Part I

General Issues in Cultural Economics

Part I consists of chapters introducing the topics that are being and have been studied in cultural economics and the economic analysis used by cultural economists. In the first place, cultural economics was mostly concerned with the subsidised arts, especially the performing arts, and heritage, particularly museums. Subsidy and state provision are financed by taxation and accordingly, welfare economics and public finance have been widely used in cultural economics. Much work continues on those areas of the cultural sector on participation by audiences and visitors and on the costs and supply of services by cultural organisations.

The switch in cultural policy in many countries from arts and culture to the creative industries led to the inclusion of commercial production of cultural goods and services in cultural economics. The creative industries (known often as the cultural and creative industries [CCIs]) embrace both the 'traditional' subsidised arts and heritage and the commercial cultural industries, for which microeconomics of the firm and industrial organisation theory are the applicable areas of economic theory. Government policy in many countries, moreover, emphasises the role of the creative industries in growth and employment, bringing macroeconomics into the story. The result is that to study cultural economics, students need to have had an introduction to all these economic theories. Some find it difficult to sort all this out and so Part I aims to provide clarification and outlines the economic concepts and terminology used in the rest of the book.

Chapters 1 to 7 introduce the subject matter of cultural economics. Chapter 1 is a general introduction to the topics covered in the book and the history of cultural economics. Chapter 2 on the economic profile of the cultural sector is concerned with the definition and measurement of the creative economy. Chapter 3 investigates the working of the market economy in the cultural sector. Chapter 4 is a new chapter on the digital creative economy and introduces theories used to analyse the economics of platforms. Chapter 5 deals with the production, costs and supply of creative goods and services and Chapter 6 similarly deals with consumption, participation and demand for them. Chapter 7 goes into the way cultural economics analyses policy using welfare economics. These chapters therefore lay the foundation for analysing and understanding the creative industries studied in subsequent chapters.

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More Information

1 Introduction to Cultural Economics

This chapter introduces cultural economics as a field of study and explains how cultural economists set about analysing the cultural sector – the arts (performing arts, visual arts and literature), heritage (museums and built heritage) and the creative industries (music, publishing, film, games, broadcasting and so on). It provides a guide to the terms used throughout the book and prepares the way for the concepts and subject matter of subsequent chapters. As some readers know more than others about economics, those who are confident economists may want to skip some of what follows; nevertheless, cultural economics has its own identity and ways of doing things and the chapter seeks to explain what these are.

What Is Cultural Economics About?

Ten or More Questions We Ask and Answer

What determines the price of a pop concert or an opera? Why is there a star system in the arts? Why are many artists poor? Why does Hollywood dominate the film industry? Can we predict the success of a film or record? Does illegal downloading damage the record industry? Does free entry to museums bring in more visitors? Why does the government support the arts? How much are we willing to pay to protect the cultural heritage? What are the reasons for government support of public service broadcasting? How has digitisation affected arts provision? What is the role of copyright law in the digital creative economy? Has digitisation improved artists' incomes? What is 'platform' economics and how does it work in the games industry?

These are some of the many questions that cultural economists have asked and tried (and are still trying) to answer. This book presents them in economic terms and in so doing introduces readers to the methods and results of cultural economics.

Readers of this book study a range of degrees in arts administration and management, cultural and media studies, management and economics. Some have a stronger background in economics than others. Accordingly, some topics require an explanation of the economic theory used that others may find unnecessary. The book is aimed at those who have completed an introductory economics course; that, however, can be taught in several ways and so I offer my own view here of what is relevant for studying cultural economics. That has changed over the years since publication of the first edition of this book: digitisation called for new ways of looking at how innovation and creativity have affected the economy and led to the study of the economic organisation of intangible goods and services. New kinds of industrial organisation and business models have evolved while old rules of supply and demand continue to exist in altered form.

