

## Position: Digital Single Market proposals

The DSM proposals come after two decades of steadily improving connectivity, increasing speeds and performance, and unprecedented innovation. In this context, many of the proposed interventions would appear unnecessary.

Not all barriers identified by the Commission can best be addressed through public policy. Some are due to legal differences between Member States, while others are driven by real economic factors which only innovation can overcome.

Broadband coverage goals currently follow political criteria. This leads to distortions and inefficient outcomes, especially given wide divergences between Member States. Public subsidies can crowd out private investment, and previous public interventions in broadband deployment have not yielded the desired results.

Spectrum allocation would benefit from a greater role for market forces. Relaxing usage requirements and trading limitations to allow for secondary markets to emerge would be a way to achieve this.

Net neutrality proposals fail to take account of user preferences and the increasing variety of Internet content. If implemented, net neutrality will reduce incentives for infrastructure investment. Given that Internet service providers own their networks, net neutrality also undermines their rights to use their property as they see fit.

Banning geo-blocking can harm consumer welfare rather than improve it. In many instances, the practice amounts to price discrimination between jurisdictions to reflect cost variations and purchasing-power disparities. Restricting it could price some consumers out of certain digital goods and services.

Neither the evidence nor economic theory support the regulation of online platforms. There is no objective way for search engines to rank results. The market for online information is ever more varied and competitive, with the rise of new specialised search engines and apps.

Proposals to simplify VAT compliance should be welcomed to encourage cross-border trade. The CCCTB, which would harmonise the corporation tax base across the EU, is not fit for purpose as it ignores the growing role of intangible assets and undermines beneficial tax competition.

**Recommendation: The digital revolution is increasingly making barriers to access, trade and innovation obsolete. Remaining obstacles to more efficient exchange of digital goods and services across the EU must be examined in this context. It is very likely that a continued open environment to innovation will be the most effective way to remove whatever barriers still exist. In general, the bias should be against new regulation.**

The European Commission's Digital Single Market strategy,<sup>1</sup> unveiled on May 6<sup>th</sup>, put forward a diverse set of proposals. In particular, while some of the measures under discussion aim to push deregulation further to keep reaping the benefits of competition, others can be understood as part of a re-regulatory agenda, which runs afoul of the last two decades' largely successful reforms and puts innovation at risk.

The stated goal of the DSM strategy is to remove barriers to growth in the EU's digital economy; but such "barriers" vary in kind and source. Some of them are the product of government intervention, which can raise the cost of investment, reduce consumer take-up and discourage innovation. Other barriers are due to discrepancies in legal systems: copyright law, tax law, data protection law and other legislation. Finally, some of the obstacles can be the product of existing economic conditions, which over time are removed by the innovative process.

EU action is most likely to be successful in addressing the first category of barriers. The rise of new technologies has made much existing regulation obsolete and undermined or even eliminated the rationale for government intervention in several areas. In the face of such developments, the goal of the DSM must be to abolish rules which are no longer appropriate, to update and soften regulations to take account of new innovations, and to refrain from enacting legislation that will hamper the innovative process. In the second sphere, where barriers are due to legal differences, EU intervention must be careful and guided by cost-benefit analysis. The third area, where barriers are due to economic factors and the current state of technology, is one where EU action will likely be ineffective and even counterproductive.

The following examines some key technical and policy developments in the EU's digital economy, explaining whether proposed measures are likely to improve or worsen the current state of affairs.

### Telecoms regulation (§ 3.1)

Telecoms rules may arguably be described as the bulk of the DSM strategy, as they provide for the infrastructure upon which the digital single market would rely. They relate to and draw on EU initiatives which are already underway, such as the European Digital Agenda and the Telecoms Single Market package.

