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Chapter Eight – Economics and the Arts

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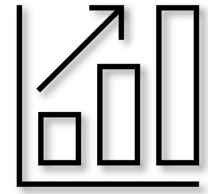
Chapter Eight – Economics and the Arts

Overview

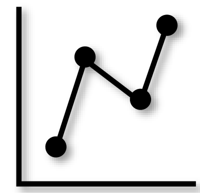
Part 1: The Economic Big Picture

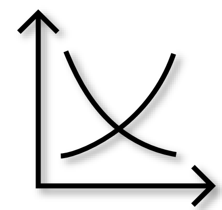
- Economic Sectors and the Arts
- Economic Impact of the Arts

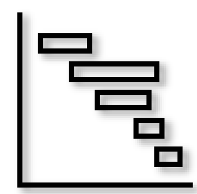


Part 2: Applying Economic Principles to the Arts

- Fixed, Variable, and Average Costs
- Costs in Perspective
- Demand, Supply, and Elasticity
- Law of Supply
- Elasticity
- Supply, Demand, Elasticity, and Revenue Maximization
- Demand-Based and Dynamic Pricing
- Behavioral Economics and the Arts







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Chapter 8 – Economics and the Arts

Learning Outcomes

8.1: Explain how macro and microeconomics and cultural economics relate to and impact the operation of arts and cultural organizations

8.2: Summarize each of the sectors that make up an economy and explain what the terms rival, non-rival, and positive and negative externalities mean in the context of the arts

8.3: Explain the significance of resource dependence theory in the arts

8.4: Offer examples of how opportunity costs, trade-offs, and sunk costs can be applied in managing the arts

8.5: Describe the differences between normative and positive statements

8.6: Summarize the key findings from the Prosperity 5 and NEA US Arts Economy Reports

8.7 Explain how the income gap and cost disease still affects the operation of arts organizations

8.8: Analyze an arts organization’s total, fixed, variable, and marginal costs of operation

8.9: Explain the laws of supply and demand and how they are applied in the arts

8.10: Formulate pricing tables that can maximize revenues for cultural organizations

8.11: Summarize five concepts from behavioral economics and apply them to the arts

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Chapter 8 – Economics and the Arts

Part 1: The Economic Big Picture

Economics and the economy have an impact on artists and arts organizations every day around the world. *Economics* is a *social science concerned with the description and analysis of the production, distribution, and consumption of goods and services*.

Macroeconomics studies the size and growth of national income, employment, and inflation and deals with economy-wide policies to achieve economic growth.

Microeconomics is concerned *with the economic behavior of the individual producer and consumer and is focused on markets created by businesses and consumers interacting based on supply, demand, price, quality, and perceived value*.

Cultural economics further narrows the focus by studying the sectors of the economy encompassing the creative industries, which include nonprofit arts and cultural heritage organizations and the for-profit commercial and cultural companies (film, TV, radio, publishing, gaming, etc.). See Table 1.1

Studying the economics of culture can help an arts manager better understand the processes people use in deciding why and how to spend their time and financial resources when consuming the experiences offered by arts organizations. Understanding fundamental principles in economics and cultural economics and being aware of the social and psychological framework people operate in when making purchasing choices can help inform decision-making, planning, marketing, and fundraising.

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Chapter 8 – Economics and the Arts

Part 1: The Economic Big Picture

Economic Sectors and the Arts – Private, Public, Social

The *private sector* operates in a market economy designed to generate a profit for business owners and corporations. A successful business offers products or services that are demanded and which generate a profit for the business owners. These outputs are considered private goods. *Private goods* (and services, including experiences) are purchased by the individual and are not shared.

The *public/government sector* provides goods and services for people's general welfare. These services include education, fire and police, roads, health and safety, and creating and enforcing regulations. This sector provides *public goods* (and services), described as *non-rival* and *non-excludable*. Non-rival goods and services are not impacted if one or more people use them.

The *social sector* comprises charities, nonprofits, foundations, faith-based, and nongovernment organizations that fill the gap between those goods and services that neither the private sector nor the public sector can or wants to offer. The concept of *market failure* explains part of this gap-filling.

