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# Creative Industries

*Contracts between  
Art and Commerce*

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## Covering High Fixed Costs

Many of the costs incurred in creative activities are both fixed and sunk. Fixed costs do not vary with the quantity of output produced. If some costs are fixed, then the average total unit cost of an activity declines as the quantity produced increases.<sup>1</sup> Sunk costs are those necessary for an activity that cannot be recovered or reversed if that activity ceases. The two concepts are independent of each other. A sunk cost might vary with the scale at which production is carried out (that is, not be fixed). A fixed cost might be recoverable when the activity is suspended (that is, not be sunk). We fall into the habit of expecting fixed costs to be mainly sunk, and sunk costs mainly fixed, because they usually are. In the creative sectors, while both properties are important, they are sometimes independent. When the sculptor carves a series of twenty statues of President Millard Fillmore, the costs of her time and (probably) materials are sunk, yet they likely vary in proportion to the number of Fillmores in the series. The performing-arts organization that rents a theatre on a long-term lease incurs a cost that is fixed, but not necessarily sunk if it may sublet. The sunkness of many costs of creative activities has been emphasized so far, accounting for the option contract's central place. Fixed costs' implications are different but no less central to creative activities' organization.

### Fixed Costs in Creative Activities

Fixed costs are pervasive in creative activities. The cost of a film negative is the same, whether it is seen by a thousand or a million people. So is the cost of recording an album or of staging and rehearsing a play or an opera. Every work by the visual artist demands a fresh burst of creative effort, and the musician incurs a cost to perform each concert—variable costs. For both visual artist and musician, however, the large cost of training and apprenticeship is

fixed (and sunk). Fixed costs pose a fundamental problem for economic organization.<sup>2</sup> First and foremost, there may be no ticket price that a performing-arts organization (for example) can charge and still cover its average unit cost (fixed plus variable). Suppose that a play's variable running cost is \$15 per seat for each performance. If it charges that price, it could sell out a substantial number of performances. It must charge more, however, to cover its fixed costs. As it raises the price above \$15, each ticket sold contributes more and more to cover the fixed cost, but also more and more play-goers choose to stay home. There might be no ticket price for which total revenue will cover total fixed plus variable cost. Roughly speaking, fixed costs "bite" when they are large relative to customers' combined willingness to pay.

We generally shed no tears over products that go unproduced because they cost more than their worth to customers, but with high fixed costs, the missing product may involve a market failure. Suppose that demand for admissions to a play is such that a \$30 ticket price maximizes gross profit—makes the maximum contribution to covering fixed cost. Yet this maximum contribution still falls just short of covering the fixed cost. This frustrates the theatre company, because many play-goers who buy \$30 tickets would pay more. If part of their consumers' surplus could be collected, the show could go on. Another lump of potential revenue lurks in the pockets of play-goers who pass up \$30 tickets but would pay more than \$15, the average variable cost of an extra performance. Suppose that, at the end of the run, a ticket-price cut to \$20 will sell out some additional performances. The \$5-per-seat gross profit nudges total revenue toward covering fixed cost.

Many a seller of creative goods pursues these lumps of consumers' surplus by means of price discrimination. The best seats in the house go for \$50 to people with a high willingness to pay, while the less eager climb to the second balcony for \$20. The cinema buff pays \$7.75 when the film opens, while the casual customer sees it a year later on broadcast TV for the "price" of watching the soft-drink commercials. Many other forms of price discrimination turn up: higher admission charges on weekends than weekdays, lower charges per admission for season tickets than for singles. Price discrimination generally can raise the gross profit from a differentiated product, and is pursued by profit-seekers whether or not it is necessary to cover fixed cost and produce a positive net profit.

