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Locking in Value from IP

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Locking in Value from Intellectual Property

As part of a recent series on Manufacturing Innovation, the Manufacturing Institute in the United States of America identified five building blocks that it claimed were vital to the growth of the innovation economy. They were:

- Well trained professionals in science, math[s] and engineering who develop new products and processes, and the skilled technical workers who can perform in increasingly technological plants;
- High levels of federal investment in basic research;
- Readily available capital through a variety of financial intermediaries;
- Openness to new ideas and processes; and
- A strong intellectual property regime that allows innovators to recoup their risk investments¹.

It is the last of these building blocks – the intellectual property regime – that this paper considers. It does so in the context of the negotiation of the implementation regime for intellectual property law amendments agreed in the Free Trade Agreement between Australia and the USA. Specifically it reflects upon the public policy framework that guided negotiations between the Australian Government and intellectual property owners – including Microsoft Australia – on the shape of new copyright laws and looks at how a balance was struck between the role of those laws as a stimulant of economic activity and the need in a digital aged to secure to the greatest extent possible Australian consumer access to creative output.

Innovation

The drive to innovate is as natural a human aspiration and activity as nurturing or communicating. Innovation, at any and every level of human activity, can be neither prescribed by executive fiat nor directed or based upon a formula or recipe comprising public policy ingredients. Organisations that seek to mandate innovation are doomed to fail. Nevertheless all entities – including Governments – are seeking processes and frameworks that will allow innovation to flourish and are looking to best practices that suggest innovative outcomes. Such endeavours are premised upon a belief that innovation will create economic growth.

Cursory consideration demonstrates that innovation takes place every minute or every hour of every day in countless circumstances and activities in every country throughout the world. It is because innovation is so prolific that often it occurs without remark and without observation. The failure to identify innovation can be one of the great economic losses for individuals, entities and states. Capturing innovation provides the capacity to commercially exploit and benefit from that innovation.

While it is often said by those who see the virtue of times gone by that “there is nothing new in the modern world” the truth is that innovation is constantly changing the world we live in and will shape the one we will encounter in the future. Those individuals, organisations and states that can best facilitate, capture and exploit innovation will be the success stories of the next fifty years.

All innovation involves – whether recognised or not by the innovator – a unique description of thought, behaviour or process that can be appropriately acknowledged as the product of

¹ The Manufacturing innovation Series, Intellectual Property for The Technological Age by Richard A. Epstein, introduction by Jerry J. Jasinowski, Page 1 May 2006

intellectual endeavour. That so much innovation occurs without specific identification and description in no way lessens the significance of the direct and indirect intellectual investment made in securing innovation.

Where innovation is identified, harnessed and recorded it is possible to ascribe to that innovation the status of intellectual property – property in the sense that the innovation has an author and can be considered to have been created or be the product of one or more people.

Not all intellectual property is granted proprietary ownership because of the efficiency benefits of common property recognition. Notwithstanding this, it is the totality of intellectual property that is recognised when states create a system of intellectual property laws. By establishing boundaries that delineate a regime of legal protection for intellectual property the state determines the extent to which it recognises the capacity of exclusive property ownership to spur innovative activity and hence economic growth.

There is little dispute that intellectual innovation should be acknowledged and encouraged. However in accepting this premise it is important to identify that innovation occurs because of a complex and ever varying interplay of incentives, motivations and impulses within the human condition.

It would be facile to claim – let alone seek to identify - that all innovation takes place because of a single incentive or is motivated in fact or theory by a principal, identifiable cause. Searching for the cause of innovation is as pointless as seeking the fountain of all knowledge. Innovation occurs because the human being exists and the human circumstance allows for and rewards innovation.

This reality should be a foundation acknowledgement by all those seriously engaged in public policy enquiry and debate on the role of intellectual property laws. It needs to be recognised as much to set the boundaries of serious debate as to illustrate the limitations of those options available to government for positively encouraging and harnessing innovation. Innovation – whether in technology or any other human endeavour - is not ipso facto the 'product' of the existence, or otherwise, of intellectual property laws. Innovation may be stimulated, supported even encouraged by intellectual property laws but it is not the inevitable outcome of intellectual property laws. Innovation is and should always be considered to be the product of human activity.