For example, the public sector may consider a contemporary art museum of value but not have the political will, expertise, or financial resources to build, fund, and staff it. The private sector might forego creating this museum because it deemed there will be insufficient demand to cover costs and make a profit.

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Chapter 8 – Economics and the Arts

Part 1: The Economic Big Picture

The Nonprofit Sector

It is estimated that 1.54 million registered nonprofit organizations in the US generate over $1 trillion in economic activity. Of that total, 318,000 were registered as public charities, and nearly 32,000 were arts organizations (The Urban Institute, 2020). Nonprofit arts organizations in the US qualify as *charitable organizations* under section 501(c)(3) of the Internal Revenue Service (IRS) tax code.

There is confusion about the term *nonprofit* because these organizations are allowed to generate more revenue than expenses and, in effect, create a profit (i.e., a surplus). Income is typically generated by charging admission, membership fees, or selling other mission-related services. Instead of distributing these “profits” to the business owners, the money is used to expand services and create reserve operating resources. The surplus revenue is not taxed by governments (local, state, or federal).

With the classification as a *public charity* comes the ability of nonprofits to solicit funds from the general public and granting entities (i.e., foundations or government) for mission-related programs and services. (See Resource Dependence Theory in Chapter 8.)

The nonprofit arts sector in the US includes performing and visual arts organizations that operate in the highly competitive experiential entertainment marketplace.

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Chapter 8 – Economics and the Arts

Part 1: The Economic Big Picture

Nonprofit arts organizations share the challenge of being a viable business in an economic system that favors profit-making. Trying to achieve artistic goals and meet outcome benchmarks funders are demanding, Balancing the budget requires an arts manager who can find a sustainable balance of revenue from sales and public and private donations.

Key Concepts: Opportunity Costs, Trade-Offs, and Other Costs

Here are a few concepts an arts manager needs to understand when operating in the economic environment.

Opportunity costs involve the tangible and intangible costs of doing one activity rather than another, which is the "value of the best alternative that had to be forgone to undertake a given course of action." Decision-making (Ch. 4) includes considering opportunity cost. What is the value related to the opportunity cost of working on next year's budget rather than making the calls to donors? Which activity will generate the most significant benefit to the organization?

Trade-Offs, while related to opportunity costs, are what is renounced to get what is wanted or desired. For example, the trade-off of working on the budget is that you finally finish this long-overdue project, and the donor calling can be done another day.

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Chapter 8 – Economics and the Arts

Part 1: The Economic Big Picture

Key Concepts: Opportunity Costs, Trade-Offs, and Other Costs

Sunk costs are *costs that have already been either incurred or committed*.

- An arts organization spends $50,000 purchasing a fundraising software system that does not work as desired. The organization purchased a different software for $35,000, which works, but the $50,000 it spent cannot be recovered. Likewise, once the sets and costumes are built for a specific production, they become sunk costs.

A *sunk cost fallacy* occurs when a person or organization is reluctant to abandon a course of action because they have invested heavily in it, even when it is clear that it would be more beneficial.

- Using the example above, the organization keeps using the software that doesn't work well when it should move on to another product.

Marginal analysis examines the additional benefits of an activity compared to the additional costs incurred by that same activity.

- An art museum that charges admission is open to the public six days a week (Tuesday to Sunday) from 10 am to 5 pm. It is considering adding Monday to the schedule and extending its hours to 6 pm. What will be the impact of this action on the operating costs of the museum? Will the extra day and hours generate enough revenue to cover new costs? If not, is it still valuable to be open more hours even if it means operating costs will rise?

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The Economic Impact of the Arts and Creative Industries

Figure 1.2, “A Map of Arts Benefits,” shows *economic impact* as only one of the many benefits the arts bring to individuals and communities. However, the economic impact often becomes the focus. It is difficult to quantify the value and impact of the “emotional reactions” or someone’s increased “self-actualization” resulting from attending an arts event. As a result, the economic activity associated with the creative industries is frequently used to make a case for the value of the arts.

