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Arts Funding in New Zealand

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by

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ABSTRACT

Why should government fund the arts? It should not do so because it wishes to prescribe (or proscribe) what artists produce. It should fund because it wants more art – more, that is, than the 'market' (private transactions between the artist and their public) would supply if left to itself.

The market falls short because the consumption of art generates 'externalities' -- benefits to third parties whose interests may not be fully taken into account in private transactions. These external effects range from culture-building, through the value of the higher arts as an input to the applied arts and technology, to the educative role that consumption of the arts now has on our likelihood of being able to enjoy them in the future.

Public benefits generally depend on the extent of private engagement in the arts, and policy and funding should therefore be aimed at fostering engagement – not, as at present, be directed onto the artists themselves. The paper suggests a performance-based funding system which, at a relatively low administrative cost, would encourage artists and their producers to achieve higher levels of engagement by topping up their revenues from sales or box-office.

The paper sketches applications of the funding system to literature, to the lively arts, and to the problematic 'glamorous megafauna' of the arts & culture scene, which currently soak up most of the arts budget. The paper also considers how to support avant garde art, which is probably not well suited to revenue-based funding.

JEL numbers H5; Z1

The basic idea:

"It's not culture for culture's sake. You know, 'Build it and they will come'? That's bullshit! Build it and sell the hell out of it, and they will come!"

Over the years, Coleman has made dozens of records, but he performs rarely. He says he might perform more if he had an energetic booking agent who understood his music.

from Nicholas Lemann, 'Letter from Philadelphia' and David Remnick, 'The Jazz Life', both in *The New Yorker*, June 5, 2000)

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1. **Introduction and Summary**

It is quite hard for governments to give away money without wasting it. Public funding can crowd out more productive private investments, it can distort incentives – even, encourage dependency; quite a bit rubs off in administrative costs, and more is lost below-the-line in the 'rent seeking' activities engaged in by those vying to get their hands on the money. Also, the public purse is fairly costly to fill in the first place, through taxation, and public spending should therefore pass a higher test of usefulness than need the transactions citizens make for themselves with their own earned incomes.

The six hundred and fifty million dollars that the central and local governments of New Zealand normally spend each year on supporting arts and culture are certainly not all wasted. But, arguably, much of this sum could be better spent, with better outcomes and lower delivery costs.

This paper develops a proposal for reform of arts funding, focussed on the design and delivery of funding mechanisms. I suggest that what is needed is not a radical rearrangement of the present arts funding institutions and structures, but a rethinking of why and how they actually deliver the money entrusted to them. This does not involve coming up with anything as grand as a new 'vision' for arts policy – visions are what artists should have, not arts administrators -- but policy should be certainly be coherent, which means it should be based consistently on (as few as possible) principles.

Two principles guide me here. One came with me into this investigation; the second emerged from the analysis. The first is the *principle of non-prescription.* The late Pierre Trudeau once famously said that the state has no business in the bedrooms of its citizens: we could add that it also has no business in their studios. The artist should be free to realise their vision, to follow their muse where it leads. I will assume this to be common ground with the reader; possibly excepting some of those currently employed as arts funding administrators. Non-prescription is indeed a fine principle, which is almost impossible to follow in practice without some compromise, except for economists of 'monetarist' bent, to whom it is simply the end of the story; the only principle needed. Just leave the arts (and everything else) alone!

Such is not unthinkable. The arts would survive without public patronage – as now indeed do many artists – especially if the rules on tax exemptions for charitable giving were liberalised so as to make private art patronage more attractive. But laissez-faire would be irresponsible. There is indeed a legitimate public interest (and duty) in taking things further, and the implications of this lead to what I call the *principle of engagement*: the idea, which is argued out at length in the paper, that the broad public benefits that justify public funding are realised only if someone actually consumes, or engages the arts; if the art is taken further, out of the studio and onto the streets and into the salons (and saloons).

There must be some tension between the two principles. Any funding formula which favours one arts activity over another will, have some 'prescription' in its makeup.[1] But the beauty of applying the principle of engagement is that it supplies its own prescription mechanism – the response in the market is used to guide funding, on the basis that public and private benefits are correlated. In practice, it would not be as simple as that, as we shall see, but that is the basic idea.

Any proposal for change must begin with a serious analysis of the failings of the existing system. It is interesting that, although our funding institutions may seem to be something of a jumble, they have all somehow ended up following the same basic funding model, and this, I will suggest, is probably the wrong – or, at least, not the best feasible – model, in nearly all cases. This model can be summarised thus: focus the funding directly on the *supply side* of the arts – specifically, lump-sum funding of the artists themselves or the activity of making the art.

Now it may seem unsurprising that our arts funding is aimed at the artist and their art – it does seem an obvious place to put it, which is probably why all our institutions have, willy nilly, adopted this model. And it may seem quite surprising that a sound economic case can be argued that this is actually the wrong way to inject public funds into the arts system (with one important exception). Yet, if we seriously ask just what is the justification for public support, and what are the implications of this for policy, we are led, I argue, to a quite different funding mechanism than the present regime.

So, first of all, why should the taxpayers' hard-earned money be redistributed to the arts? Why can't the arts sector look after itself, as do most economic activities these days? The economic justification for public funding of anything must be based on the existence of public benefits from the activity, over and above those 'private' benefits that citizens are able to negotiate for themselves, through market and non-market transactions with each other. In technical terms, there must be a private 'market failure', usually meaning that the market (or private institutions more generally) left to itself would not supply enough of the activity (or not enough to everyone), and therefore justifying, at least in principle, government stepping in to give things a bit of a push along.

Where are these market failures to be found? We should first rule out some commonly proposed but economically illegitimate rationales for public funding of the arts or other activities. What one might call naively economic arguments based on the contribution of the sector to GDP, or to employment, or to the growth in GDP bear no weight at all. Everything measured in GDP by definition 'contributes' to it. So what? There is thereby implied no *prima facie* case for diverting funds to support one activity at the expense of another.

Arguments – dangerously alluring to local body politicians in particular –

[1] Though note that, in an imperfect world, even *laissez-faire* is prescriptive in that it *de facto* favours those with private means over those without.

based on the ‘multiplier’ effect of spending–that a dollar spent on the arts will then be re-spent by its recipients somewhere else in the economy and so on and so on – are phoney, because they apply equally to just about any dollar spent anywhere in the economy (including the dollars that would be spent by private citizens if they had their taxes returned to them rather than spent on their behalf by government), and therefore favour no one activity in particular.

But there is indeed a quite long list of possible legitimate reasons to argue market failure. The paper numbers seven of these, and finds that just about all have a plausible application to the arts, so that, in sum, we have an usually–perhaps uniquely–strong qualitative case for public support. The gist of the case is based on what economists call *externalities*, or spillovers – due to third parties affected by the actions of the (usually just two) private participants in a transaction. That is, the artist sells their work to a patron, on terms acceptable to them both on the basis of the effort put in by the artist and the pleasure received by the patron: but who in this deal is taking account of the interests of others affected by the act?

Just who are these affected others and what are their interests in this? The externalities of the arts are actually pretty pervasive. Those affected can include: other artists, other arts consumers or patrons; the public at large; as-yet unborn consumers; even the private patrons themselves. Other artists and art patrons are affected because a successful artist/consumer engagement makes other successful engagements more likely (through scale economies and network effects). The public at large benefits – perhaps more than it knows (though I consider it elitist to assume that appreciation of the arts is elitist) – because Capital-C High Culture is the bedrock of Low or Popular Culture and indeed of the small-c ‘culture’ – the whole set of norms and values that makes life in society intelligible and tolerable. Unborn generations – who of course have no vote today – will want to have the culture handed on to them in good working order: this is the curatorial function of the arts. And because successful consumption of the artists is itself an act of connoisseurship or expertise – a learnt skill – the budding arts patrons themselves may not always know what is good for them – may not appreciate that an act of arts consumption now is an investment in their own better arts consumption in the future.

These factors do add up to a case in principle for government – acting on behalf of all those unconsidered third parties – to step in to help the arts. But such is necessary but not sufficient for converting theoretical principle into policy practice. The best of *possible* worlds may still have no place for public intervention.

Why not? Two reasons. One is the physician’s warning: *First do no harm!* Or, pragmatically (since some ‘harm’ must be done), policy interventions should have an expected healing/harm ratio comfortably over one if they are to be supported. Given the list of things -- noted at the head of this introduction – that can go wrong at even the prospect of the opening of the public purse, this may not always be possible.

Second, we shouldn't look automatically to government to solve every private market failure. Any civilised society will have developed – indeed, will depend on – a sophisticated system of norms, values and formal and informal institutions for, in the economists' lingo, internalising the externalities – for taking into account the reasonable interests of third parties not directly concerned in market (and non-market) transactions. I will expand on this in the body of the paper, but note here the two implications: first, that, in normal circumstances, there are other arrangements and institutions which may be doing a quite serviceable job of coping with externalities; and second, that we should expect these institutions to 'smooth out the peaks' – to focus their energies where the (social) returns are highest. What this means for public arts funding is that we should want to see quite significant public benefits before intervening, and that we should be rather suspicious, when analysing existing funding arrangements, of large discrepancies in the ratio of public to private support needed to make the activity viable.

So just how much public money should be spent on the arts? This is a difficult question, and not one that can properly be answered without specifying the mechanisms for disbursement. Anyway, it is a question I am not going to attempt to address in this paper. Instead, I will answer this: 'Given the present total arts funding budget, could it be spent better?'

Such is, of course, a very useful, if more limited, issue to deal with, and it can call on some political economy claims to wider legitimacy. New Zealand's arts funding budget is the aggregate result of decisions by generations of democratically elected governments. Perhaps, and be it through mechanisms which may remain mysterious to the likes of economists, these democratic institutions have somehow fumbled their way to a total quantum of arts spending which is roughly appropriate to the job at hand.

Now, the same sort of essentially *laissez faire* arguments could also be used to justify the more micro details of current arrangements – that is, the actual funding mechanisms being deployed. Such considerations must be kept in mind and taken seriously. The status quo has its reasons. But I see at this level a situation in principle more susceptible to the economist's tools, and few signs of those analytical instruments having been deployed – systematically or even unsystematically. So it is worth a try.

Well, then, where does the economic approach take us? It starts from the source of those public benefits, which are based on the external or spillover benefits to third parties from private arts 'transactions'. And here a quite striking generalisation emerges: it is not production that matters, but consumption. The public justifications for the arts are realised only when the public *engages* the artist and their art: reads, hears, watches, talks & thinks about them. A poem unread, a symphony unplayed, may or may not represent a worthy aesthetic/emotional experience for its creator, but its value to anybody else, and, in particular, to the public at large, is zero.

And yet, most of our funding mechanisms are directed at production, not consumption – at supply, not demand. Take literature as an example. Creative New Zealand hands out grants of, typically, $18,000 to writers to enable them to, say, 'write a novel'. Here we are not even funding supply directly, but the preconditions for supply – time, food on the table, etc. The book may not even get written, never mind published, and never mind read.

Creative NZ also doles out grants of two or three thousand dollars to publishers, to help with the publication of a named work. This is two steps closer to the consumer, but it still does not directly encourage what is the only thing that is in the public interest, which is that people buy, borrow, steal, read, talk about, write about, *engage* the book. And, although the act of supply - publication – by itself will probably induce some demand, a publication grant system could actually have the effect of reducing the number of copies sold and read. Especially with a 'difficult' book, the publisher may feel that artistic honour is satisfied by just eking out, say, a print run of a thousand or fifteen hundred and letting the work look after itself; and the publisher may be financially able to get away with this strategy given its grant from Creative NZ to top up revenues.

The core of the present paper is a proposal to focus arts funding on encouraging consumption, or, more to the point, 'engagement', which has both quantitative ('bums on seats') and qualitative ('the earth moved') dimensions. This is where the public benefits are to be found, and so this is where the money should be put.

The specifics of the proposal are shaped by some particular propositions about the nature of public benefits, and about the technology of arts production. I suggest that public benefits (ie, those spillover etc effects which make an arts transaction worth more in total than it is worth to the immediate private beneficiaries) are not likely to be significant at low levels of consumption. A work of art that is largely ignored is not likely to generate the 'buzz' that makes it bigger than itself. And then, at the other extreme, public benefits may erode and even turn negative for works that have a sizeable commercial success: the art may be coarsened by mass replication, and it may crowd out smaller scale but worthy artistic efforts.

On the supply side, a feature of most (not all) arts production technologies is that they are susceptible to economies of scale – it is producing the 'first' unit – making the art happen at all – that is expensive; replication is cheap. Thus, for a book, doubling the print run from two thousand to four thousand copies incurs costs which, although not insignificant, are much less than the 'fixed' costs of actually writing and designing the book. For a play, there are all the costs of mounting the production to be spread around – twice as many performances means halving the per night share of the set-up costs. And, at each night's performance, there are usually empty seats which would incur almost zero additional costs if someone could be persuaded to sit in them. All this is quite different from the near constant-cost conditions that prevail for most services and manufactured goods. Two haircuts take twice as much time as one. Two houses take twice as many resources to build, and so on.

What cheap replication (low marginal costs, in economists' terms) means is that a strategy based on encouraging consumption, unless extravagantly excessive, is not likely to be 'uneconomic' in the sense of inducing activities which cost more than they are worth. And, indeed, cheap replication along with the direct-service characteristic of much (especially performance) art makes the activity particular fertile territory for the revenue-enhancing practice known to economists as 'price discrimination' – charging different people different prices based on their willingness to pay. Now of course government can't tell artists and their agents how to extract the maximum revenues from their audiences, but it can *encourage* them to turn their talents and efforts in this direction.

All this leads to a proposal for a funding formula. We take actual 'box-office' or market revenues as a serviceable proxy for the level of engagement generated by a marketed arts activity, which in turn generates desirable externalities etc, which we want to encourage with funding. (For non-marketed activities, like some museums and art galleries, we would have to use 'willingness to pay', which is a more difficult number to estimate.) That is, we are saying that the level of public benefits is related to the level of private benefits. But the relationship is not linear. The funding formula would not kick in until after a certain minimum critical mass of engagement had been reached, and it would switch off at a higher level representing the quite rare but desirable state of a solid commercial success. It might, at that level or later, actually reverse from a subsidy to a royalty, so that the exchequer actually gets to share in the surpluses generated by a box-office hit.

This is not a new or untried idea. We see a good example of it in action in the book trade – what in New Zealand is called The Authors' Fund, which gives authors of NZ books a rather modest sum of money ($1.90) for each holding of their book in the catalogue of a public library. The payments don't kick in unless fifty copies are found. In larger countries such as Canada and the UK the payments are capped, so that the already groaning coffers of the Barbara Cartlands and Jeffrey Archers of the literary world are not excessively enriched at the public expense. At $1.90 per book, it has not seemed necessary to cap the fund in New Zealand.