Fixed costs have profound effects on the structures of markets for creative goods. Make them large enough relative to the market's size, and no set of price-discrimination gimmicks will generate enough revenue to cover fixed costs. Enlarge the market just enough, though, and a monopoly seller can turn a handsome profit without attracting entry by a competitor. (The competitor's arrival would push down prices and each firm's demand until neither

entrant nor incumbent was profitable, but the incumbent's misery makes the situation no better for the entrant.) Enlarge the market further, and it can support a few firms (oligopoly), likely earning positive profits. *Infinite variety* is only potential.

Consider the Hollywood studios that dominate the exhibition of large-budget films by virtue of their distribution systems (Chapter 10). Those organizations incur a large annual fixed cost to operate. With the distribution system in place, a studio can promote and distribute a certain number of films each year at no additional cost except for the prints and advertising of each individual film. Only a handful of studios perform this function, and on average they earn ample profits. New competitors do not enter (or grow into the role), because a newcomer could not expect to earn positive profits from North American distribution, once its distribution capacity is added to that of the existing studios. Perhaps for this reason, the new studio Dreamworks, founded with much fanfare by three super-rich entertainment executives, chose to arrange for distribution of its films through Universal rather than to build its own distribution network. The same pattern appears among the "promoter" firms found in the record industry, book publishing, and toys and games. Their prices exceed the marginal costs of their outputs, and they earn on average more than enough profit to keep them in the game, even while would-be competitors cannot expect to find sufficient room to prosper if they enter and mimic the incumbents.

In short, a high enough incidence of fixed costs makes even a monopoly opera company strain for enough revenue to cover its costs, while a moderate relaxation of the fixed-cost constraint allows a profitable oligopoly to prevail.<sup>3</sup> Enlarge the market greatly, holding the fixed costs constant, and many rivals find room, though the typical one earns little excess profit. The U.S. magazine industry and New York art galleries are examples among the creative industries.

### Nonprofit Organizations and the Fixed-Cost Problem

Nonprofit organizations are very common in creative-good markets where the fixed-cost problem is severe. It seems logical that nonprofits take over where profit-seeking enterprises cannot cover their fixed costs. Yet that explanation in its simplest form is wrong. Costs have to include a normal profit on the capital and managerial services, regardless of who incurs them. The profit-seeking enterprise will stay in the game if it can cover those costs, although it would *like* an extra profit. The nonprofit, unless it enjoys some special advantages, cannot survive without covering these same costs. Neither has an advantage over the other.

In creative markets with fixed-cost problems, however, nonprofit organizations (NPOs) do enjoy several advantages that explain their prevalence. Consider a valuable device for covering high fixed costs—the two-part charge by which customers pay a fixed or membership fee plus a unit charge for each ticket or use of the facility. However the enterprise is organized, this device offers a major efficiency advantage. The per-use fee can be set equal to marginal cost. The fixed charge collects enough of the consumers' surplus to cover the organization's fixed cost. If necessary and feasible, the fixed charge itself can be differentiated to pick off more surplus from the consumers who value the creative good highly. The gold-card member's enthusiasm wins her an invitation to a party after the opening-night performance, while the less keen tin-card member gets only the privilege of buying tickets at marginal cost.

#### Contract Failures and Nonprofit Organizations

On its face the two-part charge is equally attractive to profit-seeking and nonprofit organizations facing high fixed costs. The former uses the fixed charge (if possible) to skim some excess profit, while the nonprofit uses it only to the extent needed to cover fixed costs. Of course, consumers are not indifferent, and would prefer the NPO for its lower fixed or membership fee. That still leaves the door open for the profit-seeker willing to match the NPO's membership fee and settle for normal profits. But there are more subtle advantages that the NPO enjoys in running a two-part pricing system in a creative activity with high fixed costs. It is easy enough to describe two ways to organize the arts enterprise centered on two-part prices. The profit-seeking manager organizes the firm, offers a contract, and signs up members upon their payment of the fixed fee. Or consumers form a club in which each member agrees to pay the fixed fee, and they contract with a hired manager to supply the desired creative service.<sup>4</sup> Why might the two organizations perform differently?