Early Studies of Economic Impact of the Arts

William J. Baumol and William G. Bowen’s landmark study *Performing Arts: The Economic Dilemma*, published in 1966, was the first detailed analysis of the economic conditions of the performing arts in the United States. They studied the “cultural boom” in the US and found significant growth in the late 50s and early 60s. However, when adjusting and correcting for inflation, population increases, and income growth, they found there was very little per capita change in expenditures by people on admissions to arts programming between 1929 and 1963.

James Heilbrun and Charles M. Gray’s *The Economics of Art and Culture*, published in 2001, provided a comprehensive updated view of the microeconomics of the arts in North America, Europe, and Australia and included an analysis of public policy and the cultural sector. They noted, “Many of the indicators of real arts activity showed rates of increase during the 1970s that exceeded the growth in real income [income adjusted for inflation]” (Heilbrun and Gray, 2001, p. 18). The *Disposable Personal Income* (DPI) increase in spending on the arts in the late 1980s and early 1990s was partly due to the price increases for admissions and tickets (Ibid., p. 21).

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Studies of the Economic Impact of the Arts

The United Nations Conference on Trade and Development (UNCTAD) has published several reports about the impact of the creative industries worldwide. The European Union (EU), Americans for the Arts (AFTA), and the National Endowment for the Arts (NEA) also issue reports regularly. (See CH 8 *Additional Resources: Creative Economy Reports*.)

Creative Economy Outlook: 2018 (See Fig. 1.3 for the creative industry categories)

This comprehensive pre-pandemic global report by UNCTAD includes developing and developed countries and is a long-term review of the trade in the creative industries. It profiles 130 countries, observers, territories, and non-state entities that have reported on their trade in creative goods and services. It concludes that “the creative economy is expanding globally – especially in fashion, film, design, and art crafts – contributing to nations’ gross domestic products, exports, and growth.”

EU Cultural Statistics -2019

This report “presents a selection of indicators on culture pertaining to cultural employment, international trade in cultural goods, cultural enterprises, cultural participation and the use of the internet for cultural purposes, as well as household and government cultural expenditure. It also presents data on tertiary students in cultural fields of study, learning foreign languages, and international tertiary students’ mobility. In addition, one chapter is devoted to cultural heritage. Data cover the European Union (EU) and its Member States, and the European Free Trade Area (EFTA) and enlargement countries.”

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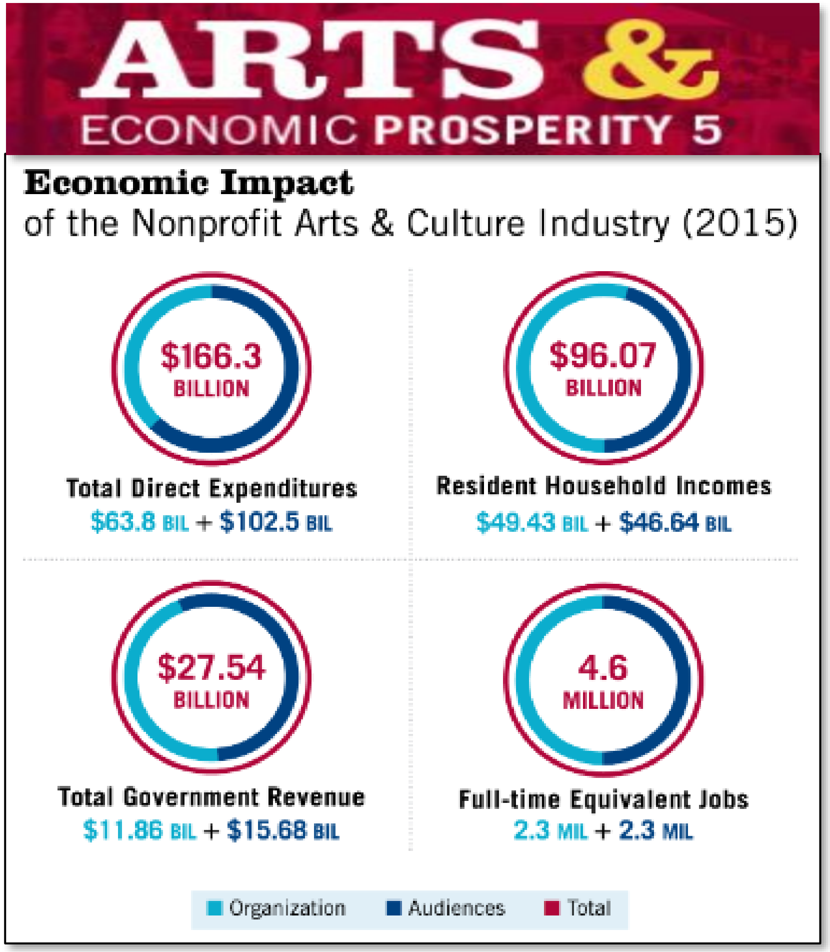
Studies of the Economic Impact of the Arts