Such public lending funds are actually quite clever. Of course, ideally, payments would be made on the basis of the number of times a book is actually lent out (super-ideally, on the basis of actual readings), and this may some day be possible to cheaply monitor through electronic databases (like supermarket 'point of sale' records). But, now, libraries have scarce shelf space, and librarians know their business, and so it is smart (low transaction costs) to use the continued presence of a book in the catalogue as a proxy for its popularity.

Indeed, if I were given just thirty seconds to come up with a comprehensive policy for funding literature, it would be this: 'Take all the money currently handed out as grants to authors and publishers and put it into the Authors' Fund.' That would not be a terrible policy at all!

However, this particular system does not differentiate books on their artistic (or any other, apart from 'NZ-made') merits, which leads naturally to the general concern that funding formulas which reward consumption might encourage low-quality or 'safe' art over the genuinely challenging and creative.

Such is actually not an issue with library lending funds, which are justified on the basis of intellectual property rather than public good considerations. But it is a point worth exploring for the more general performance-based funding mechanism proposed here. Personally, I have little interest in encouraging yet more revivals of *The Pirates of Penzance*, or *Swan Lake*, or *The Importance of Being Earnest.* Yet we (or I) shouldn't be snobbish about this. Tastes differ. And people can often do good, interesting, creative work within the constraints of 'popular' art. After all, the most 'commercial' of all the applied arts is surely the Commercial itself – yet the high production values of 35mm television advertising train and keep busy legions of film workers who are then available to make 'real' movies when the funding is available.

Nevertheless, there may be a problem here. What we really want public funding to do is to make the difference between financial viability and non-viability for projects that are artistically worthy, in that they could generate a worthwhile excess of public over private benefits. But how would the formula screen out projects which don't generate valuable surpluses for the public at large? The answer, probably, is that it couldn't, so that box-office based subsidies schemes would end up spread too far (and thus too thinly, given the overall funding constraint).

In practice, then, policy must continue to violate the principle of non-prescription, at least to the extent of prescribing categories for fundable and non-fundable projects. In the real political economy, there will always be some need for judgement and judgements on the part of those entrusted with implementing policy. In the case of books, the publishers' own responses to Creative New Zealand's questionnaire sent out as part of their *Publishing Policy Review* reached a 'consensus' that certain categories of books need not expect support. Such included Self Help, cookery & gardening, sports books and others.

Within the approved categories – fiction, poetry, scholarly works – the performance funding scheme would indeed fund more broadly than does Creative NZ at present, with its selective system. Genre fiction – thrillers, SciFi, for example – would be fundable, along with straight 'literary' fiction. So what? Who is say – to prescribe – that some fictional forms are inherently superior to others? Of course, we want *good* thrillers, but here we should trust the judgement of the professionals who bear most of the financial risk – the publishers.

At the other end of the popularity scale, a performance funding formula would fail to reach what could be called 'art for artists' sake' – that is, really new, innovative, difficult work that is at first only appreciated by other artists (to whom it may be very important indeed) and a few daring private patrons. Here private benefits as manifested in the market demand curve fall so far below costs that the levels of subsidy embodied in the funding formula – perhaps, around 20% of market revenues – would be quite inadequate for financial viability. Sizeable lump sums are needed.

How can government help? Should it even try? The basic problem is that most new art that is financially non-viable is so for a sound reason – *it just isn't any good* – and government and its agencies may be just too far from the action to pick the few future winners from the pack of wannabes.

What happens now? The truly innovative artist struggles for recognition, as they always have and always will. Help comes from family, friends and fellow artists; from 'day-job' employers; from the cadre of avant garde private patrons, and from cultural organisations such as universities. But it isn't easy, and probably shouldn't be. However, there possibly is a valid role for some government grant support, though this with more emphasis than now on fostering public engagement, where possible. But what I am arguing in this paper is that such direct granting should not be the predominant form of arts funding, as it is now for even quite 'mainstream' or 'normal' art activities, which really should be able to respond effectively to a performance-subsidy funding regime if they are any good.

The most ostentatious direct funding at present is claimed by the 'glamorous megafauna' of the arts and culture worlds – the giant institutions that cast long shadows as they munch their way across the artistic landscape, devouring most of the money and getting most of the attention: the Symphony Orchestra, the National Museum, the feature films industry, TVNZ, and Radio New Zealand. Most of these organisations would not survive in their present form without their enormous subsidies – a tempting question to ask is: should they be allowed to become extinct?

It is actually very hard to make an economic case that justifies the horizontal inefficiencies implied by the huge discrepancies in the ratios of public to private support between, say, the NZSO and the regional orchestras, or between *Te Papa* and the Auckland Museum, or between feature films and just about anything else, and there is large potential for artistic as well as financial gain in rationalising these distortions. The paper makes some suggestions, while recognising that some of these institutions may be, politically, beyond reason or rationality, and perhaps rightly so.

2. The Rationale For Arts Funding

2.1 To be a good is not good enough

Why would citizens want their government to use their taxes (and its regulatory powers) to support the arts? Not simply because the arts are a 'Good Thing' in themselves. There are plenty of good things – from sausages to sex – which aren't thereby deemed in need of encouragement from the public purse. The reasoning is that the individuals concerned with producing and consuming these things can sort it all out for themselves. The costs and benefits are born privately – that is, between those, and only those, directly involved in the transaction.

Nor is it sufficient to use an instrumental argument, that the arts are a useful input to the system in that, say, they promote economic growth. To promote economic growth is to invest – to use resources in the present to gain a return in the future. Again, the question must be: why cannot mature, well-informed individuals determine the terms of this trade-off for themselves?

We cannot just announce that 'The Arts' contribute x% of Gross Domestic Product (where x is a number between 2 and 6, depending how broadly one defines the arts sector), and stand back with our cap held out for public contributions. The food processing industry – including sausage making – contributes about 5% of GDP, and no-one seriously suggests it should be subsidised.

Nor does it help the cause to point to the impressive growth in employment in cultural industries – up 31% between the 1991 and 1996 censuses (McDermott Miller 2000, p22). Indeed, a quick response to this statistic could be: 'Aren't the arts doing well! Perhaps the infant is growing up, and is ready to stand on its own feet now.'

And – last but not least – arts advocates should never sully their case by recourse to disreputable multiplier arguments – that a dollar spent on supporting the arts will have additional 'flow-on' benefits as the dollar is spent again and again. The money does go round and round, of course, but an arts dollar is no different from any other dollar in this respect, and a dollar spent on anything, including the arts, is a dollar not spent on something else.[2] The public arts dollar has to be justified *on its merits* – that is, as being a dollar *better* spent on the arts than on some other activity.

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[2] For a multiplier argument to be valid, two conditions must be met. First, the initial dollar must indeed be a dollar that would not otherwise be spent on something else (which probably means in practice that it must be a dollar from overseas), and, second, the goods and services handed over in return for that dollar (and in return for the flow-on dollars spent) must be, to a significant extent, 'free' resources, that would not otherwise be gainfully put to use (which probably means in practice that the money must be spent in an economically depressed region. Such regions do exist in New Zealand.)

And it turns out that there are a number of solid grounds for making such a case in principle.

2.2 The search for market failure

The basis for public intervention to suborn or support a private activity is that the individuals making the decision do not correctly calculate all the costs and benefits when deciding what level of that activity to undertake. When this happens in the context of market transactions, we say there is a market failure. But the concept is quite general and applies to 'transactions' between people in the broad anthropological sense (such as sex), as well as to transactions between an individual and nature (such as chopping down a kauri tree).

There are at least seven types of reason why private transactions between sane, sober people might fail, at least in part:

Not enough money – it is assumed that each player in the market game has a sufficient stake to do themselves justice. If not – if someone would otherwise starve for lack of the price of a sausage – then we would wish to subsidise their consumption

Not competent to judge -- people may be too stupid or too short-sighted to correctly calculate the consequences of their actions. This is not a particularly popular point of view in modern liberal western cultures, though we do still apply it quite widely. We readily assume, for example that young people left to their own devices would choose too much sex and not enough schooling, so we impose a minimum age of consent and a minimum school-leaving age.

Risk - people tend to be 'risk averse', meaning that they fear a large loss (which could wipe them out) more than they favour a similar-sized gain (which might just raise them from being comfortably off to being well off). For this and other reasons private capital markets may systematically underfund[3] promising projects, and there is a potential role for government (seen as the ultimate risk-pooling institution) to support new ventures (with start-up funding) or even new industries (on the 'infant industry' argument).

Market power – when one party has a monopoly or near monopoly over the supply of something important to a transaction, the terms of that transaction can be distorted in ways that may be publicly judged unfair and inefficient. Examples range from the macro – the natural

[3] Underfund meaning that the expected return on rejected projects is positive, even if individual outcomes can be failures.

monopoly of the national electricity grid, say – down to the most micro stores of private information that each of us owns about our own nature and actions, and which is costly for others to identify and verify. In remedy, governments can choose (though ours doesn't!) to regulate access to natural monopolies, and to require full disclosure (for example it is illegal for someone who is HIV-positive to have sex without informing their partner of that fact).

Public Goods – something that is consumed freely by everybody, therefore nobody will wish to personally incur the expense of providing it. More generally, many private transactions have additional public implications. For example, an act of courtesy shown by one person to another has its immediate costs and benefits for the parties directly involved, but it also contributes to the overall climate of civility in society, in that it makes other such acts more likely. The justifications of such state-provided or supported activities as national defence, the justice system and, to an extent, education and healthcare are traditionally based on their public good characteristics. Also, highly valued people or institutions can themselves be seen as public goods, or 'national treasures', but there may not be an efficient mechanism for individuals to show their appreciation. A collective act, such as bestowing titles and other honorifics, is called for.

Externalities (spillovers) – when third parties are affected, for better or worse, by transactions in which their interests are not taken into account. Generally, the private market will over-provide goods and services with negative external effects (eg noisy parties) and under-provide those which generate positive externalities (eg, apprenticeships). In theory, the solution is brilliantly simple: just assign property rights (ownership) to everything that is of value, so that all effects do have to be taken into account in voluntarily negotiated transactions (ie, internalise the externalities). But, in practice, the transaction costs of assigning property rights and negotiating settlements may be prohibitive – especially when many people are involved – and the cruder instrument of direct government intervention may be more efficient.

Existence/amenity/option/bequest value – when we don't actually want to pay to personally consume something now (or perhaps ever), but we ascribe some value to it being available for use by us or by others to whom we feel well-disposed (option/amenity value) or to future generations (bequest value), or just like having it around (existence value). Thus we may favour costly restrictions on the logging of slow-growing native forests just so as to not foreclose on the opportunity of future generations to decide whether they wish or not to log those trees.

2.3 Application to the Arts

All these reasons for private market failure apply to the arts. It is indeed difficult to think of another sector of the economy for which the case in principle for a public-private sector partnership can be made more strongly. Let us review the arguments in turn.

The needs-based case for subsidy is perhaps the weakest, at least on economic grounds. Of course the poor lack the means to pay for the arts, but they lack many other things as well, and it is not clear that easier access to culture is at the top of their list of needs. More sausages might be better appreciated than more symphonies. Subsidies can be targeted (means tested), though this can be expensive and demeaning. When they are not targeted, as with free admission to museums, the net effect on the income distribution is actually likely to be regressive, in that the beneficiaries are predominantly higher income groups, who for various reasons are better positioned to take advantage of the subsidy.[4]

The 'they don't know what is best for them' argument for encouraging consumption is particularly – perhaps uniquely – applicable to the arts (Throsby, 1994). This is because successful consumption of the higher arts requires substantial expertise on the part of the consumer, and such expertise cannot usually be acquired without the experience of previous consumption. That is, we get better with practice at appreciating the arts, in ways which even normally intelligent and rational people may not easily foresee before they have been immersed in the process. The exploratory toe in the water may report back to the brain 'too cold!', but once we have been pushed in (and assuming basic competence in keeping afloat) we may yet thoroughly enjoy our swim.[5]

Risk is a big factor in the arts, because the outcomes of creative processes are of their nature unpredictable, in particular for new artists and radical ideas. And even though the track record of an established practitioner is a pretty useful predictor of their future performance, the scale of success – how many books they will sell, or how large an audience they will attract – can never be surely foreseen.

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[4] A visit to *Te Papa*, for example, is cheaper for those who live or work in downtown Wellington, than for families who have to travel in from the (generally poorer) suburbs in the hinterland (not to mention travellers from the rest of the country).

[5] Of course the 'practice makes appreciative' argument applies even more strongly to the production of the arts, as anyone who is eternally grateful to their parents for forcing them to take piano lessons in childhood will testify.

Thus, it is crucial that there be failure in the arts (as in other creative enterprises, such as scientific research and new business start-ups). No failure means no risk-taking means no big payoffs from extraordinary success. Of course, failure must not be courted frivolously, but nor should the returns be too sure.

The private sector has developed quite effective institutions for pooling risk, notably the limited liability company, but there may still be a role for the public sector, possibly as a risk-sharing partner in private enterprises (such as subsidies to book publishers); possibly in providing a more favourable market environment – as with tariff or other forms of protection (such as local-content quotas) – which generally reduce riskiness and enhance profitability of domestic production.

Market power issues arise throughout the arts sector. At the national level there is the problem of responding to the undoubted force of foreign influences on our culture, in particular those imported from the United States. Within the arts sector problems of market access arise – or are alleged to arise – more in some activities (film, television, music recording) than others (drama, publishing, fine arts). In some cases the problems may be privately generated (access to mainstream cinema distribution), in others the public sector agencies themselves may be the culprits (the buying power of the commissioning editor for TVNZ).

As for private information – the fact that each of us knows vastly more about ourselves than we can ever know about anyone else – this is such a basic and pervasive feature of the human condition that there doesn't seem much point in calling it a 'problem'. But it must be taken seriously, in particular in the design of practical policies aimed at relieving market failures. If not, then the cure can easily become more harmful than the disease. We will return to this.

The public good argument for public support of the arts is by now fairly familiar (for lucid expositions, see George Barker (1999) and Brian Easton (1999, chapter 15)). It centers on the contribution made by big-C Culture (the arts) to small-c culture (the set of shared norms, values, understandings of a society). A lively arts sector contributes to an alive, connected community. This is valuable in itself and also instrumentally, as an contributor to 'social capital' – the willingness to trust and be trustworthy (in particular with 'strangers') -- without which a market economy simply cannot function (as the experience since 1990 of the former Soviet Union and its satellites dismally demonstrates).