My preference in economics is towards the more practical application, to use economics to answer the questions I believe are important for society at large, such as the distribution of income and economic power, topics that are addressed in cultural economics through the analysis of artists' labour markets, participation in and the economic organisation of markets in the creative industries. The approach requires a combination of economic principles and empirical evidence. Empirical evidence in turn requires data and statistical analysis: in the past basic data on the cultural economy were hard to find and had to be collected laboriously. The use and abuse of statistics on the arts and creative industries is a topic that has been and continues to be a problem and can often alienate both those in working in the cultural sector and in the economics profession. In the book, examples of qualitative and quantitative data are to be found, often in the boxes used throughout the chapters.

Cultural Economics

Cultural economics studies the foregoing (and other) questions using economic analysis. The approach is summed up in the Aims and Scope of the *Journal of Cultural Economics* (which I wrote as an editor of the *Journal)*, reproduced in Box 1.1.

Why 'Cultural' Economics?

Why *cultural* economics and not just 'economics'? One reply is that there are many areas of applied economics, each with its own designation, for example, economics of education, economics of health, environmental economics (each, by the way, having some affinity with cultural economics). Any applied

Box 1.1 The aims and scope of the *Journal of Cultural Economics*

"Cultural economics is the application of economic analysis to all of the creative and performing arts, the heritage and cultural industries, whether publicly or privately owned. It is concerned with the economic organisation of the cultural sector and with the behavior of producers, consumers and governments in that sector. The subject includes a range of approaches, mainstream and radical, neoclassical, welfare economics, public policy and institutional economics.

The editors and editorial board of the *Journal of Cultural Economics* seek to attract the attention of the economics profession to this branch of economics, as well as those in related disciplines and arts practitioners with an interest in economic issues. The *Journal of Cultural Economics* publishes original papers that deal with the theoretical development of cultural economics as a subject, the application of economic analysis and econometrics to the field of culture, and with the economic aspects of cultural policy. Besides full-length papers, short papers and book reviews are also published."

area requires a knowledge of the specific features of the sector it studies: you cannot do economics of the electricity industry without some understanding of the technology of the generation and distribution of electrical power and you cannot do cultural economics without some understanding of the performing and visual arts, museums and heritage and industries like film and broadcasting, as well as of creativity and the training of artists. But it is not just a matter of being well informed about these things; it is also that economic ideas have to be adapted where necessary to take into account issues that are distinctive to the cultural sector. Just using 'ordinary' economic theory of labour markets is not enough for understanding artists' economic behaviour, for example. Cultural economics adapts economic ideas to the specific features of the cultural sector.

Though cultural economics is defined as the application of economic theory to the cultural sector, the subject can be approached from different points of view, reflecting different approaches within economics as a discipline. Sometimes, students worry about which theory is being used and how that matters. Moreover, some authors explicitly promote or reject one approach or 'school of thought' over another and this can be confusing. In the section that follows, the various theoretical approaches that have been taken by cultural economists are identified and briefly explained. They are macroeconomics; the neoclassical economics approach to markets – microeconomic theory of price, industrial organisation and welfare economics; public choice theory; and transaction cost and property rights theory.

Macroeconomics

Macroeconomics is the study of aggregate economic variables, such as the size and growth of national income, employment and inflation, and it deals with economy-wide policies to achieve economic growth. Macroeconomics is involved in national income accounting used in measuring the size and composition of the creative economy and the effect of copyright and the contribution to national income of the creative industries and to economic impact studies of arts institutions. It provides the theoretical basis for Baumol's cost disease (Box 1.2), which is analysed as due to the differential growth in the economy. Macroeconomics and national income accounting are used in Chapter 2.

Neoclassical Economics

Neoclassical economics is what most people learn when they first study economics, and most elementary textbooks, without necessarily saying so, adopt the neoclassical position.[1]

Neoclassical economics does not lend itself easily to a precise definition but it includes the following points:

- It assumes that individual producers and consumers rationally calculate all alternatives when making their choices and they have sufficient information for doing so; consumers seek to maximise satisfaction from the goods and services they buy and producers are motivated by the desire to maximise profits.
- Producers and consumers are able to anticipate and allow for ('discount') future income and expenditures when making a decision in the present.
- Resources can be switched between uses in response to changes in prices.
- Markets work in the sense that supply and demand respond to prices and to competition and prices therefore act as signals as to what to produce.