How do Intellectual Property Laws Support Economic Growth?

Like all property rights intellectual property rights are fundamentally tools of economic distribution that support the allocation of economic benefit between various economic entities. As such they are an important, albeit not unique, mechanism for encouraging and then allocating the financial benefit of creative (that is innovative) activity.

During public discussion of the possible changes to Australia's copyright laws arising from the Free Trade Agreement between the governments of Australia and United States of America in 2004 it was argued by some that strengthening the intellectual property rights of copyright owners would at best negatively impact and more likely destroy the benefits enjoyed by the users of that property. It was further argued that strong intellectual property laws would negatively impact those who were excluded by those laws from a right to immediately exploit the intellectual property. In effect it was suggested by some that the copyright laws – and by extension all intellectual property laws - were a zero sum game between creators, the users of intellectual property and all others.

It would be naive to suggest that any system of property rights, whether for tangible or intangible objects, could always produce all gain and no pain. The exclusive allocation of property rights always creates an economic resource distribution between alternative if not competing interests. Societies adopt and support these allocations on the basis that they judge such allocations to be likely to lead to greater utility as between individuals and more likely than not to deliver maximum economic and social benefit to the society as a whole.

Asserting that every person, entity, organisation, society and economy will always, universally and equally benefit from the adoption and enforcement of strong intellectual property laws is as misleading as is the proposition that such laws must inevitably damage all those who do not enjoy the benefit of those laws. Adopting either polar position for the purposes of public policy setting will inevitably lead to the inefficient allocation of scarce resources.

Good public policy requires that decisions are made on the basis of rational judgements as to the probability of various alternative courses of action impacting both the macro measurements of policy action and the micro impacts on the various economic players in the economy. In the area of intellectual property law, more so than tangible property, ignoring secondary impacts – specifically the extent to which individual behaviour is altered by policy alternatives – is likely to result in inappropriate and potentially socially expensive choices.

As intellectual property laws are intrinsically related to economic concepts, they call for respect of the economic rights of others rather than a respect for the physical condition of another human being. It is often argued that infringement of intellectual property laws is a victimless crime and should not be enforced by state sanction as the beneficiaries of those laws are economic entities. Such arguments ignore not only the human impact of economic dispossession but also the detrimental impact on the ethical compact within a society of establishing separate legal status for tangible and intangible property. Moreover they ignore the economic impacts from the misallocation of national resources arising directly from infringement and indirectly from lost opportunity.

Moreover they fail to give sufficient weight to the capacity of intellectual property laws to impact the motivation and incentive for positive human behaviour in a society.

By granting exclusive rights for economic exploitation, intellectual property laws seek to encourage innovation in individuals, organisations and societies. To the extent that those economic benefits are judged valuable by intellectual property creators the existence, strength and enforceability of intellectual property laws will impact the extent or degree to which creative, innovative activity takes place and, more directly, impact the extent to which scarce resources will be allocated to supporting that creative activity.

It is through the filter of investment in a risky activity that the economic benefits of intellectual property laws can be most clearly understood. Any economic entity considering allocating its scarce resources to an activity must weigh up not only the level of the possible return against the cost of the investment but also the probability that the forecast return and cost profile will eventuate.

Direct investment in creative or innovative activities whether by an individual or a collective (company, co-operative, state) must, like any investment, contemplate the direct and indirect costs of that investment, the size of the potential gross return from the investment, and evaluate the probability of a variety of risks impacting both the cost and the return assumptions.

In so far as all investments are uncertain, a creative, innovative, intellectual property-based investment holds a different dimension of risk rather than a distinguishing investment

characteristic. It could be argued that the potential costs of investment in intellectual property may be greater than for tangible property investments or that the economic cost of enforcing or extracting value from the investment is more complex or significant.