The answer is that the two contracts will both prove imperfect, but the NPO in a creative activity might well work better.<sup>5</sup> We normally welcome the power of profit incentives to promote the efficient operation of an enterprise, expecting the profit-motivated manager to beat out the salaried management of a NPO. This advantage crumbles, though, if the contract cannot effectively specify just what product the manager will supply, for the profit-seeking manager may have both incentive and opportunity to cheat on the quality or variety of product offered, while a hired-hand nonprofit manager would not. Creative goods with all their noncontractable properties invite this problem, though it also turns up elsewhere. When her toddler is sent to a day-care cen-

ter, the parent cannot practically observe the quality of the lunch that is served. Would she prefer that the decision be made by a manager who minimizes costs, or by a manager who loves children? When a hospital stay is required, and the quality and thoroughness of the treatment cannot be contracted in advance, does one prefer a manager who minimizes costs or one who wants the best for humankind?

As these examples show, the profit-seeking organization may have a double disadvantage. The quest for profit promotes forms of opportunism such as giving customers a product inferior to what they expected when they paid their fixed charges. Furthermore, the NPO may be able to contract with a manager who gets positive utility from supplying a product with just the attributes sought by the customers who form the NPO club. The manager of the concert series or the repertory company cannot feasibly write a contract with audience members specifying the thoroughness of preparation or the prowess of the artists. Will a manager who minimizes costs deliver as much audience satisfaction as a manager who loves good theatre or music? The audience rationally trades off the incentive for efficiency against the incentive to seek high quality; some *art for art's sake* in the manager's tastes is better than none. As often happens with contract failures, repeated transactions between audience members and a profit-seeking manager might get around the problems of writing a satisfactory contract for the one-shot provision of creative wares. The infrequency with which performing-arts "seasons" come around, and the difficulty in determining *ex post* why a creative product was unsatisfactory (Chapter 6), deflate the value of repetition and reputation for solving the problem of contracting with the profit-seeking arts manager.

Club membership as a way to cover high fixed costs does face a problem of forming the club at the outset. One reason why people buy club memberships is that nonmembers can be excluded from consuming the good or made to pay more for a ticket. If nonpaying audience members cannot practically be excluded from performances (concerts in the park, for example), forming the club becomes problematic in the first place, as prospective consumers dodge the membership drive hoping to become free-riders at actual performances. All we can say is that, at the outset, either enough people make irrevocable pledges for costs to be covered, or there is no club and no performance. This problem of free-riding carries over to the ongoing performing-arts organization that seeks recurring contributions but chooses (as most do) not to restrict ticket purchases to those who make donations. Then the lapsed member has little reason not to free-ride on others' donations, as dodging the solicitor is unlikely to deal the fatal blow to the organization's ability to cover its costs. To keep the donations flowing without excluding nondonors from the performances, it clearly helps if people take an altruistic

view of the support that they donate to an arts organization. The feeling that built-up cultural consumption capital has improved the quality of one's life easily brings a warm glow upon making a donation likely to trigger this improvement in others' lives.<sup>6</sup> Altruism suffices to explain why performing-arts clubs welcome (indeed, pursue) nonmember ticket buyers and new audiences. Nonaltruistic club members benefit, however, when more wallets can be pried open to cover fixed costs.

### Contract Failures with Creative Inputs

These contracting problems that favor nonprofit enterprise have been presented from the viewpoint of consumers of creative goods. Because of the *art for art's sake* attitudes of artists, parallel problems arise for their services in providing creative inputs. Their reservation wages are low, but their eagerness to perform with an organization depends as well on the particular creative tasks assigned to them, the degree to which those tasks challenge and develop their skills, and the match between their values and those of the director or coordinator who sets the organization's aesthetic program. Nothing about the profit-seeking status makes a manager intrinsically callous about these creative objectives. But in the for-profit arts enterprise, they can fall prey to the pursuit of profit. The creative performer faces exactly the same problem of contracting with the manager as does the club of consumers. The creative coordinator cannot articulate and thereby commit to a contractually enforceable set of policies.<sup>7</sup> Still worse, the role of inner necessity in creative activities causes the artist to resist precommitment in principle. The artist's best chance lies with a manager who not only espouses values compatible with her creative objectives, but also does not trade them against profit goals. The nonprofit manager can hence hope to attract capable and ambitious creative talent on better pecuniary terms than can a profit-seeker under suspicion of compromising aesthetic goals. The longer the time period for which artists attach themselves to a performance organization, the more do they hold aesthetic shares in the creative goals that it pursues, and the more important should this consideration be. Of course, the creative urge of performing artists likely interacts with altruism of donors, favorably for the NPO, because the knowledge that one's donation lessens the dedicated artist's privation is a likely source of a warm glow.

