Ethical Issues in the Music Industry Response to Innovation and Piracy

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Abstract

The current conflict between the recording industry and a portion of its customers who are involved in illicit copying of music files arose from innovations involving the compression and electronic distribution of files over the internet. This paper briefly describes some of the challenges faced by the recording industry, and examines some of the ethical issues that arise in various industry and consumer responses to the opportunities and threats presented by these innovations. The paper concludes by highlighting the risks associated with responses that threaten further innovation, ultimately reducing the chances of finding solutions that hold appeal for all parties.

Keywords: disruptive innovation, music piracy, recording industry

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Introduction

For several years now the recording industry has been battling music piracy, primarily by going after software and website developers, as well as consumers, in the courts. This may be holding back the evolution of the music industry towards an ultimately beneficial embrace of the possibilities inherent in electronic distribution of music. Yet the history of industry response to innovation generally suggests that this effort is likely to fail, and some research suggests that the music industry has more to gain than to lose from embracing many of the innovations it is currently battling. This paper examines some of the ethical issues that arise in responding to innovations that are perceived to be threatening, in particular with respect to music piracy.

The Difficulties Inherent in Responding to Innovation

There is a long history of research on the response of industry to threatening innovations, going back to Schumpeter's gales of competitive destruction (Schumpeter, 1947). Eric von Hippel (1988), for example, argues that examining the source of innovation is important to determining what advantage, if any, may be gained from it. He classifies innovations as originating from one of three sources: a manufacturer, supplier or user; and emphasizes a key distinction between innovation by firms and suppliers who must market the innovation to profit from it, and innovation by users who must, on the contrary, guard their innovation as a trade secret to obtain any advantage. A particular challenge in responding to the innovations that are fundamentally altering the competitive landscape for e-business is that they can, in some cases, arise from other sources. Consider the case of standards adopted by organizations such as the Motion Picture

Expert Group (MPEG) which developed technical standards for audio and video signal compression. This standard was then implemented in software made freely available to users, requiring virtually no marketing effort for that benefit to be obtained, with the published standard precluding any possibility of trade secrecy. The audio version of the standard, commonly known as MP3, allowed music files to be reduced in size to the point that they could easily be copied over internet connections. This quickly led to services such as Napster that offered simple ways for internet users to share their music collections online, a development that the recording industry is still struggling to address.

Christensen (1997) suggests that innovations from unusual sources may be more likely to become disruptive technologies. His explanation for the lack of interest in disruptive technologies, on the part of market leaders, fits the initial recording industry response to MP3 very well:

> … the conclusion by established companies that investing aggressively in disruptive technologies is not a rational financial decision for them to make, has three bases. First, disruptive products are simpler and cheaper; they generally promise lower margins, not greater profits. Second, disruptive technologies typically are first commercialized in emerging or insignificant markets. And third, leading firms' most profitable customers generally don't want, and indeed initially can't use, products based on disruptive technologies. (Christensen, 1997: xvii)

Christensen's central point is that firms that ignore disruptive technologies, despite the fact that they do so for perfectly good reasons, can suffer severe consequences if they are left behind when the market moves en masse to a new technology. But it is instructive to examine each of his three points in the context of the music industry's response to internet-based music piracy.

First, it is clear that the major threat to record labels posed by electronic distribution of music is to their margins. Consumers, who learned through burning their own CD's that the cost of producing a CD was just a few cents, are now aware that the marginal cost of distributing an

electronic copy of a compressed version of the same music approaches zero. There is no packaging, there is no CD, only the digital file. Clearly this puts pressure on the consumer's expectation of a reasonable product price. As Shapiro and Varian (1999) point out:

> In our experience, information providers with established brand names often hesitate to drop prices quickly enough to warn off potential entrants, perhaps because they think their brand name shields them from competition. Sure a valuable brand name will allow you to command *some* premium, but it will not guarantee you the same prices or margins you enjoyed before new information technologies arrived that caused per-copy and distribution costs to fall.