A strong, distinct national culture increases the transaction costs of dealing with other cultures, with different norms and expectations. Taken to an extreme, this can lead to xenophobic attitudes to foreigners. But I see national culture as an important substitute for more overt forms of protectionism (such as tariffs) in fostering the successful engagement between domestic producers and consumers. Indeed, studies of trade patterns reveal quite strikingly the power of culture and the importance of nations. Canada and the United States, for example, share the world's longest border, have free trade (no tariffs), very good transportation links, and what one might place as a relatively high degree of communality in their consumer cultures. Yet a business in Ontario is more than *twenty times* more likely to do business with another firm in British Columbia, than with a firm in the state of Washington, which is the same distance away (Helliwell, 1998).

I do feel strongly that the contribution made by the arts to our culture and to the general quality of civilised economic life must be prime amongst its social functions. But I have a couple of worries. First, nation-building is not in fact official policy of the government of New Zealand, and indeed it contravenes official policy. Neither of the two most popular metaphors of nation-building apply to us. We are not, like the Americans, stirring cultural ingredients into a 'melting pot' from which a shared and unique national identity will emerge. But nor do we follow the Canadians in celebrating a 'cultural mosaic' of groups of different ethnic and religious backgrounds maintaining their diversity but bound together by the threads of common values.

Instead, we are officially bicultural – Maori and the rest – and I am not sure what is the logic for social capital of the development of two strong but distinct cultures. A monocultural society has just the one culture to nurture. A multicultural society has so many cultures that it is forced to develop a strong core of common values so that those cultures can communicate with each other – or else you end up with Croatia, not Canada. But successful biculturism could, it seems to me, easily leave us with 'two solitudes' – internally stable but mutually disjointed ways of seeing and behaving.[6] Is that going to be good for social capital and the economy?[7] Has this issue been adequately addressed or even recognised in the literature on the arts as a culture-building institution?

My second quibble is with the assumption – which again seems rather to have slipped through the dialogue unchallenged – that what creative people do is indeed sustaining of national identity, norms, shared values and so forth. It seems to me that, on the contrary, big-C Culture is often, and at its best, thoroughly subversive of the small-c culture from which, inevitably, it springs. Many artists (at least, creative if not always

[6] Actually, 'two solitudes' is a metaphor from Canada, and refers to the divide between English-speaking Canada and Quebec. The cultural mosaic is a construct found only in English Canada – immigration policy within Quebec rather favours the melting pot. But is a great tribute to the shared good sense of Canadians that the deeply felt issue of Quebec separation has, over the past three decades, resulted in only one violent death (in 1970).

[7] Rob Garrett has pointed out to me that the Treaty obligation to develop 'in partnership' may counter two-solitudes tendencies in New Zealand.

interpretative artists) are radicals, not conservatives. They challenge, reject, even abuse 'society's' smugly held values and conventions.

Of course we wouldn't – I wouldn't, anyway – want them to be anything else, but perhaps we should expect to pay a price in economic growth lower than that achieved by more homogeneous and conforming peoples (Japan? Korea? Germany?). Perhaps not.

As for the 'national treasure' market failure, I expect that most of us are happy to have our government bestow prizes and honours on the Kiris and Douglases on our behalf, but the arts don't expect or receive preferential treatment in this – it is really not an arts policy issue at all.

The externalities argument does seem very apt for the arts. It comes into play on both supply and demand sides of the story. On the consumer side, because of the 'rational addiction' nature of enjoyment of the arts, the fact that some individual has been persuaded to attend, say, a certain performance of a certain play benefits not just the people who sold the ticket (the private beneficiaries), but also the producers of other plays, because, by helping cultivate a taste for live drama, it makes it more likely that that individual will purchase another theatre ticket. It also makes the theatregoer a bit more experienced and acute a critic, which is beneficial to artistic standards generally.

On the other side of the market – the production or supply side – externalities or spillovers apply in strength to the collaborative arts such as dance, drama and film. A higher standard of writing, for example, helps actors give better performances, which makes for more successful productions, which encourage further activity and investment in writing and so on – a 'virtuous circle' of positive feedbacks. The idea of scale or critical mass is important here, leading to viable networks or 'clusters' (in Michael Porter's phrase) of creative workers all benefiting from each others presence.

Such clusters can crop up naturally – good examples are the grouping of used and rare bookstores along Auckland's High Street, and the dealer galleries that have found their way into the same neighbourhood, in the shadow of the Auckland City Gallery. But they may not crop up naturally enough, in particular (as in film production) when a number of quite different trades and skills – from carpentry to composition – are needed. There remains, then, at least in principle (and this must be stressed – the actual practice may not be feasible), a role for the public sector.

On both supply and demand sides, there is the argument of Robert Tollison that 'a society that encourages creativity in the arts stimulates creativity in general', exemplified by the (apocryphal?) story that Einstein once thought of a good idea while listening to Beethoven. Are the arts the key to unlocking the riches of the fabled 'knowledge society'? There are certainly plausible links, through the applied arts and their industries (graphics, architecture, design, multimedia).

The high arts also provide the essential platform, albeit with long lags, for pop culture – “No Beatles without Beethoven” would be a good slogan to chant at those who sniff at the ‘elitist’ nature of support for the arts. These spillovers can flow a long way, and of course there is no reasonable way their value can be compensated at source (some Maori would disagree with this). How could the estate of F. Scott Fitzgerald be paid off for the intellectual property appropriated by the nickname ‘The Great Gretsky’ tagged by the sporting press to the Canadian ice hockey superstar Wayne Gretsky?

As for the existence/amenity value of the arts, this is surely a strong suit in their play for public support. Indeed, there may be many people who believe (or are unwilling to admit that they do not believe) in the arts as a Good Thing, but who don’t want to actually consume culture themselves. A person whose private definition of opera is ‘Italians behaving badly’ may still wish to tithe some of their taxes in the support of a National Opera Company.

The motive may be national pride, or perhaps just a reasonable recognition that tastes differ. After all, personal accomplishment or connoisseurship across all the arts is rare. Most of us have our bad-taste zones. There are gifted artists who listen to Barry Manilow, and brilliant musicians who never open a book, and famous authors who dress badly.

But invoking the amenity value of the arts to justify support is actually an admission of failure. We do not really want our creative artists to be sealed off and preserved, like gene banks, for the possible edification of future generations. We want them to be engaged with us now, and that basically means more consumption of the arts. The other arguments for public support are just about all dependent on the arts being used, and justifiable public policies will be aimed at increasing the quantity and quality of the public’s consumption.

3. The Design of Arts Funding Mechanisms

We have established the likelihood of market failure in the creative sector, meaning that if we leave the allocation of resources to the arts to private market transactions (basically one-on-one transactions between buyers and sellers), then, in general, not enough art will be produced. Total public plus private benefits exceed costs, at the margin. So what could government do about it?

In this section we develop a fairly general proposal for arts funding based on both the intrinsic nature of the market failure and on mechanism design considerations in the presence of imperfect and asymmetric information. It turns out that both these factors point in the same direction; to the same type of performance-based funding mechanism, and away from the dominant current practice of up-front block grants.

3.1 The Nature of the Market Failure

The interesting point is this. Just about every one on the list of market failures in Section 2 share the implication that it is *consumption*, not production of the arts that matters from a public policy point of view. That is, we the taxpayers are concerned with the successful public *engagement* with the arts, not with the existence of the arts product or activity for its own sake, and nor with the well-being of the artist *qua* artist. Those spillovers and public goods which are not adequately taken into account in private transactions are proportional to the numbers consuming the arts product. The more people who attend a concert now, the larger and better will be the audiences for future concerts, and the livelier will be the overall culture of the society.

Possible exceptions to this generalisation are the existence/option value and the National Treasure motive for arts support. So, for example, we could wish to support a Symphony Orchestra that nobody currently wants to go listen to on the grounds that future generations should have the option of so doing – in essence, funding a limitless succession of rehearsals for a concert which may or may not ever occur. However, it does not take much insight into the human side of arts production to appreciate that this would probably be a pretty feeble sort of orchestra – that, in contrast to inanimate objects, living organisms such as orchestras are best ‘preserved’ by being used.

This hardly seems a controversial proposition. *Yet it is systematically ignored in most arts funding systems.* Nearly all of the $175million or so of annual government funding for the arts in New Zealand is production or artist oriented; that is, it facilitates the output of a work of art without concern for what level it is consumed at (or even whether it is consumed at all).

Let us see where this idea takes us. We will call the 'net public benefits' the excess of total social or public benefits over the private benefits directly captured by the arts consumer (the person buying the ticket). It is these benefits which we cannot normally expect the market to take into account. Figure 1 shows Total and Marginal Net Public Benefits (TNPB and MNPB) as a function of units of consumption for some arts activity. To fix ideas, let us say the activity is producing a play.

A play that is a miserable flop generates no public benefits. Perhaps it would be more accurate to presume negative benefits (losses), if, for example, the experience puts some people off going to see any more plays. In any case, at some box-office level Q^0 the public benefits from engagement start to kick in, and are increasing at the margin at first, say, due to network effects. But the law of diminishing returns is inexorable, and marginal public benefits eventually start to decline, and may even become negative for very popular plays, if there is some coarsening of the product with mass market success, and if 'hits' crowd-out more innovative productions.

Thus we have a level of consumption, Q', which maximises total net public benefits. But this level is not, however, in general socially optimal – that depends on private benefits and on costs of production. Figure 2 brings these factors into the story. Marginal private benefits are given by the demand curve, D (the area under which measures the private consumer surplus enjoyed by the audiences at the play). Marginal total benefits, MTB, are the sum of private benefits and the Marginal Net Public Benefits from Figure 1, drawn, for simplicity, starting from the point of declining MNPB.

The Total Cost function is given as:

$$(1) \qquad C = F + mQ$$

with fixed costs F (the production costs – rehearsal, sets, design, costumes etc) and marginal variable costs m, here assumed constant per unit of output, Q (which would therefore need to be taken as measured in nightly performances of the play), including actors' and front-of-house wages, rental and so on. This must be considered a quite generally plausible arts production function – most such activities have scale economies generated by relatively low reproduction costs (books, recorded music, films, art galleries). Exceptions, at least to some extent, are one-off television productions, live music concerts and the private art market for unique works of painting or sculpture.

Scale economies imply a hyperbolic unit or average cost function – costs per unit decreasing with output at a decreasing rate, to asymptotically approach marginal costs, m, at very high levels of output:

(2) $AC \equiv C/Q = F/Q + m$

It is the relationship between those costs and the marginal private and public benefit curves that determines how successful will be the arts activity, and how successful it deserves to be. We will say that an activity is financially *viable* if there is some level of output at which market revenues would cover costs, and that it is artistically *worthy* (of support) if there some level of output at which total public benefits would exceed costs.

This gives us four possibilities, which are demonstrated on Figure 2 with different average cost curves (though of course in reality activities differ in both their costs and their benefits):

AC1:*Neither viable nor worthy*. This is the artistic endeavour which, if somehow performed, would be both an artistic and financial flop. Of course we hope there aren't too many of these in practice, but there must be some – no success without the risk of failure.

AC2:*Worthy but not viable.* The activity cannot support itself in the private market, but it should go ahead, because there is a range over which total benefits exceed costs

AC3:*Worthy and viable.* This activity is artistically sound and attractive enough to support itself without assistance, though not at the socially optimal level Q'

AC4:*Excessively viable.* This is the hit-show case, being so popular as to enter the public-nuisance zone past $Q^{'}$ where less would be better.

Clearly, neither cases AC1 nor AC4 are suitable candidates for public support. Under scenario AC3 the market will supply the activity, but in less than optimal amounts. Thus, in theory, output-increasing policies are justified. In practice, it may be not worth bothering -- given the practical considerations of policy error and the costs of raising taxes to pay for subsidies -- unless the benefit curves were very elastic at the break-even point Q^3, so that subsidies would really have a quite large payoff in terms of valuable additional output.

But it is really case AC2 that we are hoping to catch: without support nothing would happen; with it a solidly worthy piece of artistic endeavour would go ahead. How could government be the catalyst to this?

3.2 The Formal Analytics of Funding

The elements are assembled on Figure 3, with average total costs – the hyperbola AC2 of equation (2) -- converging on marginal costs, m, from above. Unfortunately, AC2 never gets down as far as the market demand curve, D, so there is no single price which would bring in enough market revenue to cover costs at any output level, including the socially optimal output level Q*, where the marginal production costs equal the marginal total (private + public) benefits of the play.

So a subsidy will need to be paid. There are two possibilities: a lump-sum grant, which in effect reduces F in equation (2), and a per unit or consumption-based subsidy which reduces m. How would these work? Consider first the lump-sum case.

We have to bring the motivations of the 'players' into this; specifically the play's producer. Suppose first that the production is fully commercial, so that a reasonable assumption is that the producer will try to maximise profits. Most films, many plays and concerts, and most books are sold under commercial conditions. The profit-maximising (or loss-minimising) level of output is always found where marginal revenue equals marginal cost – here drawn as output Q^{LO} ,which would sell at a market price per ticket = P^{HI} .

In order to mount the production at all, the lump-sum subsidy would have to reduce fixed costs F by enough that average costs were less than P^{HI} While this is quite possible, and while such an outcome is better than no play at all, what is clear is that there is no way a lump sum subsidy scheme can induce a profit-motivated producer to offer the socially optimal level of output, Q* . However, a per unit output subsidy could achieve this, say by reducing marginal costs to m^s , if this were low enough for the marginal revenue curve to intersect marginal costs above Q*.

Now look at the quite common case in the arts of the play being mounted on a not-for-profit (but also not-for-loss) basis. What will the producer's objective be if not profits? Following Throsby and Withers (1979, p15), we could plausibly suggest that the motivation will be a mix of number of seats sold and quality of production. Holding the latter constant, for simplicity, we predict that the producer will try to maximise sales or output, Q, subject to the constraint of needing to break even. This could be achieved by subsidising marginal costs enough to pull down the average cost curve to $AC2^S$, so that average costs just equal market price at the optimal level of output.[8]

What about a lump-sum grant? If this were generous enough to completely wipe out fixed costs, then marginal and average costs would be

[8] Note that the level of marginal costs that will effect this outcome will be higher than m^s ,because a breakeven producer does not need such a large subsidy as does a profit-maximiser to put a given level of output on the market.

the same, m, and the producer's break-even output would be Q’‘ - which is well below Q*. Only if the grant was even bigger than F would it be possible to entice the producer to Q*. Then, the first term on the right hand side of (2) is negative – we have a net fixed subsidy, not a cost, and the average cost curve would approach m from below.

