The Marginal Cost Controversy in Intellectual Property

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In 1938, Harold Hotelling formally advanced the position that “the optimum of the general welfare corresponds to the sale of everything at marginal cost.”¹ To reach this optimum, Hotelling argued, general government revenues should “be applied to cover the fixed costs of electric power plants, waterworks, railroad, and other industries in which the fixed costs are large, so as to reduce to the level of marginal cost the prices charged for the services and products of these industries.”² Other major economists of the day subsequently endorsed Hotelling’s view³ and, in the late 1930s and early 1940s, it “aroused considerable interest and [had] already found its way into some textbooks on public utility economics.”⁴

In his 1946 article, The Marginal Cost Controversy, Ronald Coase set forth a detailed rejoinder to the Hotelling thesis, concluding that the social subsidies proposed by Hotelling “would bring about a maldistribution of the factors of production, a maldistribution of income and probably a loss similar to that which the scheme was designed to avoid.”⁵ The article, which Richard Posner would later hail as Coase’s “most important” contribution to the field of public utility pricing,⁶ was part of a wave of literature debating the merits of the Hotelling proposal.⁷ Yet the very success of the critique by Coase and others has led to the entire contro-

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² Hotelling, 6 Econometrica at 242 (cited in note 1).

³ See, for example, James C. Bonbright, Major Controversies as to the Criteria of Reasonable Public Utility Rates, 30 Am Econ Rev Papers & Proceedings 379, 385 (1941) (praising Hotelling’s article as “one of the most distinguished contributions to rate-making theory in the entire literature of economics”).


⁵ Id at 180.


⁷ The extensive literature on both sides of the controversy is reviewed in Nancy Ruggles, Recent Developments in the Theory of Marginal Cost Pricing, 17 Rev Econ Stud 107 (1949).
versy being "largely forgotten today." Modern regulatory policy generally accepts that a declining average cost industry—that is, a so-called "natural monopoly"—will not have its fixed costs subsidized from general government revenues and that therefore the industry must be allowed to price above marginal cost so that it can cover its fixed costs. The rejection of the Hotelling thesis is so complete that reputable economics encompasses the very opposite of Hotelling's view—"that, generally, prices which deviate in a systematic manner from marginal costs will be required for an optimal allocation of resources, even in the absence of externalities." Indeed, in the parlance of public utility regulation, the very phrase "marginal cost pricing" now refers not to Hotelling's proposed marginal cost pricing and subsidy scheme, but rather to a pricing system akin to the "multi-part" pricing system that Coase advocated as the more efficient alternative to Hotelling's proposal. In short, modern public utility theorists generally do not recommend using pervasive public subsidies to chase the Holy Grail of global marginal cost pricing.

Yet despite this consensus, a recent vein of literature on the economics of intellectual property seems preoccupied with the perceived problem that prices for intellectual property may sometimes exceed marginal cost. This literature proposes the institution of significant public subsidies to resolve or at least to ameliorate the marginal cost pricing problem, and such proposals are already beginning to affect the course of policy debate in prominent public fora. This literature has developed thus far

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8 Posner, 7 J Econ Persp at 198 (cited in note 6).
9 See, for example, W. Kip Viscusi, John M. Vernon, and Joseph E. Harrington, Jr., Economics of Regulation and Antitrust 361 (MIT 2d ed 1995) ("[T]here are compelling reasons to accept the constraint that natural monopolies should operate such that total revenues and total cost are equated."); Alfred Kahn, The Economics of Regulation: Principles and Institutions 130 (Wiley 1970) (noting that "taxpayer-financed subsidies" present a theoretical solution to the contradiction between marginal cost pricing principles and the requirement that "total revenues equal total costs," but concluding that "since governments do not usually follow this practice with respect to privately owned utilities, we devote no more attention to this way out of the conflict").
11 See Coase, 13 Economica at 175 (cited in note 4). See also R.H. Coase, The Theory of Public Utility Pricing and Its Application, 1 Bell J Econ & Mgmt Sci 113, 122 (1970) (noting that the more recent proponents of marginal cost pricing were championing not a policy of government subsidy but merely "a policy in which the advantages of making price equal to marginal cost are taken into account," "no difference of any substance" remained between the opponents and proponents of marginal cost pricing).
13 For example, in a recent op-ed published in the Washington Post, Northwestern economist Burton Weisbrod proposed that the government should make "massive awards...to the developers of safe and effective new patented pharmaceuticals" through a program of "purchasing drug pat-
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with little apparent recognition that it is a modern reprise of the marginal cost controversy of the mid-twentieth century. The literature treats the marginal cost pricing problem of intellectual property as a unique phenomenon, and it remains isolated from the more general literature on public utility regulation.

This Essay is a first step toward ending that isolation. Part I begins by establishing the parallels between the economic theory of public utility regulation and that of intellectual property law. Part II reviews the recent literature proposing public subsidies for intellectual property and shows that these proposals are subject to the same objections that Coase raised in the public utility context more than a half century ago. Furthermore, the recent subsidy literature has not examined the important question whether intellectual property possesses some distinguishing features that make it a more appropriate target for public subsidies than other industries having natural monopoly characteristics. Part III addresses this question and finds that, while there are distinctions between intellectual property and traditional natural monopolies, these distinctions do not uniformly favor subsidizing intellectual property over other natural monopolies. Part IV concludes with the hope that, as the marginal cost controversy continues in the field of intellectual property, it will proceed with a more complete understanding of the earlier controversy, and that perhaps it can offer new insight into a very old and very fundamental debate.