Americans for the Arts (AFTA)

The Arts & Economic Prosperity 5 report (AEP5), published in 2017, offers a comprehensive view of the nonprofit creative economy's impact on the US. AFTA has been publishing research on economic impact since the mid-1990s. The report details the economic impact of the arts in 250 study communities and 341 study regions in 2015. Their findings concluded that $166.3 billion was generated by the nonprofit arts industry. (See Box 8.1a for details).

NOTE: The next report will likely be published in 2023 using data collected in 2022. The pandemic disrupted AFTA's survey schedule.



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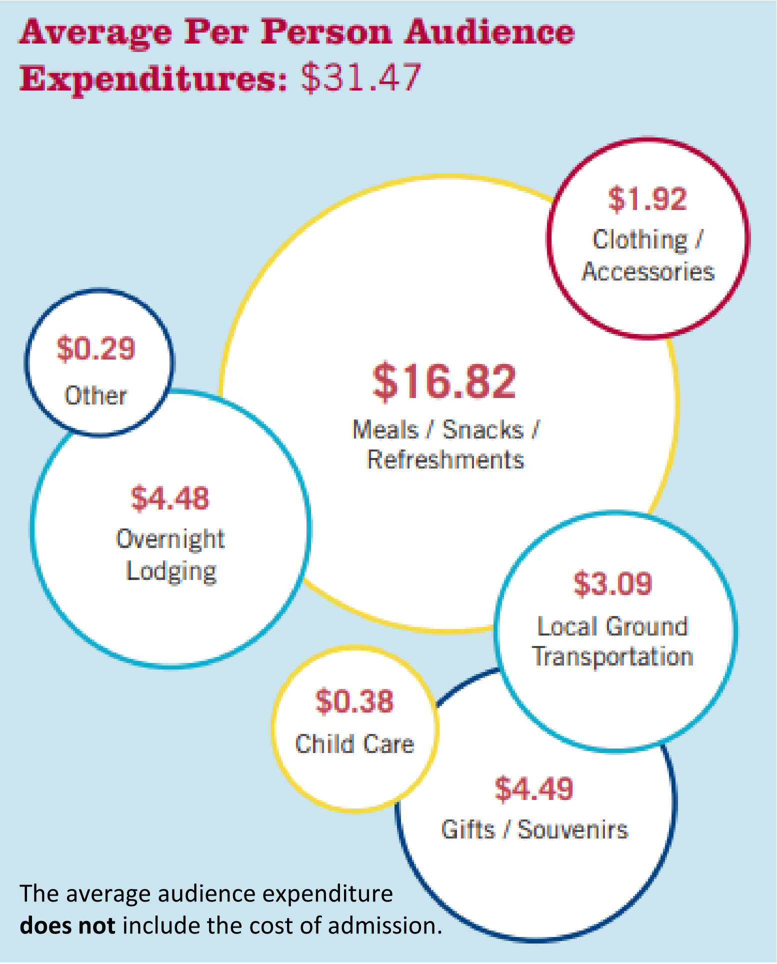
Studies of the Economic Impact of the Arts

ARTS & ECONOMIC PROSPERITY 5

Spending by Arts Audiences Sends $102.5 Billion to Local Businesses

Researchers collected detailed expenditure and attendance data from 14,439 arts and cultural organizations and 212,691 of their attendees to measure total industry spending. Based on the audience surveys conducted for this study in 2015, the typical arts attendee spends $31.47 per person, per event, beyond the cost of admission.