While such arguments are important it is the measurement of the probability of the multiple layers of risk in an intellectual property investment that challenges the potential investor. It is this risk profile that also warrants society granting substantial economic benefit to intellectual property owners to encourage their creative participation.

Intellectual property laws that grant exclusive benefits to the owners of the creative endeavour mitigate for potential investors in that activity an element of the risk that they face when determining the potential level of their investment. If investors can be assured that the product of the creative process in which they have committed their resources will be capable of a level of exclusive economic exploitation by them then their investment risk is reduced and they are more likely to invest scarce resources in supporting creative activity.

Once again it is vital for balance to recognise that the presence and strength of intellectual property laws are just part of an investment equation. The evaluation of any investment opportunity must take into account many factors and this is equally true of creative industry investments. However, to the comparative extent that investment in one jurisdiction reduces investment risk for a given proposal (because the intellectual property laws of that country are strong and enforceable) then it is more likely that the investment of resources will take place in that jurisdiction.

As a result of its 2004 Free Trade Agreement with the USA, the Australian Government legislated a package of copyright laws that provided significant additional protection and certainty to the creators of intellectual property. At the same time the law clarified the rights of users to consume technologically delivered audio and visual entertainment.

As an example of this point, the introduction into Australian law of a presumption of copyright for software will have the effect of significantly reducing the cost to software copyright owners of participating in litigation to defend their intellectual property rights. Such presumptions have existed in Australian law for other forms of intellectual property and the extension to software was considered by the industry to be a sensible and practical measure. While still only a legal presumption, capable of being displaced by evidence, the inclusion of the presumption in Australian law has provided additional certainty for software copyright owners and thereby reduces both cost and risk.

From a consumer perspective, the clarification of the law giving consumers a right to time shift their consumption of publicly broadcast television was both a sensible and practical measure. Given the 'affliction' Australian sport fans endure in being able to view their favourite sports on television, the change in the law acknowledged and legitimised widespread practice and thereby provided legal certainty without adversely impacting the economics of public broadcasting.

These laws were the product of extended discussion and debate. No one side of the creator-user equation achieved across the full legislative position a status, collection of rights or economic power for themselves at the expense of the other. The balance struck looked to the reasonable rights, expectations and investments made by owners and users in the development and consumption of creative intellectual property.

From the very earliest point of the discussion and debate as to how the copyright laws should be framed Microsoft adopted a position that called for the strongest possible legislative protections for creative, intellectual property commensurate with an economic framework that encouraged consumers to make use of that property.

Microsoft's position was recognition of two factors:

1. That in an age of digital distribution creative innovation can be rapidly replicated and disseminated among users/consumers; and
2. Creators of intellectual property want and need consumers to engage in voluntary commerce in respect of their property.

This second point is an overt recognition of the specific importance of consumers to intellectual property owners. Without consumer demand the intellectual property owner has no market. Actions that therefore unduly limit or restrict the commercial market are rarely helpful to either consumers or intellectual property owners. Such recognition should be as obvious to policy makers as it is to those who seek to produce and consume intellectual property.

The reduction in transaction friction that has been brought about by digital communication has elevated the importance of digital rights management (DRM) tools as a means of securing the economic benefits of creative endeavour. There are many who fear that DRM (whether in the form of security passwords or sophisticated encryption) can lock up content or lock out application or device competitors.

Governments in particular have genuine and valid concerns about the potential deliberate and inadvertent use of DRM, particular in so far as it relates to the documents and other digital files created within government. While such concerns need to be and can be addressed from a technical and policy perspective it should be recognised that the use of DRM is the inevitable consequence of the development of technologies that allow for rapid and transparent production and reproduction of intellectual property.

The veracity of an intellectual property law must be determined by the capacity of the law to achieve the policy outcomes for which it was introduced. This includes the ability of the law to shape consumer behaviour and its ability to be enforced, either by the intellectual property creator or by the state.

By acknowledging the supremacy of the consumer in its policy consideration, Microsoft reaffirmed its belief that open markets with transparent information are the best method of allocating scarce resources and thus achieving substantial consumer benefit.