I. INTRODUCTION: INTELLECTUAL PROPERTY AS A SPECIAL CASE OF NATURAL MONOPOLY

In both legal and economic thought, the topic of intellectual property is typically segregated from that of public utility regulation.14 This segregation is unfortunate because intellectual property is in fact just a special case of the problem of natural monopoly, a subject familiar to public utility regulation.

14 As one commentator has noted, “[n]atural monopoly theory creeps into the development of patent law from time to time.” John W. Schlicher, Patent Law: Legal and Economic Principles § 2.14 at 2-40 (Clark Boardman Callaghan 1992). But legal authorities typically reject the analogy between the two because they focus on the product embodying the intellectual property, which usually can be produced competitively, rather than on the intellectual property itself. See, for example, Fishman v Estate of Wirtz, 807 F2d 520, 538 n 16 (7th Cir 1986) (reasoning that “[a] patent is not a natural monopoly in the same sense as is a franchise for the provision of electric power at retail” because the market for the innovative product “could accommodate two or more producers”). The intellectual separation between intellectual property and natural monopolies is also maintained in economic thought. See, for example, Viscusi, Vernon, and Harrington, Economics of Regulation at 351–72, 831–46 (cited in note 9).
A "natural monopoly" is said to be present in any market where the average cost of providing a good continues to decline throughout the relevant range of demand. Such "declining average cost" conditions commonly arise where the fixed costs averaged over each unit of production remain relatively large compared to marginal cost throughout the range of market demand. For example, production of electricity has frequently been considered one example of a declining average cost industry because an efficient electrical plant requires large capital expenditures but, once such a plant is built, the marginal cost of producing electricity is relatively small.

There are two important implications of declining average costs. First, the classic condition of perfectly competitive markets—a market price at marginal cost—is impossible to achieve as a long-run equilibrium without some sort of governmental subsidy. The reason for this result is that, if the market price of the good were driven to marginal cost, producers would be unable to recover their fixed costs and they would not enter the industry in the first place. A second corollary of declining average costs is that concentrating all production in a single firm is more efficient than having multiple firms undertake production. Such concentration allows the firm to realize an economy of scale by spreading the fixed costs over more units of production and avoids wasteful duplication of the fixed costs of production.

Intellectual property is a special case of a good with declining average cost. The fixed costs of producing the intellectual property are the costs of writing a book, filming a movie, or researching and developing an innovation. Once the intellectual property has been created, the marginal cost of using it an additional time is very low; in fact, in most cases, it is essentially zero. The zero marginal cost of copyrighted works is easy to see in the modern world where photocopiers, computers, and VCRs are ubiquitous. For inventions, the intellectual property covered by a patent is often labeled as a "non-rivalrous" good: It can be used without being consumed. But the concept of non-rivalry is identical to zero marginal cost, for we could just as easily imagine that each use does consume—that is, destroy—a unit of intellectual property but that another unit is instantaneously produced at zero cost.

Because intellectual property is subject to declining average costs, it is also subject to the two effects discussed above. Indeed, these effects are

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15 Formally, the concept of "subadditivity" is used to define natural monopoly, but declining average cost is a sufficient condition for the existence of a natural monopoly. See Viscusi, Vernon, and Harrington. *Economics of Regulation* at 355 (cited in note 9).


17 This point follows directly from the assumption that average costs decline throughout the entire range of demand. The total cost of satisfying the demand (that is, the sum of each firm's average cost times the quantity produced by the firm) will be minimized by having all the production undertaken by one large firm, which will have lower costs than smaller firms.
familiar. First, a market price at marginal cost is not a long-run equilibrium solution without some sort of governmental subsidy. Marginal cost pricing for intellectual property could be achieved by, for example, refusing to grant exclusive legal rights. As in the case of other natural monopolies, however, that policy would mean that producers would not be able to recover their fixed costs and thus would not produce the property in the first place. The second effect also holds: By concentrating production of an intellectual property good in a single firm, that firm is able to realize an economy of scale by spreading the fixed costs over more units of production. Thus, as in the case of a natural monopoly, having only one producer of each particular piece of intellectual property avoids wasteful duplication of fixed costs.8

II. SUBSIDIZED MARGINAL COST PRICING FOR INTELLECTUAL PROPERTY: OLD PROBLEMS AND NEW VARIATIONS

Hotelling's marginal cost thesis is most clearly restated in Rewards versus Intellectual Property Rights by Steven Shavell and Tanguy van Ypersele. Like Hotelling, Shavell and van Ypersele argue in favor of a system of public subsidies to cover the fixed costs of several major industries. These subsidies would come in the form of rewards for intellectual property production rather than as payments to cover the fixed costs of public utilities. But in all other respects, the proposals broadly parallel each other. In both, the payment of fixed costs comes from general government revenues and would, if fully implemented, require significant government expenditures. And in both, the goal of the system is to drive price down to marginal cost across a broad range of industries. Hotelling wanted to achieve marginal cost pricing for the products of "electric power plants, waterworks, railroad, and other industries in which the fixed costs are large."2 Shavell and van Ypersele target "drugs . . . , all computer software . . . , and electronically recorded materials."21 Different industries have been chosen, but the tools and goals are the same. As shown in

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18 I leave for later discussion the issue of degree of monopoly. The recent literature has generally described intellectual property rights as conferring "monopoly power." See text accompanying note 57. To a certain extent, that description is always accurate and, for purposes of elucidating the basic analogy here, I indulge it. However, as discussed below in Part III.D, the degree of monopoly conferred by intellectual property rights is often far less than that considered to warrant concern in other areas of the economy.