In summary, the fixed-cost problem yields a number of predictions about the economic organization of creative activities. It explains some of the pricing schemes that are in common use. In light of the problems of writing contracts for creative activities, it predicts where NPOs will undertake the production of creative goods and something about the tastes of managers that

commend them to astute coalitions of arts consumers. The contracting problem of course exists independent of the fixed-cost problem. Profit-seeking investors in Broadway shows or Hollywood movies face their own contracting problem of motivating the producer and director to pursue their profit goal. Two things simplify their task. First, "profit" is easier to define contractually than "artistic excellence," and profit shares to the creative participants help align their choices with the investors' goal. Second, the fixed-cost problem does not "bite" so severely on Broadway or in Hollywood, large markets in which many competing projects are viable. The pressure of competitors leaves decisionmakers in creative ventures less room for pursuing quixotic courses of action, simplifying the investors' problems of channeling their objectives.

### The "Cost Disease"

One more element intersects with the contracting and fixed-cost problems: the "cost disease" flagged by William J. Baumol and William G. Bowen in their celebrated book on the performing arts.<sup>8</sup> In the long run people's real incomes rise because of innovations that raise the quality of goods and services, and productivity gains that decrease the costs of producing them. The corollary of higher real incomes is rising real wages. These tend to increase producers' costs of production, cutting against the cost savings that come from technical progress. Because productivity advances at uneven rates in different industries, this process alters the relative prices of goods, cheapening those with the greater opportunities for productivity advance. The performing arts, goes the argument, are the losers in this game, as the labor hours required to perform a Beethoven string quartet remain exactly what they were when Beethoven wrote it. Over the long run the cost of producing performances rises without limit relative to other things on which people spend their incomes. Other consumption goods and services will be substituted for the increasingly expensive performing arts until they disappear from the marketplace, their fixed costs squeezing relentlessly against the public's willingness to pay. This analysis has been put forth as an argument for public subsidy to the performing arts.

The cost-disease proposition calls for a number of qualifying comments. If the cost disease has made some forms of cultural consumption more costly, it has certainly cheapened those delivered by new media technologies—television, compact discs, videocassettes. Some arts producers and consumers, the ones not favored by new technologies, are worse off. Others (the superstars whose performances are favored by new replication technologies, and consumers who thrill to them) are better off.<sup>9</sup> Another qualification concerns the

effects of rising incomes on how people divide their spending among types of consumption: the “income effect” of advancing prosperity, as distinguished from the “substitution effect” spotlighted by the cost-disease hypothesis. Suppose that we can sort the goods and services that people consume into “necessities” and “luxuries,” and that increases in incomes are spent entirely on luxuries, once the necessities are in hand. Performing arts and other luxuries, if their relative prices were held constant, would then attract increasing shares of consumers’ incomes.<sup>10</sup> This seems especially likely in view of the bias in consumers of the performing arts toward those with high education levels and incomes—households not wanting for necessities (Chapter 11). The cost-disease effect of course fights against this income effect, but rising incomes could lift arts spending enough to offset the impact of rising costs on the quantity of performances. A particular form of this income effect on cultural consumption might be a taste for improved quality in the cultural experiences consumed. That is an important possibility, because attending higher-quality performances increases the efficiency with which scarce time is used, making it indeed likely that the willingness to pay for higher quality should increase. That change favors the real thing in the performing arts over the second-hand experience of a reproduced performance.<sup>11</sup>



*Story of the Armory Show* (New York: New York Graphic Society for Joseph H. Hirshhorn Foundation, 1963).