Open, efficient markets offer intellectual property owners a variety of ways of delivering consumer benefit and thereby extracting an economic return from the substantial investments that are made in the creation of intellectual property.

Recent evidence of this is the agreement for licence co-operation between Microsoft and Novell in respect of Novell's Linux based operating system. This agreement offers benefits to consumers by reducing the risk of investing in a particular form of intellectual property. It reduces the potential transaction cost for both Novell and Microsoft customers and establishes a broad developmental framework for co-operation between two major information technology companies.

Further evidence of the market working to the benefit of consumers can be seen in the greater readiness of major information technology companies to licence their un-commercialised innovation and creativity to third parties who have the time, capacity and desire to seek commercial products from this intellectual property.

Finally open, well regulated markets allow consumers to send demand signals to producers about their needs. In the information technology market, consumer demand has resulted in

competitive partnerships between long time competitors evidenced through cross-licensing and patent sharing.

Not so long ago open source based software and proprietary sponsored software were considered destructive, absolute competitors. Today while there is still fierce competition for the hearts and wallets of consumers there is also a genuine level of co-operation and joint sponsorship of bridges between the two paths across many companies. This mutual advantage is being directed by consumer demand for technology interoperability and solutions that reduce overall consumer costs.

Conclusion

There were many lessons learned during the copyright laws debate in Australia in 2005 and 2006, not the least of which was that intellectual property creators, users and government (bureaucratic and political) need to communicate with, not just to, each other.

For public policy strategists and directors in the information technology industry the following were but a few of the more important lessons:

- Intellectual property laws are a tool for encouraging economic development through innovation and creativity. They are as much an economic instrument as a legal construct and as such their value rests in both their symbolism as well as the capacity and willingness of the state to support their enforceability ;
- Proposals to amend intellectual property laws should be evaluated from first principles and not merely from an incremental economic perspective;
- Intellectual property laws should be evaluated in practical not theoretical frameworks taking into account both the direct and indirect (particularly incentive) effects of the laws;
- Protecting the value of intellectual property in a digital age requires legislative support for the technologies used to deliver that protection. The principles of copyright, including the right of broadcast, as developed in the past century need to be interpreted and applied to modern circumstances in order to continue to encourage intellectual economic innovation and activity;
- Intellectual property creators and consumers are not competitors – claims of advantage and disadvantage for either in the formation of intellectual property laws need to be tested and weighed by evaluation of the economic consequences at both a macro and micro level;
- The strength of a state's intellectual property laws is unmistakably an indicator of the economic value ascribed by that state to creativity and innovation;
- An open, well regulated market is the best mechanism for delivering consumer benefit as economic entities with good information and the ability to obtain an economic return can respond to consumer demand with flexible, targeted products and services;
- A legal prohibition is only ever effective if individuals believe that infringement will have an economic consequence greater than the benefit they seek through infringement; and
- No intellectual property law will stop infringement – this should not be the framework through which the worth of a law is judged.

Intellectual Property and Innovation

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- Innovation (creativity) contributes to economic development at every level
- Innovation is derived from an intellectual contribution
- Intellectual contribution can be encouraged through multiple channels
- Capturing innovation is vital
- IP laws encourage intellectual contribution and support the delivery of economic return

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- IP laws are a tool for economic development - Symbolism and Reality
- Evaluate IP proposals from first principles not by incremental economic perspective;
- Be practical not theoretical - consider direct and indirect effects;
- The digital age requires advancing the principles of copyright into the economic and social circumstances of this century;

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- IP creators and consumers are not competitors;
- IP laws indicate economic value of innovation;
- Open, well regulated markets will deliver maximum consumer benefit;
- Legal prohibitions are only ever effective as an economic tool if individuals believe that the cost of infringement will exceed the possible benefit; and
- No IP law will stop infringement.

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Summary

- IP is valuable – competition for creativity is evident
- IP laws are important and contribute to value through direct returns to creators and indirect incentives to investors