19 Shavell and van Ypersele, 44 J L & Econ 525 (cited in note 12). As the authors noted, id at 528 n 10, their proposal follows the suggestion made much earlier by Kenneth Arrow, who argued in favor of having "the government or some other agency . . . finance research and invention." Kenneth J. Arrow, Economic Welfare and the Allocation of Resources for Invention, in National Bureau of Economic Research, The Rate and Direction of Inventive Activity 609, 623 (Princeton 1962).

20 Hotelling, 6 Econometrica at 242 (cited in note 1).

21 Shavell and van Ypersele, 44 J L & Econ at 545 (cited in note 12).
Part A below, the objections to this proposal are the same as those advanced by Coase more than a half century ago.

The recent literature also includes some innovative proposals for administering a public subsidy scheme. As shown in Part B below, these creative schemes are designed to address one point in the Coasean critique, but even on that point they are not fully satisfying.

A. Restating Coase for Intellectual Property

Coase identified four basic problems with Hotelling's subsidy proposal; each persists in the setting of intellectual property.

1. Tax distortions.

The most obvious objection to Hotelling's proposal is that the government must impose taxes to fund the subsidies for marginal cost pricing and that those taxes could "produce results similar in character to those which follow from charging [prices] greater than marginal cost."\(^2\) Shavell and van Ypersele do not entirely ignore this point; they note that their proposed rewards will have to be funded through taxation, which has its own "distortionary cost."\(^2\)

"Hence," they acknowledge, "the potential case for reward is less strong than is suggested by our analysis."\(^3\)

Any serious proposal to institute a system of rewards would need to compare the distortionary effects of taxes and IP rights and to conclude that the tax distortions were smaller than those caused by the relevant class of IP rights. Otherwise, the same objection made by Coase more than half a century ago would apply: The marginal cost solution could "bring about . . . a loss similar to that which the scheme was designed to avoid, but arising out of the effects of increased income taxes."\(^4\) As will be discussed in Part III.D, there are good reasons to think that the monopoly distortions from most IP rights are generally not large in comparison to those caused by taxation and that they are smaller than those that would trigger concern in other areas of the economy.

2. Government ignorance: false demand and the misallocation of resources.

One of Coase's most important insights is that, unless the government has very good information (and the will to use it), subsidized marginal cost pricing can lead to a misallocation of resources. An easy example is where the government subsidizes property that then goes unused. But even if the property is used—indeed even if used heavily—the sub-

\(^{22}\) Coase, 13 Economica at 179 (cited in note 4).
\(^{23}\) Shavell and van Ypersele, 44 J L & Econ at 544 (cited in note 12).
\(^{24}\) Id.
\(^{25}\) Coase, 13 Economica at 180 (cited in note 4).
sidy scheme can still lead to misallocation because consumers can commit themselves to strategies creating demand for the subsidized good. The example Coase provides is where consumers choose a location to live knowing the government subsidizes the fixed costs of transportation. In such circumstances, consumers may choose to live too far from the city center because they will assume that they will have to pay only the marginal costs of transportation. In sum, they will "choose between different locations without taking into account that the costs of carriage vary between one location and another."

A subsidized marginal cost pricing scheme can account for this problem only if the government has sufficient information. Even though the government would subsidize fixed costs so that consumers are charged only marginal cost, the government's decision to provide the subsidy should be based on whether consumers, as a whole, would have demanded the good if they had to pay the total cost. The easiest example is where the members of a community would be willing to pay the marginal costs of a commuter train between their location and the city center. Should the government subsidize the fixed costs of train service? The answer is clearly no if the total benefits of the train service (that is, the sum of all benefits to all consumers) would not cover the total cost of providing the service.

The harder issue is presented where the current demand for service does exceed the total costs of providing the service, but that demand for service would not have been so high (because fewer people would live at the location) if the consumers had expected to pay the full costs of service prior to choosing their residences. The difficulty here is that, once the consumers have settled on a residence, their demand for transportation will appear to be real and, collectively, that demand may exceed the total costs of the train service. But the demand is in fact a false demand. Before the consumers located themselves in the hinterlands, their collective demand might not have exceeded total costs because, at that time, the consumers could have chosen to live closer. Thus, in assessing whether the demand exceeds the total costs of service, the government must be able to take into account the distortionary effects of its subsidies. In other words, it must be able to answer the question whether consumers, as a whole, would have demanded the good if government policy were different and they had expected to pay the full cost of the product. But, of course, the government will have no data to answer that question because consumers are not paying full costs and never expected to do so. And yet, if the government cannot accurately answer that question, then consumers will

26 Id at 174.
27 See id at 174–76.
have incentives to make decisions (for example, where to live) inefficiently and resources will be misallocated.

The parallel to intellectual property is straightforward. Just as consumers can make decisions that create demand for transportation, so too they make decisions that create demand for intellectual property. For example, consider a firm faced with a decision whether to computerize a certain aspect of its business. The switch to computers will save the firm labor costs, which the government does not subsidize, but increase the firm's demand for software and computer innovations, which the government does subsidize. In making its decision, the firm will not take into account the full costs of the intellectual property needed for computerizing the task and will substitute computers for labor at an inefficient rate.