Many economists question one or more of these statements and also the focus on the self-seeking individual ('economic man') that ignores social behaviour and concern with public life. Welfare economics uses the features of neoclassical economics to analyse social well-being rather than private satisfaction, applying microeconomic theory in the context of the whole society.

[1] The term 'neoclassical' is to be understood as succeeding 'classical' economics as developed by Adam Smith in 1776 and his followers in the subsequent 100 years or so.

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Microeconomics

Microeconomics is concerned with economic behaviour of the individual producer and consumer. It uses a neoclassical approach and has its focus on price theory – the study of demand decisions by consumers and of the supply decisions of firms (costs of production, revenues and pricing policy). Traditionally, neoclassical analysis has assumed that firms maximise profits; however, microeconomic analysis is also applied to non-profit organisations (which may maximise other objectives, such as attendances or membership). Private enterprise in music, games, publishing and commercial broadcasting are all assumed to be profit-maximisers and many arts and heritage organisations and public service broadcasters are non-profit enterprises. Microeconomic theory is used in Chapters 3, 4, 5 and 6 and is also applied throughout the book.

Industrial Organisation

Industrial organisation is the branch of economics that studies the structure of markets and the strategic behaviour of firms in imperfect competition. It analyses the coordination of the production process within an enterprise or through the market (often called the 'make or buy decision' for short) and principal–agent problems the enterprise experiences internally and externally. It also looks at competition in markets and the public regulation of monopolies, mergers and other competition issues. In the digital economy, industrial organisation is concerned with two- or multi-sided markets, platform pricing and network effects. Chapter 4 goes into detail on these topics and they are the basis of the economics of the video games industry (Chapter 17).

Welfare Economics

Welfare economics is probably the most widely used approach in cultural economics. Welfare economics analyses the conditions for achieving maximum social efficiency of the use of resources in every market in the economy, adopting the approach of neoclassical economics. It considers the conditions for welfare-improving policies and therefore forms the basis for government intervention in the market economy. It does so by analysing 'market' failure', when the market cannot be expected to be self-correcting, and therefore intervention by regulation and/or financial subsidy by the government is called for to achieve maximum welfare, for instance, by regulating monopoly. It is the basis of economics of regulation that is applied to network industries and platforms ('internet economics').

Cost–Benefit Analysis and Contingent Valuation

Welfare economics provides the theoretical basis for cost–benefit analysis (CBA) of long-term investments, for example, building a theatre or museum. Information about expected costs, revenues and the wider benefits over the lifetime of the project is assessed and forms the basis of the decision whether to go ahead. CBA is a widely used and accepted method of government decision-making. CBA is also used in economic impact studies which measure the costs and benefits of a cultural project to a city or region.

CBA is complemented and to some extent replaced in cultural economics by a volume of literature on contingent valuation (CV) analysis, also firmly rooted in welfare economics, which uses surveys of people's subjective estimates of the value they place on public projects as a basis for decision-making. These methods of decision-making attempt to provide 'positive' empirical evidence of economic and cultural variables.

Welfare economics is the subject of Chapter 7 and its justification of cultural policy of support for the arts and heritage is in Chapter 11. Market failure is discussed in Chapters 7, 13 and 18 and economic impact studies are to be found in Chapters 9 and 10. Chapters 6 and 9 explain the use of contingent valuation theory.