The record labels are perhaps even exceptional in their resistance to dropping prices in response to reduced costs, having settled a lawsuit launched in 2000 by a group of 40 states (led by none other than Eliot Spitzer), by agreeing to "refund $67.4 million to consumers who purchased CD's from 1995 to 2000 and eliminate policies that set minimum prices for advertised CD's" (Deutsch, 2002). So their resistance to dropping prices as a way to respond to this innovation is not surprising.

An important corollary is that there is clear evidence of a willingness to pay for online music in general, via legal download services. There is even some indirect evidence that those who download pirated copies also exhibit a willingness to pay. Jeff Tweedy, front man of the group Wilco, describes an example in an interview with Wired news (Jardin, 2004):

> We were contacted by fans who were excited about the fact that they found [copies of *A Ghost Is Born*] on P2P networks, but wanted to give something back in good faith. They wanted to send money to express solidarity with the fact that we'd embraced the downloading community. We couldn't take the money ourselves, so they asked if we could pick a charity instead -- we pointed them to Doctors Without Borders, and they ended up receiving about $15,000.

Apple's iPod service is probably the best known of the legal download services, and it has quickly established a price of $.99 per title. Legal downloads are growing, with offerings such as Connect from Sony, and Microsoft recently entering with their own product, though online sales now account for only 5% of industry revenues (Economist, 2004). The $.99 price offers

savings to consumers who are no longer forced to buy a bundled set of tracks in album form, and it is sufficient for record labels to get their usual fees from the sale without having to actually produce a physical product and distribute it. It is unclear whether this price will hold, as competition increases in online sales. Already iPod is experimenting with other types of bundles, such as an offering U2's entire catalog (16 albums, 400 tracks) for $150 (Kahney & Dean, 2004).

Second, the internet was an emerging market whose significance, in the early days of music piracy at least, was still being determined. Easley, Michel & Devaraj (2003) present evidence supporting the notion that exposure to music piracy actually played a role in pushing record labels: to adopt internet technologies (those exposed to piracy were more likely to be early adopters of internet technology), to create richer and more fully-featured web sites, and to experiment with electronic forms of distribution that are either proprietary or in other ways non-threatening (e.g., short clips of songs). These results also tie in nicely with recent theories of innovation for net-enabled organizations from the Information Systems literature (e.g., Sambamurthy 2003, Wheeler 2002) that put forth frameworks in which music piracy could be argued to play the critical role of informing the record labels of the importance of a key new distribution technology.

With this newly emerging market, the greatest threats to the existing record label business model come from a number of directions. First there is the loss of value for their existing economies of scale for production of the physical products, the CD's themselves. Even in electronic format, there is a loss of control of the format, with many efforts to establish copy-protected formats failing to attract the critical mass of users necessary to attract device makers. Then there is the threat to their existing distribution channels and control of those channels.

Channel control was one of the issues in the settlement of the price fixing lawsuit mentioned above, where the labels allegedly went too far in exerting control over pricing via distribution channel agreements. The next lawsuit from Eliot Spitzer targeting the record labels is said to involve marketing channels, and will focus on the practice of channeling "payola" through intermediaries to control playlists at radio stations (Leeds, 2004). It is somewhat ironic that record labels may be sued for paying to control radio playlists while they, at the same time, are suing to prevent the viral marketing of perhaps the very same music through internet file sharing.

It is Christensen's third point, however, which the music industry seems perhaps to have missed completely. The Recording Industry Association of America (RIAA), representing the record labels, has asserted forcefully and repeatedly that music piracy is costing it record sales. Yet there are others who might suggest they are ignoring the benefits of a massive, free viral marketing campaign. As Jeff Tweedy from Wilco explains (Jardin, 2004),

> We live in a connected world now. Some find that frightening. If people are downloading our music, they're listening to it. The internet is like radio for us.