Shavell and van Ypersele do not totally ignore this problem; rather, they assume the problem away by making an assumption about the government's information strikingly similar to that made by the marginal cost theorists sixty years ago. They assume that the government will offer rewards only for inventions with positive social surplus. This assumption requires, as they recognize, that "the government's information [be] good enough to screen out innovations with no value (or with no expected value)." As used in this context, inventions with "no value" include not only inventions with no benefit (such as a "perpetual motion machine" or a worthless variation of existing technology), but all inventions where the total demand for the invention does not justify its creation. The government must, therefore, have very good information about the demand for intellectual property even though, in the marketplace, consumers are never asked to pay the full costs of intellectual property.

3. Income redistribution and rent-seeking.

Another aspect of Hotelling's marginal cost proposal is that the system would redistribute income in favor of those who consume declining average cost goods. This effect occurs because the revenue to cover fixed costs is derived from general taxation. Indeed, this feature is essential to the goal of the scheme because, if only the consumers of the relevant product were made to bear the tax that finances the subsidies, then those consumers would be bearing the total cost of the product, rather than just the marginal cost.

Such a wealth transfer could be criticized on distributional and fairness grounds. Why, for example, should citizens who do not consume large amounts of intellectual property subsidize those who do? But there is also an efficiency objection. While wealth transfers themselves do not

28 Shavell and van Ypersele, 44 J L & Econ at 532 (cited in note 12).
29 Id at 532 n 24.
necessarily have any cost in terms of efficiency, they do where individuals are likely to expend resources seeking the transfer. The concern here is about rent-seeking. It can be understood most clearly by considering the appeal of a regime that promises, as Shavell and van Ypersele's reward system does, to make "drugs ... far cheaper," "computer software ... free," and "electronically recorded materials ... inexpensive." That regime will appeal most strongly to those who currently consume those goods, for they will obtain the largest benefit. But the economic efficiency of a reward system comes exclusively from increasing consumption among those consumers who value the good (or some units of the good) below the price that would be charged by the right holder under the current IP system. In short, the increase in efficiency comes only from consumers who are literally at the very margin of the demand curve. But the political pressure to adopt the system will come mainly from the inframarginal consumers, who have more to gain from the system even though their gains are mere wealth transfers from general government revenues.

Indeed, the rent-seeking problem is even worse in the experimental system proposed by Shavell and van Ypersele because it would implement a reward system on only a "partial basis" with application only to those "areas of innovation where the social losses due to intellectual property are likely to be high, namely, where the difference between price and production cost (after innovation) is large." If reward subsidies are targeted to particular areas, the opportunities for rent-seeking are increased dramatically, for the current consumers of particular intellectual property products will expend resources vying to have their area picked as the target for the subsidy.


Coase's final criticism of Hotelling's proposal was that Hotelling was not making the correct comparison: He was comparing marginal cost pricing (coupled with the necessary government subsidies) to a single pricing scheme. But monopolists are free to rely on "multi-part" pricing, by which lower charges would be made for incremental units. In other words, the monopolist could engage in price discrimination—charging more for

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31 Shavell and van Ypersele, 44 J L & Econ at 541–42 (cited in note 12).
32 Id at 545. Moreover, the relevant economic question for targeting rewards should not be whether the difference between price and production cost is large—though that question is likely to dominate the political choice of whether to apply a reward subsidy. The right question is whether a large amount of additional demand would be met if a reward policy were implemented.
some units of the good than for others. If the monopolist can engage in perfect price discrimination, no deadweight loss will occur.

Intellectual property right holders often try some form of price discrimination, which may reduce the deadweight loss associated with their exclusive rights. The reason they do so is not altruism. Right holders have good private incentives to find ways to minimize deadweight loss because, to the extent that they can achieve this, they may be able to capture part of the gains. But the effect of this privately motivated behavior is to reduce the distortionary effect of the exclusive right.

The point here is similar to that made in the above discussion of taxation. A reward system cannot be compared to IP rights without comparing the distortionary effects of patents and taxes. Indeed, the general issue here can be stated as simply this: Between the government and the IP right holder, who can collect the revenue needed to pay the fixed costs of creating the IP with the least distortion? The government has the coercive power to tax, including the power to use different tax rates for different categories of individuals. The IP right holder has the power to charge for the intellectual property, including the right to charge different prices to different categories of customers. Given that the IP right holder also has the potential constraint of competition from other technology, it is by no means clear that the IP right holder will cause greater distortions than the government's revenue agents.

One additional reason militates against funding fixed costs through general taxation. If left to recover the fixed costs of innovation through its pricing structure, the IP right holder will have an incentive to improve the business technology of minimizing deadweight loss. Such business improvements will improve the incentives for innovation generally, by making patents a more efficient technology.

B. Tinkering with the Machinery of Subsidy: Refining Rewards

While Shavell and van Ypersele restate Hotelling's marginal cost thesis, two other articles have offered more refined mechanisms by which social subsidies can be used to drive the price of intellectual property toward marginal cost. In general, these refinements are directed toward solving one of the largest problems associated with any subsidy scheme:

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34 And, of course, a new technology in business methods would be patentable. See State Street Bank & Trust Co v Signature Financial Group, Inc, 149 F3d 1368, 1375 (Fed Cir 1998).