Source: https://www.americansforthearts.org/by-program/reports-and-data/research-studies-publications/arts-economic-prosperity-5



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Studies of the Economic Impact of the Arts

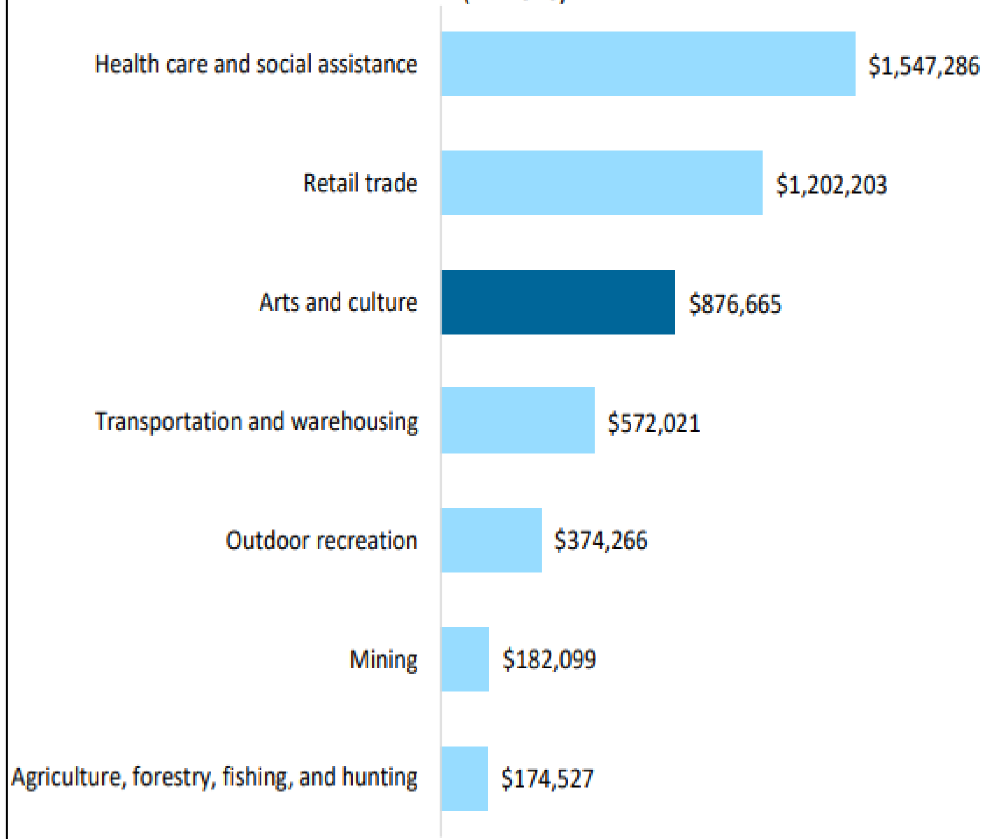
NATIONAL ENDOWMENT for the ARTS
arts.gov

The U.S. Arts and Cultural Production Satellite Account (1998-2020)

The arts represent more than 4 percent of the nation's economy. But this relative stability masks enormous declines for various subsectors of the arts.

