and employees, but me - the consumer -- and all my fellow consumers, who have been deprived of a valuable service for which we were paying a quite reasonable price.

To extend the analysis another step, consider the effect of this chain of events on the structure of this city. My organization is a small one. It, like other small organizations and individuals, cannot afford the legion of reporters needed to produce a work like *TechDaily*. Nor can it afford the price of a newsletter produced according to the old-fashioned print-and-hand-distribute methods. So one effect of eliminating e-distribution as an option would be to ensure that only large organizations, those which can spread overhead across a wide base, could survive. The creative impetus that can be provided by individuals and small businesses would be lost.

This example may seem extreme, because almost no one would admit openly to wanting to destroy the intellectual property rights that make *TechDaily* possible. But if you dissect the rhetoric of many of the consumer groups you will find that their proposals would have precisely this impact. For example, they would say that *TechDaily* should not be allowed to encrypt its product in a way that inhibits someone from making a backup copy, or from shifting the use in space or time, because these constitute “fair use.” In effect, of course, destroying the ability to encrypt or to control access would have the effect of destroying the property right entirely, and the advocates of such positions are fully aware of this. Much advocacy of “fair use” is in fact a torpedo attack on the very concept of intellectual property rights.

Thought experiment number two concerns the common grocery store. Would anyone ever claim that consumers should get groceries for free, and that we must “balance the interests” of consumers against the interests of food producers and grudgingly allow producers to charge something (but not too much)?

We would regard such a statement as absurd on its face. The interest of consumers lies in being able to pay for things, so that producers are induced by their own interests to produce food. Then these producers become consumers of other goods and pay other producers who then become consumers, and so on in that great chain we call the free market.

The same logic applies to intellectual creations. The argument that these are somehow different and thus should be subject to different rules rests upon misinterpretations of economic principles concerning marginal cost pricing and upon such economic concepts as “non-rivalry” and “exhaustion.”<sup>1</sup> These concepts are indeed important, but they do not undercut the elementary truth that products of the intellect, like physical goods, are best produced by market incentives, and that propositions that are absurd on their face when applied to groceries do not become sensible when applied to the world of creativity.

Thought experiment number three is based on my personal experience walking through book stores. I see many a work that I might like to read, or perhaps read part of to see if I want to read it all, that I pass by because I will not lay out the \$25 to \$40 price. Suppose a system existed whereby I could tailor my investment. For a dollar, I could access it for a day to decide if I am seriously interested. For \$4 or \$5, I could read it once. For \$30, I

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<sup>1</sup> James V. DeLong, “Marginalized,” *TechCentralStation*, July 29, 2003  
<<http://www.techcentralstation.com/072903D.html>>.

could add it to my permanent library. Clearly, I as a consumer would be better off to have all of these options available.

Yet, again, self-styled “consumer representatives” want to deny me this choice. They raise the horrible possibility that the book industry might impose “pay per use,” whereby the level of payment would be tied to the intensity of the use made of the work. Why, where would this end? Next thing you know, people will be renting videos rather than being forced to buy them; perhaps grocery stores would even start charging more for a gallon of ice cream than for a quart!

As in the case of *TechDaily*, or the grocery store, how can people call themselves my friends when they want to deny me options that, in my judgment, make me better off?

The logic of these three thought experiments applies to the music business, the entertainment business, or any other product. Obviously, any individual consumer would be best off if everyone else paid for things while he or she got things for free. Equally obviously, the economy and the social system do not work this way, and only very small children and psychopaths think it should. The rest of us know that societies and economies are built on reciprocity. You produce something, I produce something, and we trade. Or, in anything beyond a barter economy, we both trade with a number of third parties using money and the market as the intermediary mechanism for achieving this state of reciprocity.

The Internet is a wonderful invention for the distribution of intellectual creations because it vastly reduces the transaction costs, thus allowing these reciprocal arrangements to take place with minimum friction. One sends bits over fiberoptic cable instead of putting them on pieces of plastic and shipping them by truck.

The Internet also expands the potential dimensions of markets to include the whole world, which will greatly increase the variety of creations available. Those who say that music can be free while bands make money from concerts miss a crucial point. If a band can sell its music over the Internet, all it needs to support itself is enough paying fans scattered all over the world. If it can exist only through concert sales, then it must have a critical mass in every city. So only the most popular acts would be able to exist at all, and the people in small areas lacking a critical mass would get no music.