35 Of course, if the government funded the fixed costs of innovation through tax revenue, that would increase the incentives for the government to improve the efficiency of its tax system. But the government already has good incentives to improve taxation techniques. Moreover, the private sector can probably outstrip the government in improving the technology of deadweight loss minimization. Indeed, one assumption of any reward system must be that government is inferior to private industry in innovating, for otherwise public financing of government research would be preferable to a reward system. See Kremer, 113 Q J Econ at 1143 (cited in note 12) (assuming that government financing of research is ineffective).
the poor quality of the government's information. These articles do not reconsider the general project of subsidized marginal cost pricing in intellectual property and thus are subject to many of the same criticisms that can be made against the Shavell and van Ypersele proposal. But the refinements are nonetheless worth examining for two reasons. First, the refinements, while clever, suffer from some flaws that may not be immediately obvious. Second, to the extent that these refinements are worth pursuing, they should not be limited to the field of intellectual property but instead considered more generally for solving the divergence between price and marginal cost in other fields.

1. Striving for smarter government.

The first of the two articles, Michael Kremer's Patent Buyouts: A Mechanism for Encouraging Innovation, proposes an interesting auction system to solve the problem of government ignorance about the value of an invention. Rather than trying to value innovations itself, the government would hold auctions for patents and thereby allow private bidders to establish the price for each innovation. Of course, while auctioning might be a good valuation mechanism, transferring a patent from one private party to another does nothing to solve the marginal cost problem. The trick to Kremer's system is that, after the auction is complete, the government steps in and purchases most of the patents that have been auctioned. Of course, the government cannot use this mechanism to buy out all of the patents auctioned because, if it did, no private party would have an incentive to develop the information necessary to bid in the auction. Thus, some patents are simply transferred from one private party to another, with no solution to the marginal cost problem for those properties.

The Kremer buyout mechanism has some nice features. Obviously, it substitutes a market mechanism for the governmental welfare calculator necessary to run a rewards system. To the extent that private firms have better information than the government about the value of innovations, that substitution is desirable. Kremer's proposal also gives the patentee

36 113 Q J Econ 1137 (cited in note 12).
37 Although Kremer proposes government-run auctions to provide market-based valuations for patents, such auctions would be unnecessary for patents held by publicly traded firms. In place of an auction, the government could simply (1) suspend trading in the firm's stock; (2) declare the patent to be in the public domain; (3) allow trading in the stock to resume; and (4) observe the difference between the pre- and post-suspension market prices of the firm's stock. The stock price difference would provide a market-based test of the patent's value, without the cost of holding an auction. If the government paid that difference to the shareholders of record at the time of the suspension in trading, incentives to underwrite research would not be dulled. As in Kremer's system, a stock market system for valuing patents would need certain controls to prevent collusive tactics, and the government would have to leave some patents in private hands so that market valuations remain honest. The government could also add a "markup" to increase the incentives for innovation, though only
control over the timing of the auction, and this feature might allow pat-
tents to continue to serve what is known in intellectual property literature
as a "prospect function": A patentee with an embryonic patent can refuse
to submit the patent to auction until the property has been sufficiently
developed; the property right can therefore continue to provide an incen-
tive to invest in the further development of the idea.36

There are, however, three especially difficult aspects of the proposal.
First, to keep the auction prices fair, Kremer's system requires a randomly
selected set of patents to be sold to private parties, and thus the govern-
ment must have the political will to continue enforcing that set of patents
even though most innovations are free. This feature would be most prob-
lematic in the pharmaceutical industry, which Kremer identifies as a
"natural area to try" his buyout mechanism. A buyout system would yield
the greatest social benefits for those drugs having the largest difference
between marginal cost and monopoly pricing, and these drugs are likely
to be life-saving drugs with few good substitutes. Yet the assignment be-
tween the public and private domains must remain strictly random. The
government must be willing to allow the cure for AIDS to remain in pri-
ivate hands if random chance would have it. Nor is it a solution to this
problem to say that the government can always subsidize drugs that re-
main under patent, for, if that is so, then the government's commitment to
subsidize will distort the auction prices by raising them beyond their so-
cial value.

A second problem concerns patents that are substitutes or comple-
ments of each other. As Kremer recognizes, sequential auctions of substi-
tute or complementary patents could distort the bid prices for the patents
in a way that causes either insufficient (in the case of substitutes) or ex-
cessive (for complements) levels of research. For example, if the first of
two complementary patents were placed in the public domain, the bidders
on the second patent would recognize that the public will be willing
to pay more for use of the second patent because the first can be used for
free. Kremer's solution is to require that all substitute and complemen-
tary patents be auctioned simultaneously.37 However, one large class of
complementary patents—improvement patents—tend to be sequential,

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Econ 265 (1977) (arguing that patents on embryonic ideas serve a "prospect function" becausen
encourage their owners to invest in the further development of the idea). It is a separate issue
whether, under Kremer's system, a patentee would have an incentive to delay the auction so that
the patent could serve its prospect function. Bidders in the auction would value the patent based on
the assumption that it would remain private property because they would be required to make good on
their bids only if the patent were not going to be placed in the public domain. But the whole thrust of
the prospect theory is that the rights to an innovation may be worth more in private hands than in
the public domain.

37 Kremer, 113 Q J Econ at 1156-57 (cited in note 12).
which makes simultaneous auctions difficult. Indeed, in an earlier part of
his article, Kremer recognizes the sequential nature of improvement pat-
ents and counts as one benefit of his system that “[p]atent buyouts will
strengthen incentives for this further development [of technology in re-
lated fields] . . . because the market for a complementary invention will be
larger if the original invention is sold at marginal cost.” That passage as-
sumes that the patent on the original invention will be auctioned sepa-
rately from the later complementary patent even though, as Kremer later
recognizes, such a separate auction may create excessive incentives for re-
search into complements.