Public Choice Theory

Public choice theory adopts an economic approach to political decision-making. It concentrates on the incentives that influence the choice of policies: for example, why politicians support the arts and how they use the arts to gain political support for themselves, on the one hand, and, on the other, how cultural lobbyists influence arts policy. Public choice theory may be thought of as offering another approach to welfare economics; welfare economics takes the choice of policies as given, whereas public choice theory looks at how policies are made. Principal–agent analysis is relevant here; it considers the kind of policies or incentive structures that the 'principal', for example, the grant giver, can offer the agent, the arts organisation in receipt of the grant, to fulfil the principal's intentions. Public choice theory has been applied in cultural economics to the heritage (Chapter 9) and it also crops up in various places in the book.

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Principal–Agent Analysis and Asymmetric Information

Fundamental to public choice theory are two concepts that interact: principal–agent analysis and asymmetric information. In the political arena, the principal is the voter or taxpayer on whose behalf a certain policy is being put into practice by the agent, say a cultural organisation. Asymmetric information is the situation in which those on one side of a bargain have more information than the other parties to it and they are likely to use that for their own advantage.

Generally speaking, voters and politicians have less information than the enterprises (arts organisations or for-profit producers of cultural products) they are trying to influence about what can be achieved. So, for example: voters may support a policy of evening opening of museums but managers of museums can find many reasons why that is not possible, at least without more funding.

It is an important economic insight to realise that if people have an advantage they can exploit whether in the private or the public sector, they are likely to do so and this will affect the way resources are used; that is called ‘opportunistic behaviour’ and it is important in transaction cost economics.

Transaction Cost Economics

Transaction cost economics provides an alternative way of understanding the way firms and industries are organised to the neoclassical approach. Instead of being governed entirely by relative prices, the transaction cost approach dwells on the costs of using the market economy because that involves various kinds of costs, such as the costs of finding information, making deals and enforcing contracts, and so on. This is where opportunistic behaviour can become relevant because it increases transaction costs. Transaction cost economics explains the role of firms as reducing these costs. The topic is explained in Chapter 5.

Property Rights Approach (Contract Theory)

The property rights approach is loosely connected to transaction cost economics and looks at the transfer of property rights when transactions take place. It may also be called contract theory because it analyses the type of contracts that occur between the parties concerned so that the incentives exist for each to complete the deal satisfactorily. Property rights include intellectual property rights, such as copyright, that exist in almost every cultural good. Information problems also exist here and the transaction costs are what prevent the perfect contract from being feasible. Caves uses contract theory and the property rights approach in his theory of the economic organisation of the creative industries (see Chapters 5 and 14).

Cultural economics uses all this analysis and applies it to the cultural sector; it confronts theoretical hypotheses about the production and consumption of cultural goods and services with empirical research.[2] Cultural economics is a branch of economics but it is also part of the wider investigation of the world of the arts and culture that is studied by other related disciplines, especially the sociology of culture and arts management; there is considerable overlap of subject matter with media economics as well, especially in the area of the broadcasting, audiovisual and publishing industries.

What Economics Is and Does

Economics is a well-developed and in many ways powerful discipline. At its best, it studies the reaction of people and organisations to incentives, such as rewards or benefits (such as income or profit but also satisfaction) and to disincentives, such as raising the price or being made to pay a charge. These reactions are co-ordinated through the institution of the marketplace, mostly using the medium of money, and result in the production and supply of goods and services that are sold to people who are willing to pay for them. Markets are both real and virtual: online buying and selling, such as downloading a track on iTunes or buying a book online, is just as much a market as a car boot sale or a shop. Not all goods and services are sold for a price, though: more and more are made available to people without payment either because supply is provided by an organisation that is financed by taxes or gifts or because they have to ‘pay’ by watching or listening to advertisements. Entry to a national museum may not be charged for, nor is going to school, but these services are not free because their production takes up resources that have other uses and therefore the question of how much of them to produce and how much to spend in doing so is an economic one. In the digital economy, enterprises may supply the same good or service to consumers on a different basis – for free, using a freemium model to avoid advertising, or by subscription.

[2] ‘Services’ covers a wide range of items including financial services such as banking and insurance down to everyday items such as haircuts and car repairs. In the cultural sector, a theatrical performance and a museum visit are services while a book and a CD are goods.