62. Baur, *Revolution and Tradition*, pp. 127–129; Saarinen, *Proud Possessors*, pp. 215–217, 243–249. Dreier's collection eventually settled at Yale University.
63. Michael Kimmelman, "Art in Aisle 3, by Lingerie, and Feel Free to Browse," *NYT*, Mar. 19, 1995, sec. 2, pp. 43, 46.

#### 14. Covering High Fixed Costs

1. This is true until and unless production hits diminishing returns, so that its average variable costs rise with output.
2. The text summarizes a standard analysis that is spelled out in James Heilbrun and Charles M. Gray, *The Economics of Art and Culture: An American Perspective* (Cambridge: Cambridge University Press, 1993), chs. 6, 7; and C. D. Throsby and G. A. Withers, *The Economics of the Performing Arts* (New York: St. Martin's Press, 1979).
3. The text omits other important factors influencing the number of oligopolists that can coexist in equilibrium. Given fixed costs, higher variable costs reduce their number. Given all costs and the size of the market, the more vigorously the rivals compete, the fewer of them (paradoxically) are viable. Also, the fixed cost of an activity is to some degree a decision variable and can perhaps be reduced by (for example) settling for a lower-quality product. What matters for this chapter is that, among art realms, fixed costs unavoidably vary relative to market size.
4. The concept of a club should not be taken too literally. Individuals with sufficient combined willingness to pay need to contract with an agent to provide the creative product. It does not matter how this deal comes into existence.
5. As with fixed costs, the analysis of nonprofit enterprise is standard in the literature of economics and summarized briefly here. See Susan Rose-Ackerman, ed., *The Economics of Nonprofit Institutions: Studies in Structure and Policy* (New York: Oxford University Press, 1986); Burton A. Weisbrod, *The Nonprofit Economy* (Cambridge, Mass.: Harvard University Press, 1988); Susan Rose-Ackerman, "Altruism, Nonprofits, and Economic Theory," *Journal of Economic Literature* 34 (June 1996): 701–728. For a broad treatment of ownership issues, see Henry Hansmann, *The Ownership of Enterprise* (Cambridge, Mass.: Harvard University Press, 1996), especially ch. 12.
6. One statistical study analyzed nonprofit organizations' expenditures to persuade potential donors to contribute. Specifically, it tested whether organizations' promotion outlays are optimal, on the criterion of spending up to the point where the last dollar bags just one more dollar of donations. Nonprofits apparently do maximize net donations in that sense. Donors to nonprofits in the arts are more responsive to promotional outlays than are donors to other sectors. See Burton A. Weisbrod and Nester D. Dominguez, "Demand for Collective Goods in Private Nonprofit Markets: Can Fundraising Expenditures Help Overcome Free-Riding Behavior?" *Journal of Public Economics* 30 (June 1986): 83–95.
7. Manifestos and statements of principles are in good supply among creative orga-

nizations; the issue here is whether parties can agree on their translation into specific actions and obligations.

8. William J. Baumol and William G. Bowen, *Performing Arts: The Economic Dilemma* (Cambridge, Mass.: MIT Press, 1968).
9. For a case study, see Carl M. Colonna, Patricia M. Kearns, and John E. Anderson, "Electronically Produced Music and Its Economic Effects on the Performing Musician and the Music Industry," *JCE* 17 (December 1993): 69-75.
10. Some empirical evidence supports the implication that income elasticities of demand for arts are greater than one. See Throsby and Withers, *Economics of the Performing Arts*, pp. 103-118.
11. The time cost of consumption does have an adverse effect on the consumption of original performances, however: the fixed time-cost of transporting oneself to and from the performance exceeds the time cost of setting up the reproduced performance.