The problem of patented substitutes and complements is, however,
only a special manifestation of the more general distortion caused by the
subsidy. Subsidizing patents can distort the market price (in other words,
the auction price) for a patented substitute or complement not because
the substitute or complement is patented, but merely because it is a sub-
stitute or complement. This third and final difficulty with Kremer’s buy-
out proposal is in fact just a recapitulation of one point in Coase’s critique
of Hotelling—that the social subsidies needed to produce marginal cost
pricing can create resource misallocations of their own. Consider, for ex-
ample, a patent that decreases the cost of transportation; complements to
that patent include not only improvements to that particular technology
but also homes built far from a city center. If the homes and the patent
are not auctioned together, parties will bid up the price of homes (and,
more importantly, build more homes) in anticipation that the patented
technology is likely to be subsidized. The result is the same as if the com-
plements were both patents: The subsidies can create excessive incentives
for creating the complements (and also insufficient incentives to create
substitutes, such as homes in the city).

While Kremer recognizes the problem of substitute and complemen-
tary patents and tries to construct his auction mechanism so that the auc-
tion prices of patents are not distorted by the social subsidy system, he
does not recognize that investments in patents are only one particular
type of capital investment that may suffer distortions caused by the subsi-
dies. The problem is general, and the solutions proposed by Kremer for
substitute and complementary patents—for example, simultaneous auc-
tions—cannot realistically be extended over the full range of all substi-
tutes and complements for a patented technology.

2. Hoping for a dumber private sector.

In Perfecting Patent Prizes, Michael Abramowicz proposes an alter-
native way to refine social subsidies for intellectual property. Like

40 Id at 1152.
Kremer, Abramowicz proposes an interesting solution to the problem of government ignorance but, rather than trying to make the government's information better, Abramowicz suggests making the private parties' information worse. Abramowicz's insight is that "flawed governmental decisionmaking in awarding prizes . . . [is] of concern only if the government's biases are predictable in advance." If a government agency is charged with rewarding meritorious activity and private parties have very poor information about how the government will grant these rewards, then the private parties may assume that all deviations from the stated goal of rewarding merit will be just random and unpredictable noise. Because private parties will respond to the expected (that is, average) reward and because government errors will (by hypothesis) average to zero, private parties will behave as if the government rewarded only the desirable behavior. The trick, then, under Abramowicz's system, is to inform private parties of the goals of the reward system but otherwise to keep them as ignorant as possible about its details. Thus, Abramowicz suggests that Congress should authorize an agency to grant rewards for any "action to reduce the deadweight cost of patents," but that the rewards should be conferred only long after the relevant action, so that the structure, processes, and composition of the agency remain mysteries to the parties at the time they are taking the actions justifying the reward.

The first point to notice about Abramowicz's system is that there is no need to limit the proposal to rewards for "reduc[ing] the deadweight cost of patents." Techniques for reducing deadweight loss may be public goods, but so too are innovations. If Abramowicz's delayed reward system works, it can be used not to supplement but to supplant the patent system; the meritorious behavior targeted for rewards would be innovation itself rather than reduction of deadweight loss. Indeed, it could also be applied to other fields of natural monopoly or even to government procurement.

The question then becomes not why has a delayed reward system not been applied to minimizing the deadweight loss from patents, but why has such a system not been applied more generally to encourage conduct that the government is willing to subsidize. At least one partial answer may be that government decisionmakers—particularly decisionmakers unconstrained by any rules or by any criteria for evaluation—tend to have one bias that is predictable and hard to eliminate: Those decisionmakers tend

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42 Id at 218.
43 At times, Abramowicz frames his proposal as a plea for "flexibility." Thus, for example, he champions "agency flexibility" in part because "it would allow different approaches to reducing deadweight loss to be used in different circumstances." Id at 219. But in fact his proposal requires not only agency flexibility but also agency unpredictability. If the agency were merely flexible—that is, if it could choose amongst a variety of approaches to fit particular circumstances but its choices were predictable—then private parties would know the agency's biases.
44 Id at 212.
to be influenced by lobbying. If that is a significant problem, then the rights to prizes would be little more than licenses to lobby; they would not be worth much and few people would invest much in the activity needed to create the claim. Rather, parties would invest heavily in swaying the governmental decisionmakers.

Indeed, while Abramowicz calls for a "pilot program" in which an agency has "a great deal of flexibility" in granting rewards, there is in fact already experience with such a program. In 1991, the Federal Communications Commission—an administrative agency that, consistent with Abramowicz's suggestions, is both independent and relatively unconstrained by statute—began an experiment known as the "pioneer preference program." The program was intended to "reward[] those who develop new frequency-based services" and to "encourag[e] entrepreneurs and venture capitalists to invest time and money in new services and any related technologies." The rewards for innovation would be licenses to valuable spectrum, and the Commission retained flexibility as to how it would ultimately grant these rewards. Within a few years, the program became controversial because of the enormous lobbying efforts of firms seeking rewards, and in 1997, Congress barred the agency from continuing the program.

Of course, one such failure does not prove the impossibility of constructing a governmental reward system for which "the best way to obtain a claim on a prize is through actual scientific research, rather than through lobbying." But it does suggest that patent prizes may be difficult to perfect.