To summarise: if we want more output from our arts producer, the most direct way is make it cheaper to produce more output, by doling out funding on a per unit basis. A block grant system will never induce a profit-maximising producer to choose the socially optimal output: in ‘theory’, an output-maximiser could be so persuaded, but only under a system where every additional performance of the play would eat into the grant (make a loss), which in real life might reasonably tempt the producer to choose a more ‘conservative’, low-output outcome.

An output subsidy scheme may in theory also have a high-price, low-output outcome (shown as Q^{min} on Figure 3), but in practice, by making it easier to increase output, a subsidy is likely to encourage the producers to search for ways of growing sales, through clever and determined marketing of the play, which will shift out the demand curve and output. This leads us to ask questions about just where these curves – drawn so sharp and sure in microeconomic theory – actually come from.

3.3 Arts Funding under Imperfect Information

The above is a fairly standard analysis of the case for subsidising output and thus consumption when the private market underproduces because it fails to give value to spillovers and other public benefits from the activity. Perhaps our ‘twist’ is to make specific assumptions about the nature of the public benefits as a function of output – that they don't kick in until some minimal level of engagement is achieved, and then may increase at the margin before eventually declining, possibly to eventually become negative for very commercially successful shows.

The theory is fine as far as it goes, but how do we put it into practice? In particular, how can the funding agency *know* where all those curves and functions actually are placed? Well, they can't know, and nor can anyone else. Imperfect information is a pervasive feature of market life, in the arts as everywhere. Further, information is not just imperfect or incomplete, it is asymmetrically distributed – some people have more of it than others, and everybody has their own areas of special expertise, if only knowledge of self.

This amounts to no more than saying that information is a scarce resource like everything else, and that ownership of the resource is widely distributed, like just about everything else. That is, basic economic principles apply. The field of microeconomics which specialises in applying those principles to situations of imperfect and asymmetric information is called Agency Theory. In the world of Agency Theory there are two actors – a principal and an agent. The principal wants something done, but can't do it for them self, and so seeks to induce the better-qualified agent to do it for them. The twist is that the very asymmetry in capabilities (such as information) which makes the agent attractive to the principal also gives the agent the opportunity to mislead the principal.

Thus, in the standard market situation, the buyer or consumer is the principal, seeking a service from the producer or seller – the agent in the case. Will the agent deliver the service as promised, or will there be some difficulty in detecting deviation from the terms of the deal? In the arts funding case, the agent is the artist and government is the principal, seeking to procure public goods for the populace.

In the application of this theory it has been standard to assume that agents are self-seeking and opportunistic – that is, that they have only their own interests at heart, and that they will be ruthless in pursuing those interests. The world of agency is bereft of such concepts as ethics, honour, altruism, decency and self-restraint. For this reason, the determined application of agency theory through programs of 'commercialisation' and 'managerialism' is a rather nasty business, and indeed it can become something of a cancerous monster in the body politic, creating for itself the preconditions needed for its own growth – if you treat people as fundamentally untrustworthy for long enough, you will eventually induce them to become so. Those who have lived in New Zealand over the past fifteen years know more about this than most.

Nevertheless, taken in judicious doses, agency theory can be quite helpful. After all, once the public purse has been opened in the sight of the artist, all innocence is lost, and the funding agency[9] has a duty to advance matters in a civilised and sensible fashion – or, better to keep the purse firmly closed (which indeed may often be the preferable option). The proposal developed here is offered in this spirit.

It is customary in thinking about agency situations to distinguish two basic categories of imperfect information: information about *states or types*, and information about *actions or behaviour*. Both are readily observed in market situations. For example, in a transaction involving the exchange of a used car for cash, the seller (the agent) probably knows a lot more about the true condition of the car than will the buyer (the principal). This asymmetry of information about the type or state of the object can lead to Akerlof's famous 'lemons' problem, when bad cars (lemons) drive good cars out of the market. Then, once the car is purchased and needs to be fixed, how does the owner ensure that the mechanic does all the things charged for – the actions of the agent are hidden (or not costlessly revealed) from the principal.

[9] I hope that the reader is able to cope with the two different meanings of the word 'agency'.

I will suggest that in the arts funding context hidden information about types is not our main concern. What we are here talking about is the quality of the artist and the promise of their proposal, and arts funding agencies can be quite expert at judging this – indeed, because objective, more reliable than the artists themselves, who may tend to have an inflated view of their own ability and of the merits of their work. That is, it is not that the funding agency can know how a particular piece of creative work will pan out (especially when the work is collaborative, as with a film or a play), but that they will not be at a systematic disadvantage to the artists in this respect.

So we focus on hidden actions as the source of the agency problem in arts funding. And here we can narrow things further: there is not – in general – a problem with the act of creative production itself. The canonical agency situation in economics is someone trying to get someone else to do some 'work' for them, and the standard assumption is that people don't like work – they prefer 'leisure' – and so will shirk unless monitored or incentivised to do otherwise.

Whether or not this is a broadly realistic assumption for the workforce as a whole, it can hardly be plausibly applied to the individual creative artist, who may have their problems getting out of bed in the morning like everyone else, but who can safely assumed to be creators because they want to be – indeed, are driven to be. So the arts funder principal does not have a problem with the motivation of the artist[10]; nor should the funder have any problem with the particular direction taken by the artist, since it is not or should not be the role of the state to prescribe the subject and object of creative work.

So just where lies the agency problem in the arts? I suggest that it arises not from the production process but from the marketing and distribution of arts activities: the business of selling the product. The creative juices may rather fizzle out at this stage of the process, but it is surely the artists and their immediate collaborators (publisher, producer) who are the best placed to put in the effort that actually persuades the public to buy the book or see the play or attend the concert.

That is, the funding mechanism should be aimed at inducing marketing effort from the artist. And such efforts of course, are absolutely consistent with the theoretical goal of arts funding, developed in Section 3.1, namely that it is the consumption of or public engagement with arts activities that

[10] We are talking here about individual creative artists. Interpretive artists working in routinised organisational settings, such as symphony orchestras, may be rather less 'driven'. And even with the creative artist one should probably not be too trusting. Leisure has its temptations, which is why I have doubts about the efficacy of giving quite large sums of money to people to 'work on some poems'. Against this, it could be pointed out that nobody can write a good poem if they are starving. Well, perhaps the poet should take a day (or night) job (as indeed most do). But note in any case that the funding ideas proposed in this paper do not envisage reductions in the total sums doled out, and indeed (because they would have lower delivery costs) should permit more money to actually reach arts practitioners.

will be inadequately provided by the market and that should be encouraged by public subsidy.

It is worth asking just what form 'marketing effort' will take. In the standard neoclassical setting of, say, Figure 2, the demand curve is just sitting there, and the only problem is getting the producer to choose the optimal point on it, when private and public benefits are not congruent. In the real world, and especially the real world of creative endeavour (for which much or all of the output will be novel – ie 'created'), the demand curve is not just sitting there in plain view – demand is to be discovered - even, made, by what we call marketing. Remember, one of the features of arts consumption is that many people 'do not know what is good for them' – they have to be persuaded into the experience, along the path of developing their own arts expertise.

That is, we want to give incentives to the arts producer to *shift out* their demand curve. And there is more. Consider again the situation represented by cost curve AC2 on Figure 2, which we accepted as financially unviable because the market demand curve is nowhere above the average cost curve – there is no single price at which revenue would cover costs. But need there be a single price? Charging a single price, P, means that two large hunks of consumer surplus are left lying on the table: the surplus above P garnered by all the customers who would willing have paid more, and the surplus below P but above marginal costs that nobody gets, because these less keen (or poorer) potential customers are not even in the market at this price

What is needed is some *price discrimination* – that is, setting different prices for different customers or identifiable groups of customers based on their differing willingness to pay. Service activities (such as performing arts) are particularly fertile territory for price discrimination, both because it is often relatively easy to identify groups with different willingness to pay (whereas it is quite hard to identify, say, the different willingness to pay for a pound of butter), and because it is relatively hard to arbitrage price differences, because the whole point of consuming the service is to be there yourself, in person.

Thus, energetic theatrical promoters can carve up their market – offering especially low prices to schools and university students, and especially high prices to wealthy and willing patrons of the arts. And, because unlike most personal services, which are one-on-one (like restaurant meals and haircuts), most arts activities can be quite cheaply replicated (low marginal costs), the region of the demand curve over which price discrimination is potentially profitable is likely to be relatively large.

Reinforcing all this are the positive externalities of high density replication. For many service activities which are susceptible to price discrimination the externalities are negative – there are congestion costs. Thus, for example, although the direct marginal cost of filling seats on an aeroplane are low, most people would much rather fly on a near-empty plane than a full one. But it is quite the other way around for, say, performing arts – it is much more fun watching a performance in a full house than surrounded by acres of empty seats.

So, in Figure 4 we have an activity which is never commercially viable at any single price. But if the producers were able to perfectly price discriminate – charge each customer just exactly what the activity is worth to them – they would produce Q^* and generate revenues equal to the area of the trapezoid AOQ^*F considerably greater than the total costs of supplying the activity – the rectangle BEQ^*O.

This sort of marketing effort requires energy, innovativeness and, indeed, 'creativity' over and above the creative input to the arts production process itself. Our funding formula is designed to encourage such efforts.

3.4 A Performance-based Funding Formula

The art of Arts funding -- as of funding of science and R&D -- is to find ways of delivering the money to worthy practitioners without too much of it rubbing off in the process itself (transaction costs), and without inducing excessive rent-seeking distortions in practitioners' behaviour. Of course success will never be complete. There will always be delivery or transaction costs, both above-the-line (the administration budgets of the funding agencies) and below-the-line (the artists' costs of preparing grant applications, travelling to interviews and so on). And, given the basic information asymmetry between them, no principal will ever come up with an incentive mechanism so clever as to entirely align public and private goals. For example, we can in general expect sales-oriented funding formulas to over-encourage the production of more accessible or 'popular' art at the expense of the experimental and difficult – a bias we return to below.

Let us begin with the model of section 3.2. Why not just subsidize 'bums on seats' to encourage arts producers to push towards the publicly optimal level of consumption? Unfortunately, that very simple formula would seem dangerously naive from an agency theory perspective. The problem is that, for nearly all the arts, marginal costs are often rather low in the short run (the costs of filling an otherwise empty seat at the theatre, for example, or of printing another few copies of a book or CD), and it would be temptingly easy for the artists to 'paper the house' with non-paying patrons just to qualify for the subsidy.

And why not, it might be asked – isn't the goal of public policy more patrons, period? Well, not quite. It is not just the quantity of public engagement with the arts that matters, but also its quality – the depth as well as the breadth of the arts consumption experience – and that while the occasional recipient of a free ticket may experience a life-changing epiphany, it is probably reasonable to suggest that the typical free consumer is a bit of a floater in terms of engagement.

To an economist, a natural measure of value is value – the price paid by the private consumer. We therefore suggest that total net public benefits from consumption of an arts activity are determined as:

(3) $\quad TNPB = f(P, Q)$,

which is increasing in both the price paid and the quantity consumed. A first-order approximation of (3) is the simplified function:

(4) $\quad TNPB = g(PQ) = g(\text{Total Revenue})$

– that is, total benefits are a function of total revenue (ie, sales or box-office). The very considerable practical advantages of this formulation are both that sales revenue is relatively easy to measure and monitor, and that it can handle different prices paid for the same product.

We expect that the shape of (4) as a function of total revenue will be similar to the TNPB curve in Figure 1, drawn as a function of quantity consumed. Perhaps there should be a region where the function is quite flat, where further increases in consumption do not make much difference to the net public benefits generated, before these become negative at the margin, pulling down total public benefits, possibly eventually to the point where they become negative in total – the activity is so privately popular it is a public nuisance!

So how are the arts practitioners to be persuaded to supply these public benefits? The proposal here is that the funding agency 'buy' the benefits, offering cash payments to the practitioner linked to the level of market revenues garnered. Basically, the funding agency would offer to buy any quantity of public benefits at the value of these, and the practitioners would choose on the basis of this offer schedule what quantity to supply, given their own private knowledge of the costs of effecting increases in revenues.

To keep down transaction costs, and because the funding agency is not going to have a very precise estimate of the shape and position of the public benefit schedule, the subsidy offer formula should be quite simple. Simplest of all would be:

(5) $\quad S = sR$,

where S is the total subsidy paid, R is total market revenues earned, and s is a fraction, probably much less than one in value. But we need some flexibility at low and high revenue levels. I offer two versions. The first would apply to non-recurring arts events where a group of people assemble for a specific purpose then disband. Examples could be festivals and films.

In these situations, there may (though not necessarily!) be a public policy case for an up-front payment in the form of an advance on subsidies. The advance would normally not be refundable in the event of (honourable) failure of the event. Then, the total subsidy formula would be:

$$
\begin{aligned}
(6)\quad S = G &= sR_{min} && \text{for} \quad R < R_{min}\,, \\
&= sR && \text{for} \quad R_{min} < R < R_s \\
&= sR_s && \text{for} \quad R_r > R > R_s \\
&= sR_s - r(R - R_r) && \text{for} \quad R > R_r
\end{aligned}
$$

This funding formula is drawn on Figure 5. The G in (6) can be seen as a block grant to finance or assist finance the existence of the activity. This alone is the current standard method of arts funding in New Zealand. Under the present proposals, simple block funding would be used only for non-revenue generating events, such as concerts-in-the-park and art installations in public places, as well as for experimental/avant garde art (on which more in section 5.2).

Recurring arts practitioners or organisations – including individual artists, in general – would be expected to find their own up-front financing, from their own reserves, from retained earnings from past activities, or from private backers. For them there would be no advance, and there might well be no subsidy, either, below some R_{min}. At very low levels of engagement I have suggested that the public benefits of the arts are probably not significant, because, for example, the chances are low of a consumer finding someone else who has also read/heard/seen the activity, with whom to discuss it (or of reading about in review). It would save a lot of messing around with very small sums of money to have a minimum qualification level for subsidies.

This funding formula is shown as Figure 6, and is written as:

$$
\begin{aligned}
(7)\quad S &= 0 && \text{for} \quad R < R_{min}\,, \\
&= s(R - R_{min}) && \text{for} \quad R_{min} < R < R_s \\
&= s(R_s - R_{min}) && \text{for} \quad R_r > R > R_s \\
&= s(R_s - R_{min}) - r(R - R_r) && \text{for} \quad R > R_r
\end{aligned}
$$

Up to the critical-mass value R_{min} the artist gets nothing. Then, up to market revenue R_s, the artist gets a percentage subsidy s. After R_s, and up to revenue R_r , no additional subsidy is paid. Then, beyond R_r , the funding agency starts to clawback its subsidy through a royalty charge. Beyond some level R_{nr} , the net payment (apart from any block grant, G) becomes negative – the agency actually takes a cut of the profits of the activity.