After releasing their album *Yankee Hotel Foxtrot*, for free over the internet, Wilco then released it under a new label, Nonesuch, and it debuted higher on the charts than any of their previous albums. Even an internal study by one of the major labels found that piracy accounted for at most a third of the recent drop in sales (Economist, 2004), with much of the rest attributed to competition for consumer interest from DVDs and video games, or even an admitted decline in the quality of musical acts. Independent researchers of the music industry, such as Oberholzer and Strumpf (2004) who study availability of music online and record sales, are not able to find any significant connection between downloading and the drop in sales. As Schwarz (2004) describes Oberholzer-Gee's explanation

> "Say I offer you a free flight to Florida," he asks. "How likely is it that you will go to Florida? It is very likely, because the price is free." If there were no free ticket,

> that trip to Florida would be much less likely, he said. Similarly, free music might draw all kinds of people, but "it doesn't mean that these people would buy CD's at $18"

To add a more general perspective to the issue, Shapiro and Varian (1999, p. 97) address the trade off between protection of intellectual property and ultimate profitability, saying

> We think the natural tendency is for producers to worry too much about *protecting* their intellectual property. The important thing is to *maximize the value* of your intellectual property, not to protect it for the sake of protection. If you lose a little of your property when you sell it or rent it, that's just a cost of doing business, along with depreciation, inventory losses, and obsolescence.

One could argue that maximizing the value of intellectual property requires different strategies in different market segments. For example some research has found little piracy in classical music (Easley et al, 2004), where there is still a cultivated nostalgia for "bootlegged" recordings that, though illegal, caught certain performers at their prime[1]. There are also record labels, such as those catering to older audiences, which have not experienced trouble with piracy, since the CD format is preferred by their customers. But there is clearly a market segment – especially the dominant market for hit music targeting teenage audiences – that experiences extensive piracy. It is here that further innovation will be required, perhaps along the lines of Apple's iPod business model or others as yet untested, to address the market tensions that underlie ethically questionable behaviors on both sides, for it is in exactly this demographic that we would expect new distribution models to take hold or new markets to emerge.

Ethical Considerations

So in this conflict, on one side there is a segment of music consumers that illegally download pirated music files. Though it is not clear that this activity results in reduced sales, some portion of these "pirates" may be willing to pay for legal downloads at a reasonable price.

On the other side there are the record labels, who have settled multimillion dollar lawsuits alleging price fixing, who cling to high margins despite the obvious savings in electronic distribution, and who in turn sue their own customers who are found to have downloaded pirated music files.

I believe there are a number of interesting ethical questions that can be framed from this conflict. One involves the behavior of those who share music files, making them available and downloading them. While this is clearly illegal[2], is it unethical to pirate the music? The widespread acceptance of this activity, at least in some segments of the population, suggests that this is seen as something more akin to recording a song off the radio than stealing a CD from a record store. Some argue that this is a form of civil disobedience designed to protest the excessive scope of copyright protections, and attendant limits on distribution and price gouging (Lunney, 2001). There are even cases of encouraging civil disobedience in downloading as a way of honoring civil disobedience in social justice movements, as in the recent case of the illicit free distribution of *Eyes on the Prize*, a 14-part documentary on the civil rights movement that is not currently in distribution due to copyright problems (Dean, 2005). As for the record labels, they surely have the right – and even the obligation to their shareholders – to maximize the value of the copyrights they hold. However, it is also reasonable to ask if it is ethical to sue their own customers in an attempt to slow down or stop an innovation that is likely to bring about a social good, especially given their history of legal troubles with price-fixing and payola. Granted the social good of wider and more efficient distribution comes at the expense of legitimate payments for royalties and performance, but it may nonetheless be questionable to ignore the marketing benefits that may accrue from such exposure, or the emerging markets that may actually benefit from such developments.

I don't intend to try to answer these questions here, but first wish to consider an admittedly limited yet informative parallel. Pharmaceutical companies that have developed and manufacture HIV drugs have major R&D expenses that must be recovered at some stage. Record labels often cite the risks involved in the development of new talent as a major expense that needs to be recouped. For both record labels and pharmaceuticals, marketing expenses undertaken to develop demand for products form a large portion of the expenses they seek to recoup through higher margins. Yet each offers a product whose marginal cost of production is extremely low relative to the market price, attracting piracy in the form of illegal downloading or unlicensed generic manufacture.