47 See In the Matter of Review of the Pioneer's Preference Rules and In the Matter of Amendment of the Commission's Rules to Establish New Personal Communications Services, 9 FCC Rec 4055, 4064 (1994) (reviewing the propriety of the extensive lobbying efforts by candidates for pioneer preference rewards). See also Sandra Sugawara, FCC Faces Probe on Award of Wireless Phone Rights; 4 PCS Firms Deny Pressure for Licenses, Wash Post B11 (May 5, 1994) (noting a congressional inquiry into whether "the agency's decision to grant so-called 'pioneer preference' status to [four] companies was the result of 'political and lobbying pressure'").
III. DIFFERENCES BETWEEN INTELLECTUAL PROPERTY AND TRADITIONAL NATURAL MONOPOLIES

Because the current literature on marginal cost pricing in intellectual property has ignored the marginal cost controversy of the twentieth century, it has not attempted to make the case that intellectual property is so different from other natural monopoly industries that the government should embrace a solution that has been generally rejected outside of intellectual property. Here we examine that issue and find that, although the fundamental analysis of subsidized marginal cost pricing is the same in intellectual property as in more traditional natural monopolies, there are some differences worth noting. The differences, however, cut in opposite directions and do not establish a clear case for why intellectual property in particular should be a better target for subsidized marginal cost pricing.

A. Increasing the Incentives for Innovation

One argument that appears, at first blush, to be unique to the setting of IP is that social subsidies should be preferred over private rights because social subsidies can be used to increase the incentives for investment in IP. For example, Shavell and van Ypersele argue that “the incentive to invest is always inadequate [in an IP patent system] because monopoly profits are less than social surplus,” but that a reward system need not be “systematically inadequate” in the same way. This argument is not, however, limited to the context of intellectual property. As the champions of Hotelling’s thesis noted, the incentives to invest in declining-cost industries are generally inadequate under a “Coase-plan,” or private-rights system, because, just as in the IP case, private profits are less than the social surplus if perfect price discrimination is impossible. Thus, in the traditional monopoly case, private firms may have “systematically inadequate” incentives to invest in a declining-cost industry.

In fact, in the context of intellectual property, there is a good reason to keep the incentives to innovate below the full social surplus of the innovation. As Shavell and van Ypersele note, holding out an incentive to invent (either a reward or a patent) creates “a race among potential innovators to be the first to innovate,” and “this race leads to the possibility of overinvestment in research because the private return to being first may...

50 Shavell and van Ypersele, 44 J L & Econ at 530 (cited in note 12). See also Kremer, 113 Q J Econ at 1148 (cited in note 12) (arguing that a patent buyout mechanism should include a “markup” that would “raise private incentives for original research closer to the social benefit created by the invention”).

51 William Vickrey, Some Objections to Marginal-Cost Pricing, 56 J Polit Econ 218, 226 (1948) (arguing that private, unsubsidized decisionmakers will fail to fund many socially worthwhile projects in declining-cost industries).
exceed its social value." Although Shavell and van Ypersele conclude that this racing effect is not important to the choice between rewards and IP rights, the racing effect means that an IP reward cannot be deemed inadequate merely because it is less than the full social surplus of the innovation. Indeed, it can be shown that, in any innovation system that rewards the first innovator, setting the reward equal to the full social surplus of the invention is clearly not efficient because competition among inventors will dissipate all of the social surplus. An IP reward system that sets the reward equal to the full social surplus would plainly offer inefficiently large incentives.

B. The Administration of Marginal Cost Pricing: Price Regulation versus Withdrawal of Property Rights

Intellectual property differs from traditional natural monopolies in one respect that does make the case for subsidized marginal cost pricing somewhat stronger: Once the fixed costs of creating intellectual property have been subsidized, the government has an administratively simple way to enforce marginal cost pricing; it simply places the property into the public domain. By contrast, even if the government covers all fixed costs associated with a traditional natural monopoly, the government must still administer a system of price regulation to keep the monopolist from pricing above marginal cost, and that task may be quite difficult. This difference is, of course, a corollary of intellectual property’s zero marginal cost. Holding price at zero requires not a complicated scheme of price regulation, but only a withdrawal of property rights protection.

This difference does, however, come with a cost: While the nature of intellectual property simplifies the government’s regulatory task after creation of the property, it also makes the job on the front end—that is, the setting of the subsidy—more difficult. To determine whether it is setting correct subsidies, the government needs to obtain some idea of the social value of the properties subsidized, and measuring demand is typically one step in that process. Yet it may be a much simpler matter to tell how many cars cross a bridge or how much electricity is consumed than to determine how often an idea is used. To an extent, Shavell and van

52 Shavell and van Ypersele, 44 J L & Econ at 543 (cited in note 12).
53 Id (“Because the race to be first is a factor that afflicts both systems, and because the information needed to address it under either seems to be of the same character, consideration of the race to be first does not seem to bear on the comparison between reward and patent.”).
54 See Yoram Barzel, Optimal Timing of Innovations, 50 Rev Econ & Stat 348, 348-49 (1968). See also Nancy Gallini and Suzanne Scotchmer, Intellectual Property: When Is It the Best Incentive System?, in Adam B. Jaffe, Josh Lerner, and Scott Stern, eds, 2 Innovation Policy and the Economy 51, 73 n 5 (MIT 2002) (noting that Kremer’s patent buyout mechanism would provide excessive incentives for innovation if inventors were rewarded with the full social value of the innovation).
Ypersele recognize this difficulty, for they acknowledge that the administration of a reward system is “more difficult when the value of an innovation is in part that it leads to subsequent innovations.” But the question whether an innovation has been used in creating subsequent innovations is only one dimension of the problem of defining a patent’s “scope,” which also encompasses the more general question whether the relevant innovation can fairly be deemed to be used in producing the host of various products appearing on the market. Answering that question is notoriously difficult, and the withdrawal of property rights would make it even more so because private parties would no longer have good incentives to meter the use of the idea.