What is the normative basis for cutting support at high levels of market revenues and perhaps even eventually gathering royalties? Even if we shy from invoking the 'public bad' implication of Figure 1 – to claim, for example that a smash-hit film like *Once Were Warriors* or million-seller book such as *Longitude* has achieved popularity to the point of becoming a public nuisance -- we might say that there is a certain amount of 'luck' or serendipity in the very occasional mass-market success of a serious creative work, and that this success does depend on there being a receptive audience, to which many 'failed' works of art have contributed. We could note that, given the economies of scale that typify most arts production, the private profitability of an arts activity will be highly responsive to sales, and a box-office hit or best-seller will probably make its owners quite a lot of money. For these reasons, people would probably say that successful productions 'don't need' support, and that it is 'fair' that runaway successes give something back to the taxpayer. If they were to consider the public benefits over and above private benefits, they might argue that, since these will be generated anyway (if the production is a big success), why should the taxpayer pay for them?

In any case, no producer would be forced to accept the funding formulas (6) or (7). If they were deliberately aiming at the broad popular market, with an overtly 'commercial' product, they would simply go it alone – the funding agency would never be involved.

To conclude: this section has arrived at a general proposal for an arts funding formula that might represent an acceptable compromise between practicality and principle. The principle is to encourage the public benefits that are generated as the by-product of private engagement with the arts. Practicality means coming up with funding formulas that are reasonably undemanding in their informational requirements – both to formulate and to operate. The next step, then, is to see how we might replace the s's and r's of the general funding formulas (6) or (7) with real numbers appropriate to actual arts funding situations.

4. Funding in Practice

We will take a top-down approach to funding design. We look first at the size and distribution of the 'arts pie' – the total sums currently made available for arts funding from public resources – and take these as informative as to what is, broadly, appropriate. Then we will see how the performance funding approach might do a better job than the existing schemes in delivering those public monies to the arts. Three specific applications will be looked at: funding literature, the lively arts, and the 'glamorous megafauna' of the arts world. These applications are not tightly researched case studies; rather, they are designed to illustrate some of the potential (and problems) of the performance funding approach.

4.1 How much and where to spend?

To establish our overall parameters for arts funding, we are hopefully justified in taking the current aggregate level of government support as informative of some sort of rough consensus about the public benefits of the arts in New Zealand that has evolved over a very long period of time through the democratic process. Whether it is or not, I am going to work with that aggregate here. Note that even without increasing the total quantum of funding[11] there should be more money available – the lower transaction costs of delivering a performance-based funding system would free up a larger proportion of the arts budget for the artists themselves.

We will use the sum of $350million as an estimate of total central government annual spending on arts and culture, and $300million as the contribution from local government [12]. The sector probably contributes about 3% of GDP – around $3billion.[13]. Nearly all the local government and about half the central government money goes to the curatorial sector –

[11] Actually, the total quantum under a performance funding system is open-ended. The more successful it is, the more it will 'cost' (though we are really talking investment here). In practice, performance funding schemes can be scaled up or down year-to-year as actual spending comes in under or over forecasts, so that budgets cannot explode or implode indefinitely.

[12] It is actually quite hard to say what central government is spending on a year-to-year basis because of the one-off 'blip' of $87million injected into the system by the Prime Minister in May. Using Statistics NZ (2000) as a guide, expenditure in fiscal 1998/99 was about $306million, including vote appropriations, NZ On Air and Lottery Board Grants, and not counting the large expenditures on early childhood education. The same source reports (page 21) local government expenditures of $286million on 'arts and culture' for the year 1998/99.

[13] Statistics NZ (2000, p.11) gives a figure of 2.8% for the contribution of 'cultural goods and services' to GDP, but notes this is probably an underestimate, because it misses out arts and culture workers employed in non-cultural industries. In this connection, I note that the 1996 Census found three people claiming to be gainfully employed as Librarians in the Dairy Farming industry (and three more gainfully employed as economists in sheep farming). The estimate for contribution of the sector to GDP is less than its share in total employment, which McDermott Miller (2000, p10) puts at 3.8%. The difference is possibly due to (a) arts and culture workers being paid less than workers in other industries, and/or (b) the absence of profits from many arts activities.

libraries, museums and galleries – and makes up nearly all of the income of these activities. However, the curatorial sector is small in economic terms – it employs slightly fewer than one worker in ten of the total arts and culture employed labour force (McDermott Miller, 2000, p10).

Thus, we could reasonably estimate that the creative (ie, non-curatorial) arts, including applied arts, receive about \$175million in government funding each year, and currently produce somewhat less than \$3billion of GDP. However, GDP is value added – ie, net of materials costs, and we don't know what the total costs and revenues of the sector are. Based on the ratios of gross to net output revealed by the Input-Output tables, I would 'guesstimate' a figure of around \$6billion, which would imply an overall ratio of funding to costs of about 3%.

What about the allocations of that aggregate to the different arts? The 3% average conceals the broadest possible variations – from nearly 100% public funding of some highly uncommercial activities (avant garde art galleries) to nothing at all contributed to most of 'literature' (which includes newspapers and magazines) and to the applied arts. These numbers should not be beyond questioning, but, as with the total of arts spending, I believe it sensible to impute some imbedded good sense to them, and indeed the pattern that is revealed seems quite consistent with the principle here espoused of supporting activities which are artistically worthy but not financially viable, and not funding activities which either can make it in the market on their own, or those unprofitable enterprises which are so for good reason – their public benefits are not sufficient to justify subsidy.

However, there do seem to be some anomalies when one looks inside the different arts activities, which, if corrected, might require some quite substantial shifts in resources, and which seem to be quite difficult to rationalise in economic terms. Those difficulties are extreme in the case of established arts organisations producing mainly interpretive art – that is, symphony orchestras. How could the ratio of public to private benefits be about 2:1 in the case of the NZSO, and just 1:3 – a difference of a factor of six – for the Auckland Philharmonia[14]. The former is no doubt the better band, which is reflected in its higher (in general) box office ticket prices, but this does not itself imply any difference in the ratio of public to private benefits. We return to this below.

4.2 Funding Books

Published print media - books, journals, magazines, newspapers – are very lightly funded under the present regime – probably not much more

[14] Figures based on comparisons made by the consulting firm Arthur Andersen in a report commissioned by the Auckland Philharmonia and dated February, 1999. On page 29 of this report, the NZSO's income sources are given as two thirds public funding/one third self-generated; for the APO the fractions are one quarter public/three quarters self-generated.

than one percent of their market value. Of course, much ‘literature’ is fully commercial (such as weekly magazines and daily newspapers) and is hardly a plausible candidate for public support. Let us focus on book publishing, as a case study. Creative New Zealand spent $2million on literature and related funding, for the year ending June 30, 1999.[15] In this total there is a certain amount of program funding (‘Writers in Schools’, Society of Authors), about $900,000 goes to the Authors’ Fund, CNZ gives cash grants to writers to live on while producing a book, often of $18,000, and it gives cash grants to publishers to publish books, usually of $2-3,000.

The Authors’ Fund is actually an excellent (though excessively modest) example of the performance subsidy system shown on Figure 6 (though without the royalty clawback). It is designed to compensate for a market failure, which is that people borrowing books from public libraries do not pay the author of the book for the pleasures received. There is a minimum qualifying level – the book must be estimated to be found in fifty public libraries – and no cap: for qualifying books, the author receives (currently) the princely sum of $1.90 for each library holding.

The other grants are not performance-based. On the face of things, they do not seem to show much consistency about the public value of a book. Suppose that someone given $18,000 ‘to write a novel’ has a two thirds probability of actually finishing the work and then a three quarters probability of getting it published. Thus the implied net public benefit (ie over and above the market returns) of a published novel is $36,000 (since it will, on average, require two $18,000 grants to produce one published book). This figure is an order of magnitude larger than the $2-3,000 doled out to publishers of New Zealand books.

Let us then, quite tentatively of course, sketch out the parameters for a performance subsidy system, rolling together both authors’ and publishers’ grant funds. We will use the formula (6), with no up-front grant or advance. We will consider a paperback NZ novel, which typically retails at five cents less than $25 (if not at $29.95). Following responses to Creative New Zealand’s 1999 ‘Publishing Policy Review’ questionnaire, we will set the minimum sales revenue, R_{min} , to qualify for a subsidy at $25,000 , based on sales of 1,000 copies, because, as one respondent put it, if the print run were any less than 1,000, ‘you would need to ask why the publishers were doing it’. Apparently commercial viability is achieved at around 2,000 copies sold, but it would be good to encourage the author and the publisher to move more copies than this, so we set the subsidy rate, $s = 0.10$ and R_s = $75,000 , based on a nominal sale of 3,000 copies (though of course the publisher would be free to engage in creative price discrimination, for example with a limited signed edition selling for more, and bulk sales to schools or students for less than $24.95).

[15] Annual Report, Arts Council of NZ/Toi Aotearoa, for year ending 30 June 1999, Appendix 1. Sum of grants approved, though not necessarily paid out in that financial year.

This would mean that the publisher of a book selling just 2,000 copies would receive a subsidy of \$2,500 – which is about what they can get now – but if they were able to crank up sales to 3,000, then the subsidy would double, to \$5,000 (to be funded out of the discontinued direct grants to authors). At this level, funding would be capped. Then, if the book turns into a true best-seller, which in this country means sales beyond about 5,000, it would be reasonable to reclaim some 'royalties', perhaps at a rate $r = 0.05$ (or less).

What would be the benefits of this scheme? It would entrust the responsibility of deciding whether to publish a book with the person bearing the financial risk – the publisher. It would give publisher and author the incentive to do what they can do best – actually get out and sell the book (in collaboration with booksellers, of course). And it would foster engagement – the source, according to our theory, of most of the public benefits from books that justify funding in the first place.

What about the costs or disadvantages? First, there are the actual financial costs of paying out performance subsidies. As noted above in the Introduction, if these were issued to all-comers, they would have to be spread very thinly indeed. For this reason, and to filter out books which don't generate public benefits, Creative New Zealand would need to continue to exclude whole categories of literature, such as self-help and gardening books. They would, however, be able to be less judgmental than they are at present about the worthiness of genres of fiction, such as thrillers and Sci-Fi. That is, there would still be some judgement or prescription, but not as much as now. As for not filtering out books whose value lies almost entirely in their 'worthiness' (ie, which are extremely uncommercial); here a market-based funding scheme does need to be supplemented by some direct granting system (see Section 5.2 below, on 'Art for Artists' Sake').

4.3 Funding the Lively Arts

Funding the lively or performing arts – drama, dance, opera, live music – is currently almost exclusively done on a production or program grant basis, yet almost all professional-standard performing activities are marketed commercially and could be funded on a performance subsidy basis. The different art forms would probably need different funding formulas, and I will not attempt to go into detail here.

Just to motivate matters, though, consider the Auckland Philharmonia Orchestra. The APO has been generating market revenues of about \$3million/year, and receiving public funding of about \$1million/year. The orchestra, which is set up as a player-owned cooperative, has been impressively creative in exploring niche markets (including four different levels of engagement with children and young people) and in extracting consumer surplus through price discrimination. But it is intriguing to speculate just how much more revenue they could generate if, instead of their current recurring block grants, they were funded mostly or entirely on by performance subsidies, say, at the rate of 25-30 cents on top of each market dollar earned.

4.4 What to do with the 'Glamorous Megafauna'?

In zoos, the big noisy animals – elephants, lions, tigers and the like – are the 'glamour' exhibits, and may soak up a disproportionate amount of the budget, compared with worthy but less spectacular creatures. Arts & culture funding in New Zealand has its own bulky beasts – Te Papa, TVNZ, Radio New Zealand, The Film Commission, the NZ Symphony Orchestra – which between them claim a quite large share of the public funds made available for support of creative and curatorial activities. The NZSO, for example, gets more than ten times as much public money as the APO, but has a much lower ratio of market generated revenue, so that the NZSO's public subsidy per actual seat at a concert has been calculated at more than three times that of the APO (more than $60/seat versus about $20/seat). Does this make sense? And does it make sense that the sums of money involved in preventing our megafauna from becoming extinct dwarf, for example, the few hundreds of thousands handed over to creative writers?

The Symphony has been able to present itself to us as a binary choice – would we rather have $10 million/year or a national orchestra? So far, we (or our government) have always chosen the music over the money. But perhaps there are some less stark options worth exploring. Here is an idea:[16] disband the band, then recreate it as a sort of virtual organisation – something more like, say, the All Blacks – a temporary grouping of the best musicians in the country assembled for one or two month seasons of concerts and recording. Then, for perhaps one third the present budget, we could pay more musicians more, bring in more really good guest conductors and soloists, bolster the talent available for the rest of the year to the regional orchestras, and 'nationalise' the band (ie dissolve its current Wellington base of operations).

The NZ Film Commission is a promising candidate for reform. Views in the film industry about the Commission's performance are genuinely mixed – some are firm in their praise and gratitude; others scornful or despairing in their complaints. NZ film practitioners are notably reluctant – the odd Ian Mune excepted – to criticise the Commission in public, which is understandable but unfortunate, since, on the numbers, the system of supporting film-making in this country has been one of the largest, and

[16] This idea was suggested to me by the former Split Enz keyboard player Eddie Rayner, who has worked with the NZSO. For its disadvantages (in particular, loss of *esprit de corps)* see the response of Ian Fraser, CEO of the Symphony, in a conversation with Hazledine in *Grace* magazine, November 2000.

perhaps the least successful of our arts funding initiatives.

Over the nine-year period 1990-98 the Film Commission cost about $100 million in public funds to run. The main output was twenty eight feature films – from *Ruby and Rata* to *Memory and Desire* – for which private investment and market returns to the Commission totalled about $40 million.[17] This ratio – two and a half to one - of public to private funding is higher even than the equivalent for the NZSO, and the real total cost, including tax expenditures, must have been higher still.[18]

Each of the twenty eight films cost, on average, about $4 million, including the above-the-line production budget and an imputed share of the Film Commission's other costs, but not counting costs born by distributors. Total 'wholesale' market revenues (returns to investors, including the NZFC) were nearly $17 million or $0.6 million per film. Thirteen of the movies grossed less in the local market than does a reasonably successful NZ novel, costing about one hundredth as much.

Some fine films were made (and some real duds), but it is hard to see how these numbers can be justified on public good grounds, for a strongly commercial product deeply integrated into our popular culture.