Unfortunately, getting to this happy state of Internet markets is not easy. The outlines of what is needed are clear, though, even if the exact path is not, and a workable long-term system for music will include:

### **Legitimate Downloading Services**

Clearly, music and other intellectual products must be available on a paying basis through legitimate channels. The music industry knows this as well as anyone, and is working to make it happen. But this is not easy. Music copyrights are a tangled mess, and it very difficult to negotiate out all the interests involved. In addition, the

existence of the unauthorized downloading services substantially discourages investment in legitimate channels.

As a matter of ethics, an individual consumer could take the view that it is up to the industry to figure out how to make music available online and that the consumer will be happy to pay when this is achieved, but that he is not willing to pay to put bits on plastic and move them around the country by truck when this has ceased to be necessary. But as the online services are indeed coming into existence, this rationale is losing force.

### **Digital Rights Management**

Legitimate channels must have a way of collecting money, which means that the product must be controlled by some method of electronic locks and keys. Furthermore, consumers will be better off if they are presented with options containing different packages of rights offered at different prices. Such packages require DRM. It is very important that DRM not be undermined by abstractions about “fair use.” If DRM allows producers of IP to tailor their offerings to the desires of consumers, we will all be better off. Let a hundred business models bloom.

### **Education**

The affected industries are sponsoring education programs on why unauthorized downloading is wrong. Education should go further: it should also emphasize fundamental explanations why property rights and markets are important, and why we are all better off if they are enforced and observed. In the end, as noted above, each individual would be better off if he got to cheat while others played by the rules, but this is not the way societies work. The downloading issue presents a Prisoner’s Dilemma problem, and as author William Poundstone noted, “Study of the prisoner’s dilemma has great power for explaining why animal and human societies are organized as they are. It is one of the great ideas of the twentieth century, simple enough for anyone to grasp and of fundamental importance.”<sup>2</sup> The consumer who downloads music through unauthorized channels is cheating his or her fellow consumers because the practice involves free riding on their payments. Of course, if everyone tries to free ride on everyone, the system does not work at all.

### **Enforcement**

It is not possible to do without enforcement efforts. No matter how well-protected by DRM, intellectual products such as music must be channeled through an output device, and they can be captured, redigitized, and sent out over the Internet. The problem can never be eliminated, but, hopefully, as legitimate services become plentiful, enforcement can be relegated to the minor role in the system that it plays in other areas, such as the protections against shoplifting in the retail system.

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<sup>2</sup> William Poundstone, *Prisoner’s Dilemma*. Doubleday Anchor: 1992, p. 9.

No one likes the current enforcement offensive, least of all, I suspect, the RIAA, but there is a serious chicken and egg problem. Why should anyone invest in legitimate services if they will be forced to compete with free, which is the road to bankruptcy? On the other hand, unless legitimate services exist, consumers will feel justified in using the unauthorized ones. In my view, one strong reason for the RIAA to launch its current enforcement effort was to signal potential investors that the industry is serious about supporting efforts to create legitimate channels. This will help us get through the awkward chicken-and-egg problem as quickly as possible.

### **Benign Neglect by Congress**

This body is under continuing pressure to enact temporary fixes in response to the perceived crises of the day. It should resist. Most of the proposals are bad ideas that will inhibit the creativity of the market system and damage everyone. They are backed by slogans rather than analysis. Such proposals also compound the aura of uncertainty that surrounds the area, and thus inhibit the investment and effort needed to establish legitimate channels and get the whole problem behind us.

I am an optimist. The problems can be solved, and we can indeed reach the promised land of a vibrant system of intellectual creativity sparked by property rights and the market. But it will take steadiness on the part of the Congress, and a willingness to support the fundamental values involved.<sup>3</sup>

Finally, while most of this statement has concerned the interests of consumers, some very fundamental rights of creators are at stake as well. In 1972, the Supreme Court was confronted with an argument that “mere” property rights should be treated as unworthy of Constitutional protection. It responded:

[T]he dichotomy between personal liberties and property rights is a false one. Property does not have rights. People have rights. The right to enjoy property without unlawful deprivation, no less than the right to speak or the right to travel, is in truth a "personal" right, whether the "property" in question be a welfare check, a home, or a savings account. In fact, a fundamental interdependence exists between the personal right to liberty and the personal right in property. Neither could have meaning without the other.<sup>4</sup>

Intellectual property is encompassed by the Constitutional protections of property, and by these principles.<sup>5</sup> And as a higher proportion of society's collective effort is devoted to the production of information goods rather than physical goods, the need to defend the rights of creators, and their support network of employers and financiers, grows apace.