## *Broadband*

The experience of broadband coverage, availability, speed and costs is, by all available measures, a positive one. As the Commission's own companion Working Document to the DSM strategy points out,<sup>ii</sup> all indicators of connectivity (broadband coverage, access to high-speed connections, prices) show a steadily improving environment. As is to be expected from a fairly new and steadily evolving technology, its adoption is uneven across and within Member States. Rural coverage in particular lags behind because of significantly lower user density. This is in line with sound cost-benefit analysis, whereby high-density areas (where potential benefits are higher and costs can be spread more widely) adopt new expensive technologies before low-density ones.

The 2010 Digital Agenda for Europe required all Member States to reach three specific broadband goals: full coverage of basic broadband connections by 2013; full coverage of fast broadband connections (30+ Mbps) and 50 per cent adoption of ultra-fast broadband connections (100+ Mbps), both by 2020. The first objective has been fulfilled in most of the EU; much remains to be done in order to reach the other two targets. The most pressing concern is that the particular thresholds identified by the Commission appear to be political in nature, rather than being the result of economic considerations and cost-benefit analysis. It is highly unlikely that one-size-fits-all availability and penetration goals are appropriate in the context of highly diverse national markets.<sup>iii</sup> Such diversity may justify leaving broadband coverage goals to national rather than EU authorities. Instead of imposing arbitrarily set objectives on the market, EU institutions should make sure that barriers to take-up are removed.

EU funds have been made available to Member States to meet Digital Agenda targets. It is widely understood that the injection of public money into the deployment of broadband networks may pose a threat to competition. The state aid guidelines for broadband, which were revised in 2013, provide a framework for dealing with such risk, and it is crucial that they are consistently enforced. In particular, resources should be directed to those areas where high costs and low profitability make it harder for market players to invest on their own. Conversely, pouring public money into so-called black areas might distort and even crowd out private spending. In this regard, we anticipate that the "step change" requirement<sup>iv</sup> may allow for excessive discretion and urge the Commission to apply it cautiously.

To the extent that it is undertaken, public subsidies should conform to the principle of technology neutrality, i.e. public authorities must refrain from dictating choices relating to the optimal technologies (e.g. fixed wired, fixed wireless, mobile, satellite), infrastructures (copper, cable, fiber optic) or network architectures (FTTN/FTTC vs. FTTP/FTTH) to be used. Competition drives innovation at both the service and the infrastructure level. Subsidies, if at all provided, should be awarded through competitive, open and transparent procedures. Demand-side tools, either direct (e.g. user vouchers) or indirect (e.g. increased content availability) tend to be superior to supply-side interventions from a competition perspective.

Finally, public intervention in broadband deployment should be kept at a minimum, to avoid the failures incurred by governments around the world – Australia's NBN fiasco and the US's unsuccessful history with municipal broadband come to mind. The experience of public involvement in telecommunications markets is an unhappy one, and as technology becomes more varied and complex, ensuring the flexibility offered by market mechanisms will be crucial.

## *Spectrum*

Spectrum is another instance where the good intentions of regulators may ultimately harm competition. There is good reason to believe that more spectrum should be awarded to mobile operators, especially as one considers the launch of 5G services in the near future. However, one should refrain from conflating technological and economic considerations. Although mobile may be a superior technology to broadcasting from a technical perspective, this does not necessarily imply that the release of the 700 MHz band (and possibly the whole UHF band) to wireless broadband services is the most efficient course of action. Migration costs to broadcasters and consumers should be factored into any evaluation.

Just like it is not the task of national governments to determine the best way to pursue ultra-fast broadband connections, the Commission should not pick winners in spectrum allocation. It is unfortunate that the long-standing assumption that it should be a political decision was not challenged by Pascal Lamy's High Level Group in its final report.<sup>v</sup>

The evolution of markets is affected by regulation in many important ways – nowhere more so than when regulators are in charge of resource allocation. However, efficient outcomes depend on leaving market players to decide what the best use of available spectrum is. An appropriate way to go about this would be to relax usage requirements and trading limitations and allow for secondary spectrum markets to emerge. Such a market-driven mechanism has been a possibility for some time but practical limitations have hindered its adoption.