The Commission in recent years has not always found it easy to get money out to the industry – as evidenced by 1998/99 'writebacks' of $1.5million in 'investment commitments from previous years subsequently cancelled', which contributed to a surplus brought forward of nearly $3.5million[19] – but, like most organisations, does not find it so hard to spend money on itself. It actually has a higher ratio of operating costs to total budget than does Creative New Zealand – about 25%, versus 17%[20] - and would like to increase this further.[21]

These developments may be related – the Commission attributes its funding shortfalls partly to 'the setting of higher standards.and subsequent increase in time required in development,'[22] and it seems that it would like to do more itself to help the industry achieve those standards, perhaps even to the extent of acting sometimes in almost a producer's role – implying a possibly awkward blurring of the purchaser/provider split.

What are these 'higher standards'? In my interviews I was told that the Commission has been adopting a policy of favouring 'feel-good comedies'. I didn't take this very seriously until I found the very phrase in the

[17] My calculations are from the table 'Feature Film Income' shown as Appendix V in the Film Commission's 'Draft Strategic Business Plan, 1999-2002'. The Commission also spends about $1 million/year on short films.

[18] The most recent and biggest tax expenditure is the staggering $200+ million gifted over to 'investors' in the *Lord of the Rings* trilogy.

[19] The Film Commission holds a surprisingly large amount of money in cash or term deposits – more than $13million on June 30, 1999.

[20] NZFC ratio calculated from the 'Notes to the financial statements' attached to their Annual Report for the year ending June 30, 1999; Creative New Zealand ratio (= 4/23) from section 4.1 above.

[21] See page 9 of the NZFC Draft Strategic Business Plan 1999-2002.

[22] NZFC Draft Strategic Business Plan 1999-2002, p10.

Commission's 1997/98 Annual Report, with the explanatory goal: to 'make a mainstream audience laugh, and feel good when they leave the cinema.'

Apparently, this new policy is in reaction to a raft of excessively dark and gloomy local films. I know what they mean, but is artistic interference at this level really what a public funding agency should be indulging in? Imagine if Creative New Zealand told supplicating authors that it wanted to see 'more jokes' in their novels?

The above does not give fair credit to the hard work and dedication of Film Commission employees, but we should not be afraid to ask if the job they are doing so diligently could now be the wrong job. Perhaps the Commission really is a dinosaur, fit for the old days of films shot on film, manually edited and screened in a few big downtown movie theatres, but now seriously struggling to find a valid place in the amorphous and fluid matrix of the new production and distribution technologies.

Nowadays quite presentable feature films can be made for almost nothing. An impressive recent example is the (almost) *dogma*-style movie *The Shirt*, made for about thirty or forty thousand dollars, with none of this from the Film Commission, apparently because the producer thought the transaction costs of dealing with the Commission to be not worth any payoff. As for the means of distributing films, the how and where of these change by the month. So there may be a good case for funding reforms aimed at encouraging the film-makers themselves to find their own artistic, technical and financial solutions to the problems of creating and selling films, and a quite simple box-office subsidy based funding system[23] could do that.

The Museum of New Zealand *(Te Papa)* is seen by some as, if not a dinosaur, then a white elephant. Others think it is marvellous. I am not sure what I think. It is certainly big – costing \$250 million to build and receiving \$17 million/year in public subsidy, which was increased by \$12 million/year (at least for the next three years) in the government's May 18 spending package. It claims (on its website) to get about 1.5 million visitors a year, which is a lot, though the level of engagement of those visitors (and their true number) cannot be gauged because there is no admission charge.

Rather like the Symphony, *Te Papa* has been able to present itself as an all-or-nothing choice[24], but it could be fruitful to consider less monolithic options for the future of this extremely expensive operation. One is to split off the art curating/collecting function. Another option could involve charging for admission, as do other galleries and museums, such as (unofficially) the Auckland War Memorial Museum. Although it is quite

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[23] Possible augmented by training and international marketing assistance, if developing a skills base and expanding exports are amongst government's goals for the industry.

[24] Actually, not quite 'all' – the museum has not been funded for the rather large depreciation flows on its huge capital investment.

nice to wander into a museum without paying, it may also be quite inefficient, and also unfair – more than one half of *Te Papa's* visitors come from overseas (29%) or from the Wellington region (26%), but the rest of us are paying 90% of the costs, which, properly counted, add up to about $20 per visitor. There could be effective price discrimination schemes which collect money from those willing and able to pay, but not from the poor or stingy (free Tuesdays; family packs; vouchers...).

Promoting NZ-made television programming is another expensive business (close to $50 million/year, now, in public funding), and perhaps the most complicated of all. The funding body, NZ On Air, is one of the more impressive of the public agencies, not least because it manages to unload relatively large sums of money ($88 million in 1999/2000, on TV, radio and music) at a lower administration cost ($1.6 million) than either Creative New Zealand or the Film Commission.[25]

But the structure of the industry and its funding systems seems a bit confused. There is supposedly a 1980s-style 'purchaser/provider split' between the demand and supply sides of the business which may not be a good idea in itself, and which in any case is compromised by the multifarious activities of the television stations, which both purchase, produce and retail programming. There is the question of 'quality' versus 'popular' programming, which cuts across the domestic/foreign issue, the matter of whether the State should own television stations, and if so what sort, and the role to be played by non-expenditure regulatory policies, including local content requirements. Performance -based funding could play a useful role here, but the more pressing need may be for reforms in the structure of the industry so as to introduce more diversity and competition at the downstream (commissioning and broadcasting) end of the market, guided by a coherent and compelling vision of just what we want public policy to achieve here[26].

Radio is a lot simpler, thank goodness. The state-owned Radio New Zealand operated on a NZ On Air-provided budget of $21.4million in 1999/2001, with which it put out the *National* and *Concert* programs, competing with a large number of privately owned local and national radio stations and networks.

The 'wireless' is surely one of the few truly great inventions, right up there with the wheel and the game of cricket. Our current mixed private/public radio broadcasting system works well, though the public part of it could make very good use of a 10-20% budget increase, which hopefully NZ On Air will be able to give from the $7 million/year increase in its funding included in the Prime Minister's May 18 announcement. Everyone must eventually draw their own lines in the sand. Mine would

[25] Source: 'Briefing Notes for Hon. Marian Hobbs, Minister for Broadcasting', NZ On Air, 20 January 2000.

[26] For an intelligent discussion see Grimes and Tyndall (1999).

defend the national and concert programmes – above *Te Papa,* above TVNZ (at least as it is now), and above the Symphony. Of course others will have different designs.

5. **Issues Arising**

In this section we deal with three important arts funding issues: the ‘transaction costs’ incurred in the actual operation of funding regimes, the problem of supporting truly innovative, avant garde ‘art for artists’ sake’, and the possibility of using vouchers to encourage arts consumption.

5.1 Transaction Costs

Transaction costs are the costs incurred in actually bringing supply and demand together in market and non-market situations, and the costs involved in implementing and delivering government policy. These costs can be above-the-line (money spent on advertising, wages for front-of-house staff, salaries and office space for managers and government policy makers); below-the-line (unpaid time spent preparing grants, or sitting on committees); and should include resources wasted through market or policy failure.

Economics has rather neglected transaction costs, but they seem to be important. Hazledine (1999) finds that for the New Zealand economy as a whole, the number of people employed in broadly defined transacting activities is actually not much less than the number of people ‘transforming’ – actually producing the goods and services. Preliminary analysis of Statistics New Zealand Census data suggests that these proportions also hold in the private sector arts and cultural industries.

We know much less about the costs of implementing government policy, but we should be keen to find ways of economising on transaction costs, and should always bear them in mind when designing policy schemes. We might be particularly concerned to find large discrepancies in the proportion of efforts put into designing and implementing policies.

One of Parkinson’s minor laws may be seen in operation here. At the bottom end of the system, three hundred volunteers toil away on Creative New Zealand’s committees deciding whether or not to give, for example, Longacre Press some money to help publish a ‘novel for young adults by Jane Westaway’ (they got $2,000), whereas, at the top end, very large sums have been offloaded onto the arts sector with little evidence of solid preparatory analysis.

When all the above and below the line costs are counted, Longacre’s little grant probably cost at least $1,000 to deliver[27] – a transaction to

[27] Let us do some figuring. Say, half a person-day for Longacre to prepare their grant application, a day each for (at least) two people to read and assess the Jane Westaway manuscript, and another person-day for the committee and the paperwork. Adding in a bit for overheads, put the total grant assessment cost at the equivalent of thirty skilled person hours. Value these at a rather miserly $25/hour (actually, publishers apparently pay only about $100 for a reader’s report on a manuscript, but there must be some *pro bono* in there), and we get a grant transaction cost of $750. Then double or triple this to account for the

transfer ratio of 50%, which is really too much. At the other end of the scale, if the work put into preparing the surprising May 18, 2000 arts spend-up of $87 million cost, say, $250,000, this would represent less than one third of one percent of the sums disbursed, which is probably too little.

The Jane Westaway case exemplifies the quite high costs incurred in running a supply or production grants-based system with its forms and committees and processes. In principle, consumption subsidy funding has lower transaction costs than a production grant-based system, because the funding agency does not have to assess artistic (or commercial) merit. The artists do this when they make their decision to apply for support, and the formula simply rewards their success.[28]

In practice, of course, a performance-based system would have its own transaction costs. The parameters of the funding formulas would need to be specified; there would have to be monitoring of returns, and decisions made about the eligible categories for funding. But if such a scheme could be implemented more cheaply than a grants-based scheme, the available data do suggest that there would be some serious money to be saved, to be added to the superior public good outcomes generated by performance funding.

The Annual Reports of funding agencies allow us to place lower bounds on the total transaction costs of delivering arts funding. Creative New Zealand has been incurring total governance, administration etc expenses of about $4million to disburse $19million annually. If we infer below-the-line costs incurred by the clients and the volunteer adjudicators (grant application preparation etc; reading and committee time) of, say, one half of the CNZ administration costs, then it has been costing about 30cents to deliver each dollar of arts funding from this organisation. This may or may not be a high number in comparison to similar organisations elsewhere: it does, however, represent money, time and resources which might under another regime go more directly to support arts production (or be returned to the taxpayer). Another example: NZ On Air was apparently paying a private company (BayCorp) about $11million a year to collect about $100million in 'public broadcasting fees' from the television-owning public. Now this agency is funded from general government tax revenues, which are much cheaper to collect.

Interestingly, transaction costs may actually increase, the less money is available. If you have, say, $1.2million in applications for $1million in grant funds, it may not take long to pinpoint the tail of least-worthy projects and fully fund the rest. But if there are just $200,000 available, then deciding who few should get it (and how much each) will be a relatively arduous and fraught process, if it is done conscientiously. Indeed, it really

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unsuccessful grant applications (Creative NZ only funds about one application in three) and we actually have managed to use up, not $1000, but something more like the total value of the eventual grant!

[28]Of course, some arts administrators *like* telling artists what to do - such people would probably not feel comfortable with the performance subsidy system.

may be better to have no funding at all rather than too little.

Would it not be 'unfair' to fund some art forms but not others? Not unless arts funding is intended as an income-transfer program. But I do not see how this can be justified, on political or basic ethical grounds. Why should artists (excepting, perhaps, 'national treasures') be thus privileged over other citizens? There is no *intrinsic* reason why, say, Jennifer Bornholdt should be given $18,000 by Creative NZ because she wants to 'work on a book of poems', rather than Tim Hazledine being given $18,000 because he wants to build himself a little sailboat. Society doesn't owe artists a living, any more (or less) than anyone else. What Creative New Zealand is really doing here (I hope!) is buying (expected) public benefits – spillovers to the common good that may be generated by a book of Bornholdt's excellent poems but which cannot be expected from my little boat. And so if the costs of buying those public benefits exceed their value, then we shouldn't do it

Such does not mean that due process does not matter. If an activity is judged worthy of supporting, then it is important for both equity and efficiency reasons that the process of allocating resources to it be fair and open. In this regard, the heavy reliance by Creative New Zealand in its block granting system on peer review by practitioners may be less than satisfactory, being susceptible both to cronyism and its opposite – back-stabbing. But if, after careful analysis, government should decide -- for example – that it really isn't cost-effective to fund expensive feature films, then they should proceed with ears deaf to the cries of 'unfair' from would-be movie directors and producers.

5.2 Art for Artists' Sake

What about art that is utterly incapable of supporting itself in the market, and so could hardly be viable under the performance-based funding regime proposed here? We are here talking about the newest, most radical, most innovative art – the art that is the most important in the long run but often the least appreciated in the here and now.

Avant garde art can be seen, at least in the short run, as an input, not an output. That is, it is input to other artists' creative efforts - it inspires, challenges, leads them. It is not a smoothly packaged product for the easy edification of we the everyday arts punters. Our commercially rewarding appreciation catches up later: years -- perhaps generations -- later. The wistful Tom Lehrer joke -- 'When Mozart was my age he'd already been dead five years' – is no help to Mozart, who died too young, from complications of malnutrition. The sad fact of life in the avant garde is that, unless you have the energy, stamina and luck of a Picasso, you are probably doomed to the fate of (to take things down an artistic notch or two) Ronald Hugh Morrieson, of being 'one of those poor buggers who gets discovered when they're dead.'[29]

What can government do to reward, and perhaps prolong the lives of, the Morriesons and the Mozarts of this world? Obviously, the problem is one of knowing how to choose. Maybe most of the very best art is a commercial flop when it is made. But most of the very worst art flops as well, and there is vastly more bad art than good, never mind great. How to sort them out, at the time? Clearly, the market can't do it, or it would, and because of that we cannot rely on a funding formula that hangs on the coattails of market success, such as I am suggesting here for 'normal' art.

As noted in the Introduction, there are many formal and informal institutions for supporting struggling artists, including family, friends and 'day jobs' (which of course may be night jobs). Established arts organisations, such as orchestras and theatre companies have an important role, through commissions of new art. Such organisations might grumble that they 'can't afford' to support the avant garde under a revenue-based funding regime, but they should still be required to do their bit. We expect business enterprises to temper their profit-seeking with social responsibility; so can we expect arts enterprises to temper their revenue-seeking with cultural responsibility.

Universities play an important role. They provide quite a lot of jobs for those artists who are able and willing to accept the rigours of academic life. And they also provide what may be a very useful model for government funding of avant garde art. Such art is very much like most academic research: it is an autonomous creative activity that produces what is really a non-marketable input into other activities.

Funding of research in New Zealand follows two models, one bad, one good. Most direct government funding (ie, excepting the Marsden Fund) has to be wrenched at some cost out of a ponderous institution called the 'Public Goods Science Fund' (PGSF), which is freighted with the baggage of New Zealand's commercialisation era: a top-down, highly prescriptive system based on squeezing research into dubious things called 'output classes'.