The parallel breaks down of course when you consider the client side, which in one case involves life-or-death needs that support a number of arguments for ethical violation of patent protection. But given the very seriousness of the HIV crisis, it is instructive to look at some of the ideas that have emerged to handle this conflict, such as compulsory licensing, described for example by Doctors without Borders (Berman & Ford, 1999). Fisher (2004) discusses this as a possible solution for the music industry, where one could imagine a system that compensates music labels for downloads using compulsory licenses, based on the notion of music as a public good:

> … a small number of socially valuable products and services have the following two related characteristics: First, they are "nonrivalrous." In other words, enjoyment of them by one person does not prevent enjoyment of them by other persons. Second, they are "nonexcludable." In other words, once they have been made available to one person, it is impossible or at least difficult to prevent other people from gaining access to them. Goods that share these features are likely to be produced at socially suboptimal levels. Why? Because potential suppliers of them […] recognize that they would not be able to recover from consumers the costs of producing them.

Though both pharmaceuticals and record labels may resist the characterization of their products as public goods, wishing to retain the full power accorded to them by their patent or copyright protections, it may nonetheless be reasonable to curtail that power if it would result in a greater social good. This approach has potential at least to preserve the incentives to create music, or in the case of record labels, to acquire and promote it. While there are legitimate concerns raised by the prospect of excessive government or regulatory intervention, there is at least equal cause for concern that governments may err on the side of strengthening copyright protections in a manner that would thwart the development of innovative solutions (Lee, 2004). Voluntary licensing is another alternative that has begun to take root at college campuses that have purchased campus-wide rights to the now legal Napster file-sharing service (Rafael and Anderson, 2004).

A key consideration, going back to the earlier discussion of innovation, is that we cannot predict what new markets may emerge, and what new ways of profiting from copyright may appear. Lee (2004) provides a clear summary of the Sony betamax case, in which the movie industry tried unsuccessfully to prevent the sale of video cassette recorders due to their potential use for copyright violation. Had the movie industry won, it would have prevented development of a video rental market that now, for many films, exceeds the value of the theatre box office. Though it is possible in some cases to identify technologies that are less likely to lead to piracy issues, in this case the betamax clearly was capable of copyright infringement, and yet led to development of a hugely profitable enterprise for those opposing its release in the market. This underscores the strategic importance of building on innovations that attract consumers with new products and services that may lead to unanticipated profit opportunities.

What such developments might await the music industry? Consider for example that "At $3.5 billion in annual sales, the mobile ringtone market has grown to one-tenth the size of the recorded music business."(Economist, 2004) It appears that sales have already reached the point that they may eclipse losses attributed to music piracy, with customers willing to pay about two dollars per ring tone. It also seems unlikely that the ringtone market (described, for example, by Napoli, 2002) could function without internet distribution channels – it depends on music being readily available for download onto phones (with copyright cleared) while the particular song is still popular. The agreements and procedures required for this market are the very ones that have been developed for legally downloading music, and while ringtone piracy is emerging in parts of Asia, it is not an issue with the more recent ring-back services, which involve purchasing music to play back to those who call your phone in place of the ring sound. This service, with pricing structure and market prospects similar to the ring tone market (Twist, 2003) is of necessity provided at the server level, so piracy is not an issue.

It is thus clear that some new markets are emerging which combine music with other services such as mobile telephony, that these markets may provide both better margins and better copyright protection to the music industry, and that some forms of music piracy may ultimately come to be seen as an effective marketing channel for those services. I make no claim to being able to predict the future of the music business – the innovations that will affect the profitability and perhaps even the existence of various music business models may not yet have emerged. During such a period of disruption and innovation, it is not surprising to see behaviors of questionable ethics emerging from both the innovators and the defenders of existing business models. It is nonetheless critical, in attempting to resolve the tensions that inevitably arise from

these behaviors, to avoid squelching the very innovations that may lead to new models best suited for resolving these conflicts

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[1] See for example Wakin (2004) for an account of the importance of “bootlegged” recordings of performances of William Kapell, a pianist who died at 31 in a plane crash.
[2] With some notable exceptions, such as in Canada (Webb, 2004).