## *Net neutrality*

Net neutrality is the legal requirement for all content transmitted through broadband networks to be treated equally, regardless of origin or destination. It prevents internet service providers (ISPs), i.e. telecommunications companies, from charging different content providers and users differently and offering premium access and speeds in exchange for a payment. Proponents of net neutrality see it as essential to preserve an open internet, where start-ups can effectively compete with established players.

The reasoning behind net neutrality is questionable. Internet content is increasingly varied, and not all providers and users value higher speeds equally. It is sensible to allow for differential pricing, priority access and speeds to account for the variety of product offerings and user tastes. This is also the efficient solution: a non-neutral internet allows Internet Service Providers (ISPs) to manage traffic according to customer preferences, for instance by prioritising less data-heavy traffic, or by charging a premium for streaming services. Even within a particular digital service (such as Facebook), ISPs in a non-neutral environment can offer the basic services that users want most without the expensive add-ons.

Moreover, mandating net neutrality in the context of ever-increasing speeds and ever more varied content risks slowing down future innovations. Not only would it discourage ongoing investment by ISPs,<sup>vi</sup> but it would also make the development of faster traffic lanes less likely, by removing economic incentives to setting up the necessary infrastructure.

### *Roaming*

Roaming charges, the cost of continued phone and data coverage outside the home network, is an example of a 'real' economic cost that is best addressed by ongoing innovation and infrastructure development. Attempting to eliminate them through a cap is unlikely to reduce overall costs for consumers. Instead, what we are likely to see are so-called "waterbed effects", by which lower (government-mandated) charges in one segment of the market translate into higher charges in another segment.<sup>vii</sup> Capping roaming charges, in other words, means redistributing resources from less mobile consumers to highly-mobile consumers.

Further recourse to legislation in this field would be evidence of regulators' failure to follow the direction that the market is moving in. Roaming charges are quickly growing obsolete, due to initiatives carried out by market players, whether mobile carriers themselves (which have been pushing flat rates even for roaming purposes) or outsiders (such as Apple's universal sim card or Google's Fi Project). This is an example of innovative activity addressing existing real obstacles to trade, which policy measures like price controls and bans can never achieve.

### *Substitutes for telecom services*

The DSM Strategy would place traditional telecommunications providers and new technologies such as Voice over IP services under the same regulatory regime. While the latter has become a significant competitor to traditional telecom services, it is built on a different technology. Imposing similar regulations on both technologies is likely to restrict competition in the VoIP sector by raising barriers to entry. If the goal is to promote competition in telecommunications, imposing new regulation on new VoIP players would achieve the opposite.

### **Media regulation (§ 3.2)**

The Commission is right that the Audio-Visual Media Services Directive failed to subject traditional television services and on-demand services to the same regulatory framework. However, the real question is whether the traditional framework is still up to the task. Content regulation, advertising rules and quotas were all devised at a time where competition on television networks was limited and it could be argued that viewers needed protection vis-à-vis the networks' market power.

This is no longer the case. Consumers have access to a virtually unlimited content supply on a variety of platforms and the distinction between traditional broadcasting and on-demand services is blurring. It is true that all players should be competing on a level playing field. However, the proper way to achieve this goal is not to broaden the scope of existing regulation, but rather to remove anachronistic constraints. Restricting programming in order to protect minors makes little sense in the era of automatic parental control. Limits to advertising played a role when advertising was done in commercial breaks, not with banners or product placement. Finally, the promotion of European works has no place whatsoever in a competitive market for content. All these provisions have outlived their usefulness as consumers have obtained greater control over their viewing choices. It is high time that regulations adapt accordingly.

### **Geo-blocking (§ 2.3)**

Geo-blocking is the practice of preventing customer access to digital content based on geographical location, and of re-directing users in certain locations to local websites. This may result in some users' being unable to obtain the desired content, and of customers located in different places being charged different prices for the same good or service. Some argue that this is an unfair practice and incompatible with Single Market rules.