- In 2020, arts and culture added $876.7 billion, or 4.2 percent, to the national GDP.
- The amount remains greater than the value added by each of the following industries: agriculture/forestry/fishing; mining; utilities; outdoor recreation; and transportation and warehousing.
- Overall, the value added by arts and cultural industries fell by 6.4 percent, compared with a 3.4 decline in the overall economy. (See Box 8.1b)

Figure 1. Value added to U.S. GDP by selected sectors: 2020
(millions)



Data source: Value Added by Industry, U.S. Bureau of Economic Analysis

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Studies of the Economic Impact of the Arts

NATIONAL ENDOWMENT for the ARTS
arts.gov

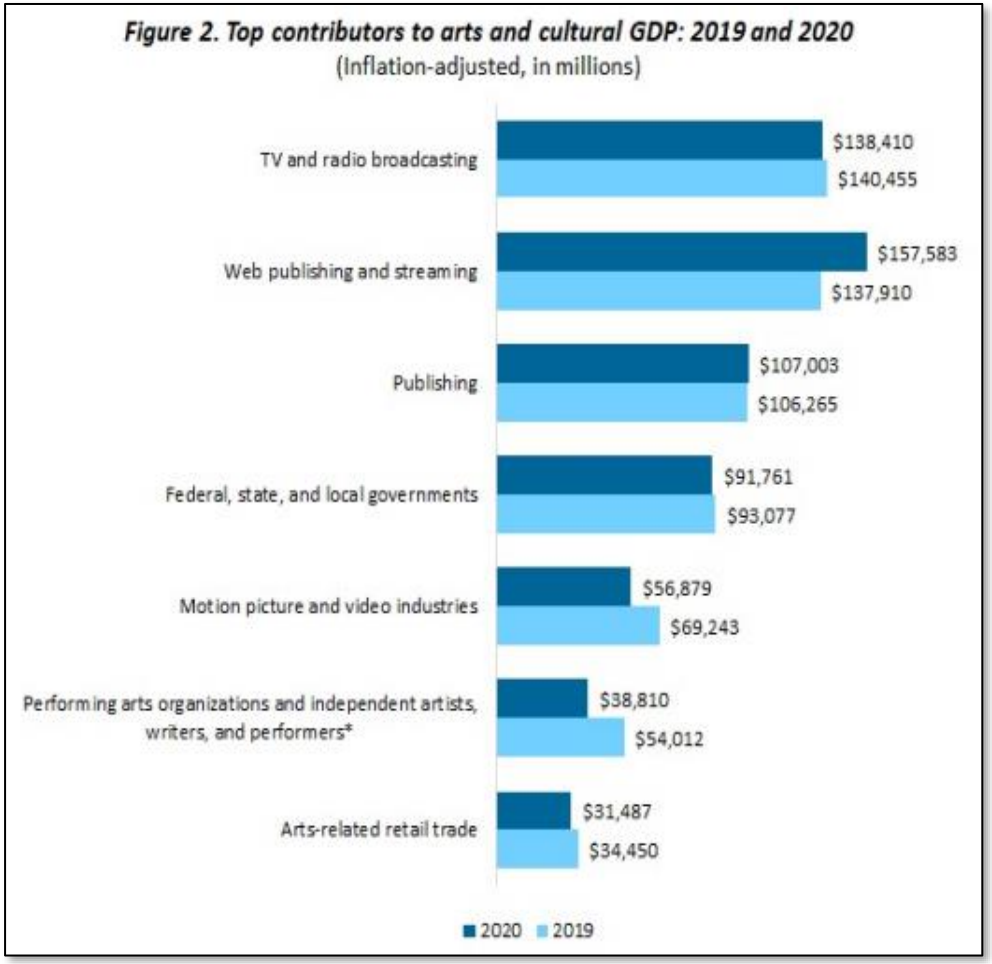
The U.S. Arts Economy in 2020

Consistent with trends from prior years is the basket of arts and cultural industries contributing the greatest economic value. They include TV and radio broadcasting; web publishing and streaming; federal, state, and local governments;

In a year of stay-at-home orders and shuttered venues, the only sizeable growth came from web streaming services and online publishers.

After adjusting for inflation, the value added by performing arts presenters (including festivals) fell by nearly 72.8 percent between 2019 and 2020.

(Source: [The U.S. Arts Economy in 2020: A National Summary Report, March 2020)]



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Problems with Economic Impact Reports

Because these various reports use differing methodologies to collect and report their findings, it is difficult to assess the economic impact. AEP5 examines the nonprofit arts and culture industry, while the NEA report focuses on multiple for-profit and nonprofit creative sectors.