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<sup>3</sup> For further discussion of many of these issues, see James V. DeLong, *Intellectual Property in the Internet Age: The Meaning of Eldred*, Progress & Freedom Foundation Progress on Point No. 10.5 (Feb. 2003) <<http://www.pff.org/publications/POP10.5.pdf>>.

<sup>4</sup> *Lynch v. Household Finance Corp.*, 405 U. S. 538, 552 (1972).

<sup>5</sup> *E.g.*, *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986 (1984).

In closing, it is worth emphasizing that there is no conflict between the rights and interests of producers of intellectual property and the interest of consumers. As Justice Ginsburg said in her majority opinion in the recent Supreme Court decision *Eldred v. Ashcroft*.<sup>6</sup>

As we have explained, "the economic philosophy behind the [Copyright] Clause . . . is the conviction that encouragement of individual effort by personal gain is the best way to advance public welfare through the talents of authors and inventors." *Mazer v. Stein*, 347 U.S. 201, 219, 98 L. Ed. 630, 74 S. Ct. 460, 1954 Dec. Comm'r Pat. 308 (1954). Accordingly, "copyright law *celebrates* the profit motive, recognizing that the incentive to profit from the exploitation of copyrights will redound to the public benefit by resulting in the proliferation of knowledge . . . . The profit motive is the engine that ensures the progress of science." *American Geophysical Union v. Texaco Inc.*, 802 F. Supp. 1, 27 (SDNY 1992), aff'd, 60 F.3d 913 (CA2 1994). Rewarding authors for their creative labor and "promoting . . . Progress" are thus complementary; as James Madison observed, in copyright "the public good fully coincides . . . with the claims of individuals." The Federalist No. 43, p. 272 (C. Rossiter ed. 1961). JUSTICE BREYER's assertion that "copyright statutes must serve public, not private, ends" *post*, at 6, similarly misses the mark. The two ends are not mutually exclusive; copyright law serves public ends by providing individuals with an incentive to pursue private ones.

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<sup>6</sup> *Eldred v. Ashcroft*, 537 U.S. 186, \_\_\_\_ n. 18 (2003).

# THE PROGRESS & FREEDOM FOUNDATION

## MISSION STATEMENT

The Progress & Freedom Foundation is a market-oriented think tank that studies the digital revolution and its implications for public policy. Its mission is to educate policymakers, opinion leaders and the public about issues associated with technological change, based on a philosophy of limited government, free markets and individual sovereignty.

PFF's research combines academic analysis with a practical understanding of how public policy is actually made. Its senior fellows and other scholars are leading experts in their fields, with distinguished careers in government, business, academia and public policy. Its research is substantive, scholarly and unbiased. At the same time, PFF is focused on having an impact on public policy.

PFF's underlying philosophy combines an appreciation for the positive impacts of technology with a classically conservative view of the proper role of government. We believe that the technological change embodied in the digital revolution has created tremendous opportunities for enhanced individual liberty, as well as wealth creation and higher living standards. Those opportunities can only be realized if governments resist the temptation to regulate, tax, and control. Government has important roles to play in society, including protecting property rights and individual liberties, but its tendency is to reach beyond its legitimate functions in ways that harm consumers, burden citizens and slow progress.

PFF is an effective voice for market-oriented policy in a variety of key issue areas. Among its contributions:

- Leading the intellectual battle for true deregulation of communications markets, including immediate deregulation of broadband services, and forbearance from regulation of wireless communications and the Internet.
- Explaining the imperative to protect rich digital content and encourage innovation through the traditional legal notions of copyright and patent.
- Urging private solutions to help reduce digital piracy and increase the availability of rich digital content, without government mandates.
- Explaining the need for lower taxes on telecommunications services, a tax moratorium for Internet commerce, and privatization of government-run cable TV and telephone companies.

- Promoting competition in electricity markets, using demand-side, deregulatory market mechanisms rather than pervasive and costly government regulatory schemes.
- Advocating antitrust over regulation in the software market.
- Applying benefit-cost analysis to proposals for regulation of the market for personal information, and showing why severe regulations will not protect online privacy.

For ten years, from the beginning of the Internet Revolution in 1993, through the high-tech meltdown of 2000-2002 and beyond, PFF has been a consistent voice for a market-oriented approach to capturing the opportunities presented by technological progress.

Located in Washington, DC, The Progress & Freedom Foundation is a 501(c)(3) nonprofit organization founded in 1993.