The first objection to this line of argument is that the rationale does not apply to physical goods or services. It is perfectly reasonable for a physical newspaper not to be sold EU-wide – economic considerations (production and delivery costs, potential customer base, retail space availability) are allowed to govern publishers' decisions in this regard. And when newspapers are sold in foreign countries, they are often priced at a premium over prices in the home market. The same should be true of digital goods and services – producers should be able to decide where and how they market their goods. This includes the freedom to pursue contractual and licensing agreements as they see fit.

The second objection is practical – namely, is geo-blocking necessarily harmful to consumer welfare? Geo-blocking is simply a form of price discrimination; and economic theory has long shown that price discrimination can enhance efficiency

and benefit consumers, where purchasing-power disparities, cost variations and business model differences occur. In the same way that cinemas attract a larger customer base by offering targeted discounts to pensioners and under-25s, digital businesses expand the number of potential consumers by selling goods and services at different prices across the EU – even cross-subsidising sales where necessary.<sup>viii</sup>

In this respect, geo-blocking may have a positive effect on social equality within the EU: by allowing for below-average prices, it extends access to goods and services to areas where it may not be otherwise viable to offer them. Banning geo-blocking would reduce businesses' ability to structure their sales and marketing strategies in an optimal way, thus potentially hurting consumers. It may be that in some instances, geo-blocking takes place because of divergent copyright legislation across the Member States. One may argue that harmonising copyright rules could improve consumer welfare in this regard, but that in itself is not an indictment of the practice of geo-blocking. Moreover, it is critical that proposals for copyright harmonisation also take account of the potentially high costs involved in merging legal systems.

### **Platform regulation (§ 3.3)**

It is widely acknowledged that online platforms play a key role in facilitating trade in digital goods and services. The rise of search engines, price-comparison tools and specialised apps has made vast amounts of information readily available to consumers and businesses. Platforms have also enabled online advertising, which has turned into a key revenue source for many online businesses and a way to combine a public good (freely available information from which it is hard to exclude people and where the marginal cost of an additional consumer is zero) with a public 'bad' (to some).<sup>ix</sup>

#### *Competition*

Intervention in online platforms looks increasingly likely, as the ongoing competition case against Google and calls for regulation in some Member States show. At issue is the alleged dominance of certain platforms, and their status as enabling infrastructures for other digital services with which platforms themselves sometimes compete. Suggested interventions go from preventing certain business practices, such as exclusive advertising deals and the preferential treatment of search results, to applying regulation used in other sectors (notably utilities) to digital platforms. The rationale behind the latter is often that platforms are an 'essential facility' which might allow its owner to restrict access to competitors. In this view, platforms are akin to the electricity grid or telephone networks.

The economic case for platform regulation is weak. Proponents often use market share as an indicator of a firm's dominance, but this ignores the fact that the market in which, for instance, horizontal (i.e. general) search engines compete is not just formed by other horizontal search engines, but also vertical (specialised) ones, as well as apps and websites more generally.<sup>x</sup> When the relevant market, which is the market for online information, is properly considered, notions of high market share in a specific segment of that market lose importance.<sup>xi</sup>

Furthermore, previous experience of allegedly dominant players in the digital sector undermines the case for intervention. It is not just that Microsoft, which only a few years ago was considered a software monopolist, has rapidly lost market share with the rise of smartphones – even online search traffic is changing rapidly as users move from horizontal search engines to ever more specialised alternatives. It also cannot be ignored that more and more consumers browse directly through apps.

The determinant for intervention must be that competition, and not just individual competitors, is being harmed by a dominant firm's practices. There is rich evidence of a competitive environment with a growing number of players vying to provide information to users. In this context, it is hard to argue that innovation is being harmed.