Fortunately, the universities themselves are still able to do some research funding, and we have a better system than the PGSF. At Auckland, applications for funding from within the university are dealt with by the University Research Committee. The Committee -- on which I have twice served -- splits into small sub-committees (usually of two people) which are each assigned the applicants from particular fields to briefly interview and make recommendations on, these then being assembled and brought before the full committee for coordination and final adjudication. Although the full committee has access amongst is members to a broad range of academic expertise, the sub-committees are never assigned their

[29] Quoted by Brian Easton (1999, p178).

own fields to interview.

The system seems to function quite well. The deliberate lack of specialist expertise at the subcommittee interview and recommendation phase is not a problem[30]. Because the members of the committee deal with the whole range of academic research fields, they develop a useful corporate memory and expertise which seems to result in quite balanced and fair allocations across very different disciplines – something that would be impossible to prescribe in a written manual of rules, of course.

There is absolutely no attempt to prescribe or proscribe research fields or problems – applications are judged solely on their scholarly/research soundness and on the assessed ability of the researcher to carry them out successfully. All this seems to be very different from the Creative New Zealand system of a vast network of specialist panels each judging the merits of artistic proposals in their own fields, and it is arguably a better model – fairer, cheaper, more effective – for direct funding of creative enterprise.

But I may be wrong about that. In any case, the point of this section is to recognize that there are corners of the artistic enterprise – very important corners – which a market performance-based funding mechanism cannot be expected to reach, and that do justify the retention of some direct granting system, albeit one modified and reduced in size from the present institutions.

5.3 Why not Vouchers?

To liberal-minded economists, the most attractive mechanism for allocating public funds to an activity – if such must be done at all – is often some form of voucher system. A voucher is in essence a restricted form of money. It may be restricted to the person to whom it is issued (not for resale) and it always is restricted to be spent (instead of cash) on a certain good or service (or set of related goods/services). The big advantage of vouchers, from the liberal perspective, is that they give the power of choice to the consumer, and thus engender competition amongst suppliers (as, of course, does money).

A good example of a voucher system operating in New Zealand on a large scale is the funding of tertiary education. Students choose at which university or polytechnic they wish to study, pay their fees, and these are (still) more than matched by an automatic government contribution. Thus, universities' incomes are largely determined by the number of 'EFTS' (equivalent full-time students) they are able to attract.

Why not go the whole way and just give consumers money, to spend

[30] This works for 'small grants' (applications less than $20,000). Large grant applications for major programs or equipment are more complex to evaluate, and for them the expertise of external referees is called on.

on whatever they want? A good question, from the liberal perspective! The answer must be that there is some public good achieved by having people receive tertiary education (or feed their children) which would not necessarily be achieved if choice were not restricted.

This public good idea fits comfortably with our justifications of arts funding. And the let-the-consumer-choose notion seems, at least superficially, to be consistent with the idea advanced in this paper that public benefits are linked to private consumption, though of course it would not sit well with the more traditional supply-side oriented, paternalistic, 'we know what's best for you' arts funding approach.

But there are problems with using vouchers to encourage arts consumption. First, we do indeed want to *encourage* consumption; meaning that we don't want to fund purchases that would occur anyway. Second, we don't want people to simply turn their vouchers into cash, by selling them, which is obviously not a problem with tertiary education, but which would be hard to prevent with lower value, more widely usable arts vouchers. Third, any universal voucher entitlement system would be either very expensive or very feeble. Tertiary vouchers cost about $1.2billion/year, even though they are taken up, in any given year, by a quite tiny fraction of the population (less than 6%). And fourth, low value vouchers can be relatively very expensive in the transaction costs of issuing, monitoring and redeeming them.

So here is a possible scheme. Vouchers in units of $5, to a total value of $20, would be given to each school child on their birthday[31], to be used within one year. The vouchers, along with information packs about how and where they can be spent, would be issued by schools, who would receive an extra allotment of vouchers themselves, to use as they see fit, as compensation for administering the system. The vouchers would be restricted in use, possibly to just the heritage sector (museums and galleries), possibly also including live events, such as plays and concerts (but, notably, not including books, which have many other pathways for getting to children). There would have to be a further restriction to 'approved' activities, which would be no problem in the case of permanent facilities such as heritage sites, but would be trickier for one-off live events. Perhaps eligibility would be restricted to activities already qualified for direct or performance-based funding, though if this seemed a bit unfair, then Creative NZ would have to take on an additional certifying role. The arts providers would redeem vouchers to their face value, perhaps at the post-office.

This system would supplement, not supplant, other direct forms of funding. That is, an artist on a subsidy-based performance scheme would just count voucher revenues as part of the box-office take on which their

[31] Or, on the last school day before their birthday.

subsidy would be based. How much would vouchers cost? There are about 750,000 schoolchildren in New Zealand, so a $20 birthday voucher pack for each of them would cost $15million/year [32], plus administration costs, which would have to come from somewhere else in the Arts and Heritage funding budgets of central and local governments, which currently total about $650 million.

[32] Actually, less, because not all vouchers would be used.

6. **Conclusion**

The arts funding system in New Zealand is not broken; does much good, and will no doubt continue to do good if left alone. But could it do even better? Most likely. The present system is focussed almost exclusively on what economists call the supply side – funding artists or works of art, either directly or through program grants in the case of the larger arts producing organisations.

This system violates the two fundamental principles – as I perhaps rather grandly call them -- of sound arts funding policy: the principle of non-prescription (*artists have visions, not administrators)*, and the principle of engagement (*the public interest is activated only when the public is interested).*

Instead, I suggest a performance-based funding system which works on the demand side, topping up market revenues (box office, etc) with public subsidies that increase with the market success of the arts activity. The idea behind this is, first, that most of the public benefits of the arts (ie, those beneficent spillovers over and above the private benefits directly enjoyed by the consuming arts patron) depend on the level of 'engagement' between the art and the audience, and, second, that that level of engagement is in practice quite serviceably proxied by the actual amounts that the patrons are willing to fork out to consume the art.

Though such a system will still need to be administered, compared with the present supply-side grants, performance funding should reduce the amount of predicting or prescribing required of the arts administrator, simply because the public benefits that we want to encourage *reveal themselves* through the level of private engagement with the arts activity.

In calibrating performance funding to actual art applications, I have been happy -- perhaps too happy, but it avoids a much bigger problem – to accept guidance from our existing total arts funding budget and its allocation between activities as to the broadly appropriate levels of support. But it is hard to dodge what appear to be striking inconsistencies and anomalies in the treatment of similar or comparable art forms. Popular films (popular in intent if not outcome) still receive vastly more funding support than does popular music, not to mention more highbrow performance formats, such as drama. Some classical music orchestras are much worthier and needier than others, judging by the ratios of public to private funding awarded. Certain categories of middlebrow literature (eg young adults' fiction) are deemed fundable; others (thrillers, sci-fi) are not. The work of dead artists receives tens of millions of taxpayer support (public art galleries), while their living successors mostly struggle unassisted in the market place.

A performance funding system would not solve these problems – if problems they are. Indeed, it might exacerbate them in a political sense, by making the discrepancies more transparent. Nor would performance funding be always and everywhere fairer, more efficient, more effective than the present supply-side grant system, whose pragmatic advantages I may have underplayed here. Clearly, ‘more research is needed’ into both the principles and practice of arts funding before any major reform should be implemented. This paper is offered as a contribution to that research program.

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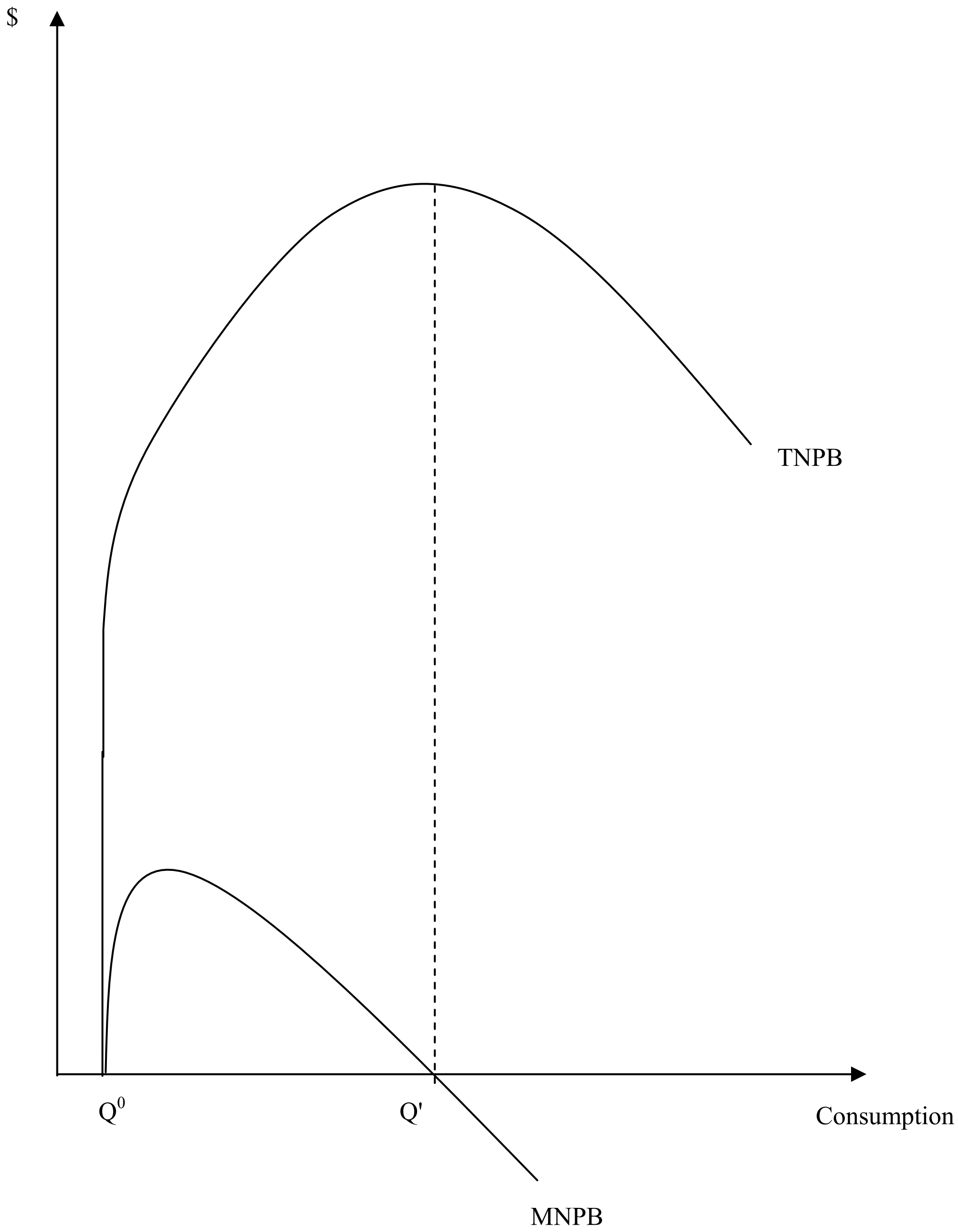