C. Local versus Global

Unlike a cable network, a bridge, a utility, or other traditional natural monopoly, each piece of intellectual property typically satisfies demand across a worldwide market. This difference almost certainly complicates any pure subsidy scheme because the problem of providing the efficient subsidy (or reward) must be solved not by one government but by many, each of which has incentives to behave strategically in contributing toward the reward.

This feature of intellectual property may, however, be less relevant for optional systems of the sort proposed by Shavell and van Ypersele. Under their proposal, the innovator is allowed to choose between a reward and IP rights within the country. This model assumes a preexisting system of property rights that divides IP rights along national lines and thereby transforms a global public good into a local one. Indeed, a multinational, optional reward system can be viewed as simply changing the market for IP—allowing the right holder to sell the innovation to countries as well as to individuals. Deadweight loss can theoretically be eliminated, but only if the IP right holder is able to practice perfect price discrimination among countries. If such price discrimination is not possible, then deadweight loss will persist as some countries will find the price charged for the IP rights to be above the reward that they are willing to offer.

D. The Degree of “Monopoly”

The recent literature on the marginal cost problem in intellectual property tends to describe IP rights as conferring “monopoly power” or as leading to “monopoly pricing.” In one sense, all IP rights are “mo-

\[56\] Shavell and van Ypersele, 44 J L & Econ at 543 (cited in note 12).
\[57\] Id at 529 (noting that “[u]nder the patent system, the innovator’s incentive to invest in research is the monopoly profits he would earn”); Kremer, 113 Q J Econ at 1137–38 (cited in note 12) (describing the patent system as creating “monopoly price distortions”). See also Ian Ayres and Paul
nopolies” because one accepted definition of “monopoly” is “an exclusive privilege of engaging in a particular business or providing a service, granted by a ruler or the state.” But this is purely a semantic point. For purposes of public policy, the relevant concept must be an economic one, and the economic concept of monopoly is a matter of degree, not an all-or-nothing proposition. Moreover, defining the degree of monopoly or market power implicates a notorious ambiguity in economics—the definition of a market, which “remains unavoidably a matter of judgement in some degree.” The judgments made in defining markets and monopoly are ultimately pragmatic ones. They are based on a sense of whether the distortions produced in the market should be a matter of concern, and that judgment, in turn, is based on the sense of the likely success of governmental intervention.

Thus, while the recent literature advocating social subsidies for intellectual property focuses on the undeniable divergence between price and marginal cost caused by intellectual property rights, the relevant questions for formulating a governmental response should be whether, and to what extent, that divergence should be a matter of concern. Here there is good reason to believe that the divergence is usually not a matter of concern, or at least that it does not rise to the level that would create concern in other areas of the economy. Indeed, the U.S. Antitrust Guidelines for licensing intellectual property explicitly state that the government “will not presume that a patent, copyright, or trade secret necessarily confers market power upon its owner.” The Guidelines recognize that “[a]lthough the intellectual property right confers the power to exclude with respect to the specific product, process, or work in question, there will often be sufficient actual or potential close substitutes for such product, process, or work to prevent the exercise of market power.”


60 See Mark A. Lemley, The Economics of Improvement in Intellectual Property Law, 75 Tex L Rev 989, 996 (1997):

[1]ntellectual property rights ... allow the intellectual property owner to raise the price of that work above the marginal cost of reproducing it. Indeed, intellectual property rights must permit prices to rise above marginal cost in some cases if they are to have their intended effect of providing an incentive to create.


62 Id.
mentators also have recognized that intellectual property rights do not "automatically confer market power or create 'monopolies' in an economic or antitrust sense." If this is so, then the distortionary effects caused by IP rights might generally be small or, more accurately, small in comparison to the expected distortionary cost of the taxes needed to fund a social subsidy scheme.

CONCLUSION

Despite its flaws, the developing literature advocating public subsidies to achieve marginal cost pricing of intellectual property has provided scholars with an opportunity to return to one of the fundamental debates in economics theory from the twentieth century. The debate has now shifted from railroads and electric utility plants to pharmaceuticals and software, but the underlying economic issues are similar. This Essay has suggested that this new scholarship would be better if it acknowledged the similarity between the marginal cost controversy of today and that of the past. Such an acknowledgment is important because, if the new literature can provide an answer to the marginal cost problem in the field of intellectual property, that answer is likely to apply to a broad range of industries.

More generally, however, this new marginal cost controversy should be welcomed. Revisiting fundamental debates always holds out the possibility of fresh insight, and we should not be Pollyannish about our current system of intellectual property. That system is itself an experiment no more than a half millennium old, and it continues to evolve. The champions of intellectual property should not become Luddites when it comes to improving the legal technology of encouraging creativity. Still, we can hope that regulatory innovators will proceed with a full understanding of the scope of the problem and an appreciation of the ideas of the past.

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63 Lemley, 75 Tex L Rev at 996 n 26 (cited in note 60). See also Edmund W. Kitch, Patents: Monopolies or Property Rights?, 8 Rsrch L & Econ 31 (1986) (arguing that, even in the case of Xerox's patents on photocopying, the existence of older technology limited Xerox's ability to increase its prices).