More specifically, the ways in which, for example, search engines or e-commerce platforms rank results or display products are business judgements involving subjective choices – there is no neutral or objective way because the key variables are ever-changing user preferences and business models.<sup>xii</sup> As regards exclusive deals for advertising services, this is a matter of contractual agreement between the parties involved, and given the number of existing alternatives no intervention appears justified. Finally, on the subject of classifying certain platforms as essential facilities, the economic rationale for applying such regulatory requirements to utilities (high fixed costs and low variable costs which make a single infrastructure provider most efficient) is not present in online platforms. Because alternative infrastructure providers can and do enter the market, the essential facilities doctrine should not apply.<sup>xiii</sup>

#### *Intermediary liability*

It is appropriate for regulators to ask themselves how best to deal with copyright-infringing material and other illegal content. However, fundamental interests such as freedom of expression and freedom of enterprise should be part of the discussion. The framework designed by the e-Commerce Directive has achieved the goal of placing liability with actual knowledge of harm and power of intervention, thus allowing for innovation to flow freely. While notice-and-takedown procedures may leave room for improvement, they still are the best way to ensure that every party's rights are taken into account.

The Commission should resist two related temptations. First, to speed up detection by eliminating judicial supervision and entrusting such sensitive matters to quicker administrative entities. Second, to weaken the safeguards included in the e-

Commerce Directive. The language included in the DSM Strategy raises serious concerns on the latter front. Imposing “duty of care” requirements on intermediaries would dramatically lower incentives to invest in new services and platforms. This also has clear anti-competitive implications: established players are better equipped than interlopers to deal with the costs and burdens of regulation.

### **Taxation (§ 2.5)**

The Commission is right to point out the substantial compliance costs caused by new requirements (effective 2015) for e-commerce sellers to file VAT in the Member State where sales are made. For all other goods and services, VAT is levied in the purchaser’s country of residence – and the Expert Group on Taxation of the Digital Economy endorsed this practice for digital trade as well.<sup>xiv</sup> However, the application of such a requirement clearly involves a pragmatic cost-benefit analysis of outcomes. Many e-commerce businesses have sales volumes (particularly to individual Member States) that are low enough to make compliance costs exceed potential benefits. Thus the new VAT requirements can be expected to discourage cross-border e-commerce by small firms. Instituting a threshold of sales below which the VAT rules would not apply would go some way in removing such negative incentives. Enabling compliance in the company’s Member State of residence would also be beneficial, though proposed reforms would have to be studied in detail to see if they genuinely reduce costs for e-commerce businesses.

More concerning are the remarks made with regard to corporate taxation. The Commission’s view is that the tax should be levied “where the value is generated,” a decidedly arbitrary concept. There are signs that the 2011 proposal for a Common Consolidated Corporate Tax Base (CCCTB) may be revived to reform corporate taxation in the EU. Yet, the 2011 proposal, by excluding intangible assets from tax base share calculations, ignores a key and growing component of corporate value generation, namely intellectual property.<sup>xv</sup> This proposal also penalises low-tax jurisdictions within the EU, undermining tax competition, which is essential to ensure an attractive business environment. If the CCCTB is revived, it must remain optional, take account of intangible assets when assigning tax base shares to Member States, and preserve tax competition between jurisdictions. Any proposal lacking these three features will do more harm than good.

### **Conclusion**

The Digital Single Market offers opportunities and threats. The opportunity is to update outdated regulations and, where necessary, remove them. This would acknowledge the fact that technological progress has eliminated the need for heavy-handed public intervention. It is also an opportunity to reconsider certain public policies in light of the progress made in recent years. The threat is that the scale of recent changes in the digital sphere will spur a wave of new interventions by public authorities, slowing down the pace of innovation and curbing incentives to trade. Net neutrality, platform regulation and restrictions on asset mobility for tax purposes would all stall technological progress. What is required is an understanding of the beneficial impact of digital technology, and a willingness to grant it the freedom to evolve.

In less than twenty years, digital technology has transformed European economies and enabled businesses to cater to a growing number of customers regardless of location, and users to access a wider variety of goods and services than ever before. Performance has grown exponentially, and prices have fallen apace. Internet speeds have improved by several multiples, while reaching a greater number of people each year. The trend is clearly positive and there is no reason to believe that it has stalled, let alone reversed, in recent times.