Figure 1: Total and marginal Net Public Benefits

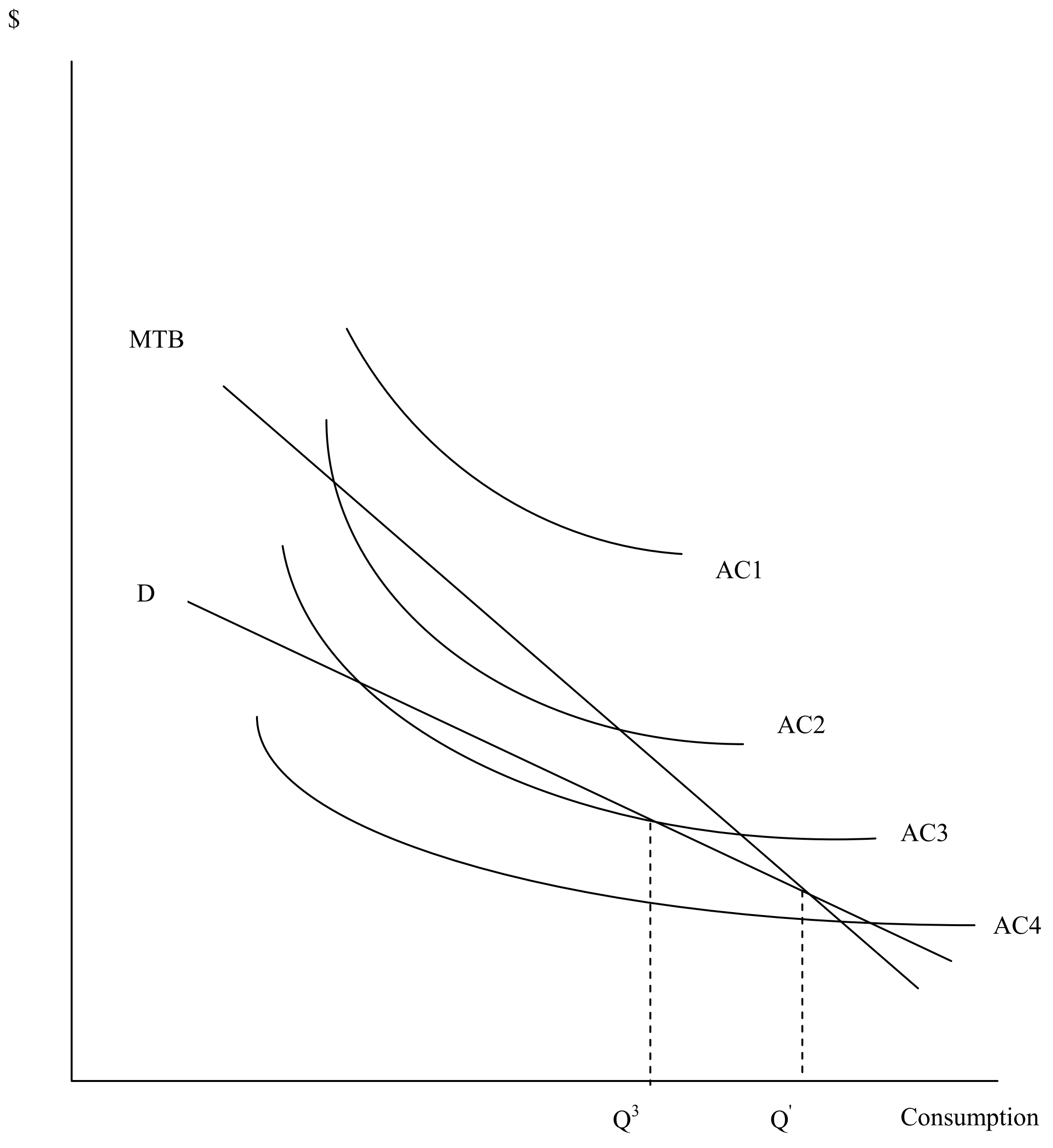

Figure 2: Viability and Worthiness: Four Possibilities

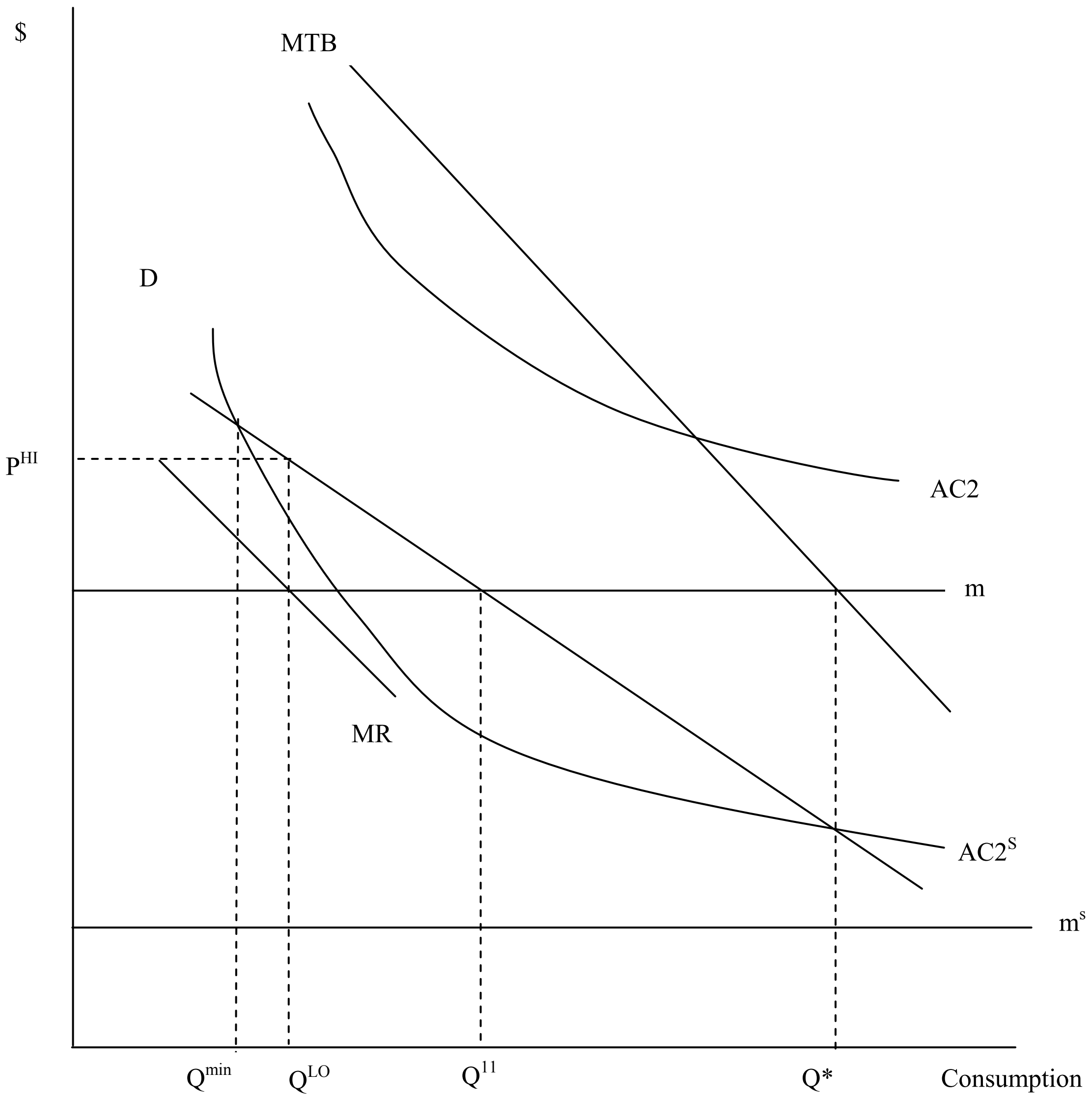

Figure 3: A Worthy but Non-Viable Activity

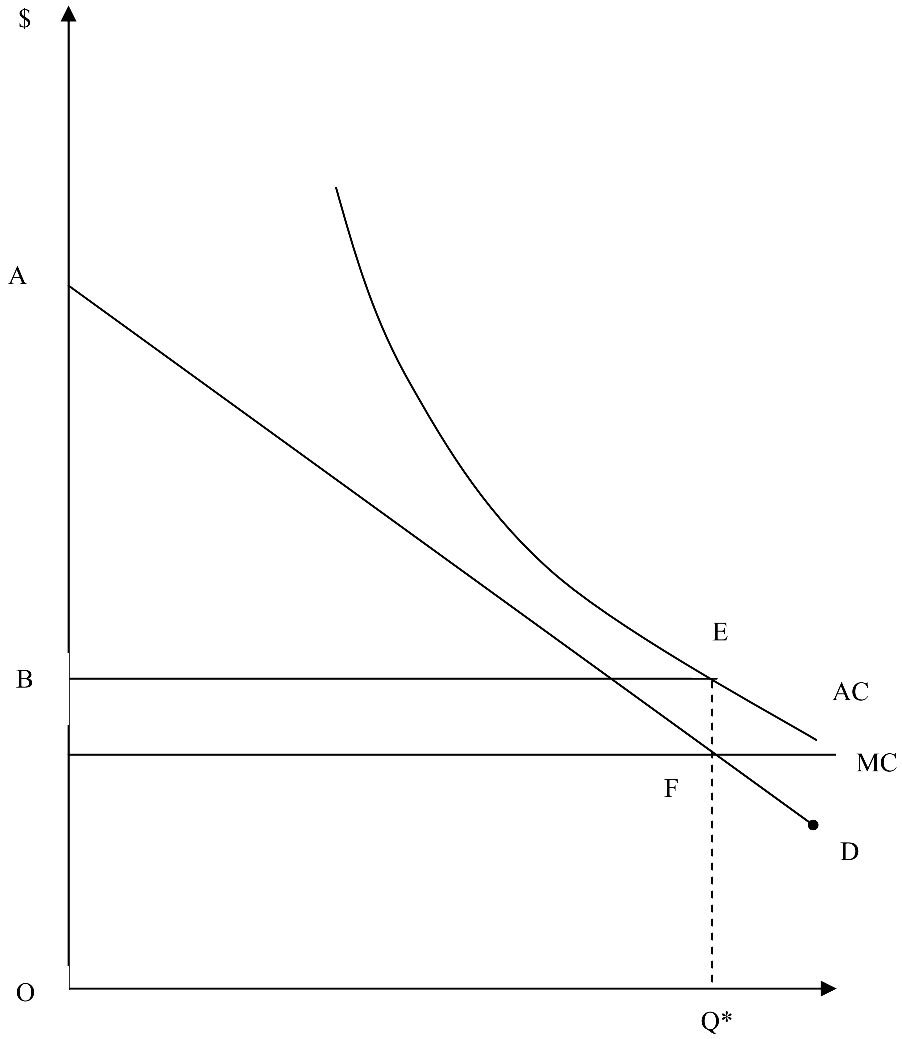

Figure 4: Revenue Extraction with Price Discrimination

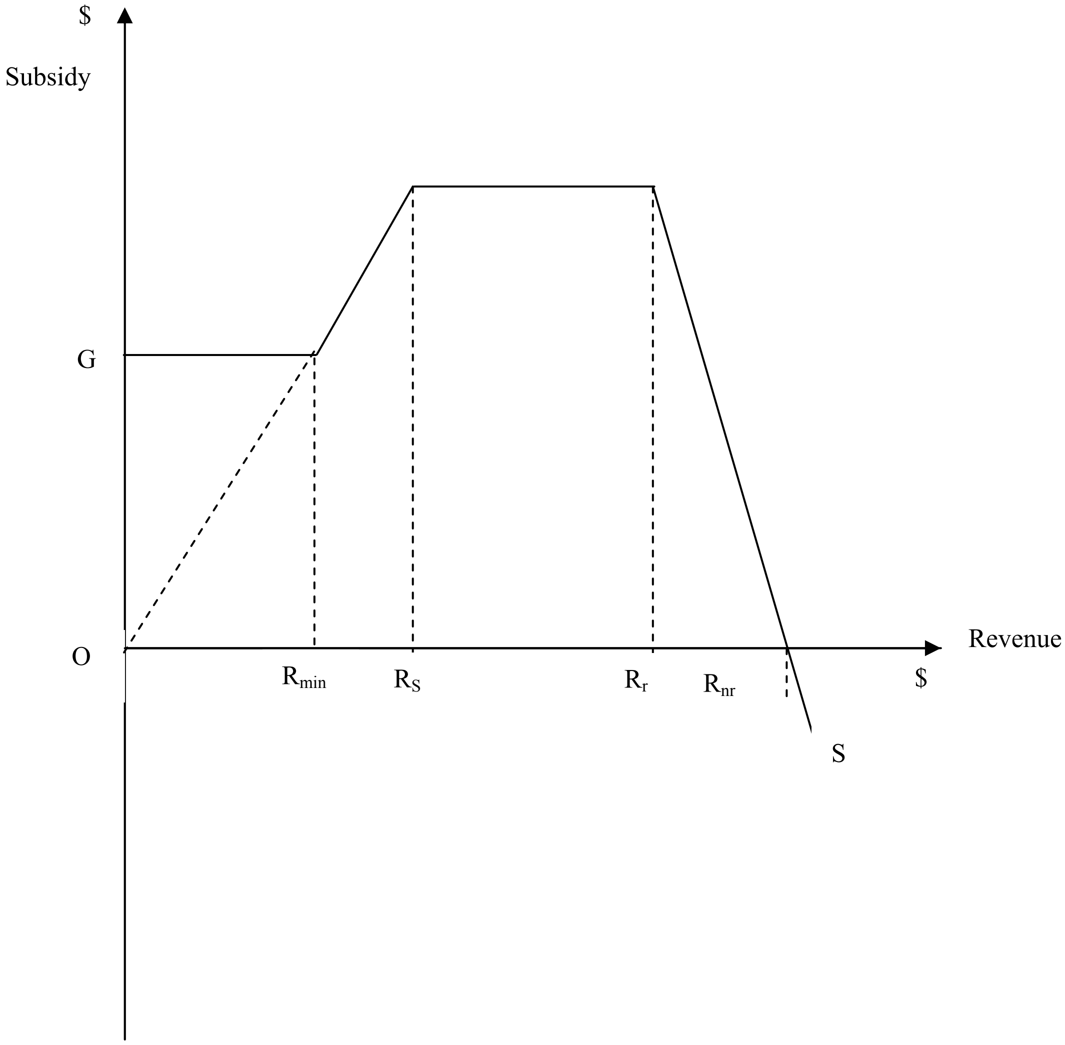

Figure 5 : Funding Formula with Advance

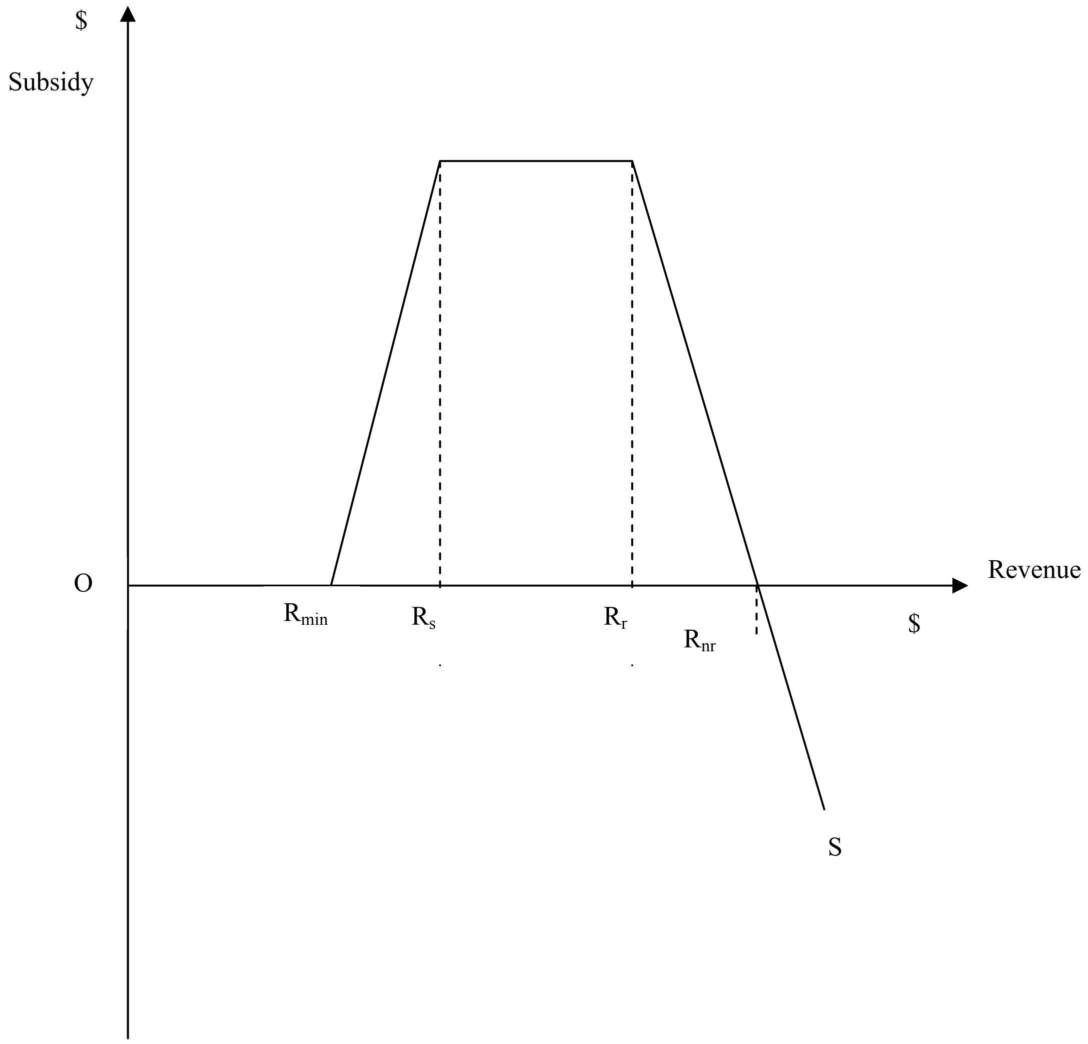

Figure 6: Funding Formula with Minimum Critical Level