Professor Ruth Towse noted that "*… sector-wide studies were dismissed by economists as misunderstanding the marginal nature of analysis and the meaning of external effects at the national level but even when studies were done well and surrounded with caveats, policymakers nonetheless exaggerated the results and ignored any reservations on the part of researchers and simply brandished "the number." . . . As a result, economic impact studies acquired a bad name, not least with government economists, as there has been a tendency recently to write them off.*"
(Towse, 2019, p. 341)

Economists also tend to discount the value of economic impact studies for arts advocacy. Here's a link to Professor Michael Rushton's 2020 blog post "Economic Impact: A Quick and Dirty Critique," in which he warns his "students off using economic impact studies as an arts advocacy tool."

(See "Assessing the Value of Economic Impact Studies" in the *Additional Resources* for Chapter 8.)

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Chapter 8 – Economics and the Arts

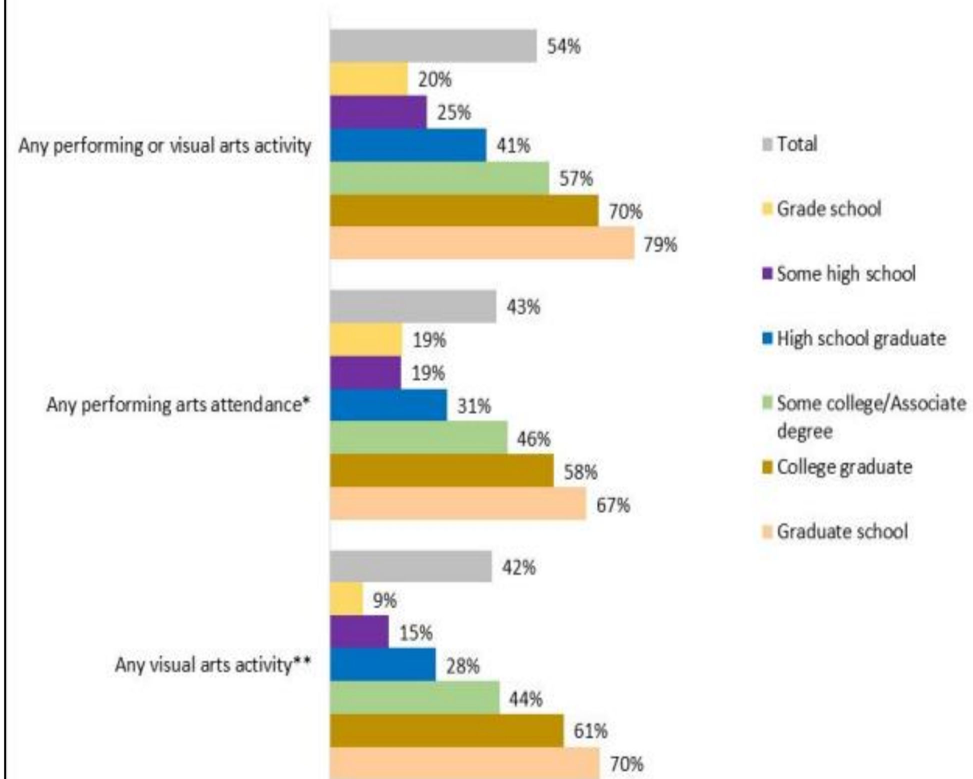
Arts Attendance and Participation

Economic impact results from people spending their discretionary income on creative industries programming. A range of global studies attempts to capture this data and report attendance and participation. (See “Creative Economy Reports” at the end of Chapter 8.)

Baumol and Bowen and Heilbrun and Gray provided insights about attendance and audience demographics from the 1960s to the 1990s. These profiles are still relevant today.