In these circumstances, it is critical that intervention takes a light-touch approach – not only because there is reason to believe that market forces and further innovation will gradually bring down whatever ‘real’ barriers there remain to digital trade, but also because new regulations can actively deter the innovative process and thus slow down progress.

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- <sup>i</sup> Communication: “A Digital Single Market Strategy for Europe” (Brussels: European Commission, 2015).
- <sup>ii</sup> Commission Staff Working Document: “A Digital Single Market Strategy for Europe – Analysis and Evidence” (Brussels: European Commission, 2015).
- <sup>iii</sup> Lithuania offers an illustration of the inadequacy of uniform EU-wide targets. According to the Lithuanian ministry of transport high-speed broadband coverage in Lithuania stands at 97 per cent, but use of the network lags behind at 58 per cent. Demand for such extensive coverage clearly is not there.
- <sup>iv</sup> According to the Guidelines, state aid may be permissible if a “subsidised network [can] ensure a ‘step change’ in terms of broadband availability.” However, under § 83, “in ‘black NGA’ areas, [...] the ‘step change’ [...] is proved on the basis of [three] cumulative criteria:  
(a) the existing or planned NGA networks do not reach the end-user premises with fibre networks; (b) the market situation is not evolving towards the achievement of a competitive provision of ultra-fast services above 100 Mbit/s in the near future [...]; (c) there is expected demand for such qualitative improvements.”
- <sup>v</sup> Pascal Lamy, “Report on the results of the work of the High Level Group on the future use of the UHF band”, August 2014, available at <https://ec.europa.eu/digital-agenda/en/news/report-results-work-high-level-group-future-use-uhf-band>.
- <sup>vi</sup> Andrea Renda, “Antitrust, regulation and the neutrality trap: a plea for a smart, evidence-based internet policy” (Brussels: CEPS, 2015), 11-13.
- <sup>vii</sup> See Christos Genakos and Tommaso Valletti, “Regulating prices in two-sided markets: The waterbed experience in mobile telephony”, *Telecommunications Policy*, 36.5, p. 360-368.
- <sup>viii</sup> Cf. Joseph V. Kennedy, “Why geoblocking can increase consumer welfare and improve income equality” (Washington, D.C.: Information Technology and Innovation Foundation, 2014). In “Geoblocking and the legality of circumvention” (2014) Tal Kra-Oz, while arguing that the practice is largely harmful to consumers, thinks growing demand for content and evolving technologies will render geoblocking obsolete.
- <sup>ix</sup> Philip Booth and Alberto Mingardi, “Markets move on as competition policy stands still,” CapX, 30 April 2015. Available at <http://www.capx.co/markets-move-on-competition-policy-stands-still/>.
- <sup>x</sup> Cf. our briefing “Competition policy in the digital economy” (April 2015) for an explanation of why market share is an inadequate criterion to determine dominance. Available at [www.epicenternetwork.eu](http://www.epicenternetwork.eu).
- <sup>xix</sup> Geoffrey A. Manne and William Rinehart, “The market realities that undermined the FTC’s antitrust case against Google,” *Harvard Journal of Law & Technology* (Cambridge, MA: July 2013), 9-11.
- <sup>xii</sup> Renda, 13-19.
- <sup>xiii</sup> Cf. Manne, “The problem of search engines as essential facilities: an economic and legal assessment,” *The Next Digital Decade: Essays on the Future of the Internet* (Washington, D.C.: TechFreedom, 2010), 419-434.
- <sup>xiv</sup> Report: Commission expert group on taxation of the digital economy (Brussels: European Commission, 2014), 5-6.
- <sup>xv</sup> Our briefing “Updating the Common Consolidated Corporate Tax Base” (December 2014) provides a more in-depth look at CCCTB proposals. Available at [www.epicenternetwork.eu](http://www.epicenternetwork.eu).

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