The NEA began publishing its *Survey of Public Participation in the Arts* (SPPA) reports in the early 1980s. All the reports noted that performing and visual attendees (see graph to the right) had higher levels of education. Previous SPPA reports also showed income levels were higher than the general population. Link to 2017 report: https://www.arts.gov/news/press-releases/2020/national-endowment-arts-releases-latest-survey-public-participation-arts

Figure 15. Percentage of U.S. adults who attended arts activities during the last 12 months, by activity type and highest level of education: 2017



* Except for attending outdoor festivals, respondents were asked to exclude elementary or high school performances. Respondents were required to respond 'yes' or 'no' to at least one of the ten performing arts activities to be included in the summary estimate for any performing arts attendances.
** Respondents were required to respond 'yes' or 'no' to at least one of three visual arts activities to be included in the summary estimate for any visual arts activities.
Source: National Endowment for the Arts, 2017 Survey of Public Participation in the Arts (SPPA), Core 1.

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Productivity, Inflation, Income Gap, and Cost Disease

Productivity measures the increasing efficiency of worker output over time based on inputs and the dollar value per hour the worker contributes to the employer's output. The lack of capacity to improve productivity in many areas of the arts (e.g., performers) results in increased costs to deliver programming.

Inflation is the increase in the prices of goods and services over time. There are two types of inflation: demand-pull and cost-push. *Demand-pull inflation* is created when the demand for goods or services exceeds the supply. When supplier costs increase to deliver their goods and services, they raise their prices, resulting in *cost-push inflation*. Both types of inflation impact an arts organization's operating costs.

An *income gap* is created when income is chronically below operating expenditures. Non-profit arts organizations usually don't price tickets to cover their total operating costs to promote greater access to their programming. However, depending on contributed income to make up the difference, there is the risk of an income gap being created if fundraising goals are not met.

Productivity, inflation, and the income gap contribute to *cost disease* in some segments of the creative industries. Nonprofit arts organizations have limited capabilities to increase productivity. The only way to cover the income gap is to increase ticket prices and seek greater levels of contributed income.

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Chapter 8 – Economics and the Arts

Part 2: Applying Economic Principles to the Arts

Fixed, Variable, and Average Costs

Fixed Costs (FC) or *overhead* are expenses that remain the same no matter how much programming the arts organization does. Renting or leasing space, utilities, insurance, salaries, benefits, etc. are typical fixed costs. Overhead can also be broken out into mission-driven cost centers like operations, administration, development programming, or exhibitions. **Variable Costs** (VC) are those costs that change as a result of the organization increasing its output. However, most arts organizations don't vary their outputs.

One simple way of looking at **Average Fixed Costs** (AFC) would be to take the annual total fixed costs and divide them by months, weeks, or days (e.g., $750k total operating costs divided by 12 months equals an average monthly fixed cost of $62.5k). Costs could also be calculated based on the number of performances given or days open in a year.

Costs in Perspective

An arts manager needs to monitor fixed costs over time. For example, if the organization has increasing fixed costs year over year that are not offset by increasing income and donations, then it will suffer from a form of cost disease.

Table 8.1 shows an example of how costs and revenues can be plotted and at what point a program of activity may cover its costs and generate additional revenue (i.e., a surplus).

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Chapter 8 – Economics and the Arts

Part 2: Applying Economic Concepts to the Arts

Demand, Supply, and Elasticity

Demand – The **law of demand** states *the lower the price charged for a good or service, the larger the expected quantity demanded*, or QD. QD for arts events may be influenced by *substitutes, complements*, and the *income effect*. Demand can go up or down if there is a similar arts event available (substitute), transportation costs to get to the event significantly change (complement), or income levels change (income effect). (See Fig. 8.3, QD1, 2, 3).

Supply – The **law of supply** states that *the quantity supplied will increase when the price is raised and will decrease when the price is reduced*. QS can be influenced by cost changes related to *factors of production* (lower cost favors more supply) and the *number of suppliers* (fewer suppliers means more costs to consumers).

However, arts event suppliers typically have limited control over supply. Event schedules are determined long before knowing what the demand will be, and there is often a limited supply of seats. (See Fig. 8.4, QS 1, 2, 3)

Arts programming demand and supply typically do not follow either of these laws. Performing arts events tickets that are the costliest sell first. The unsold tickets typically are those that are the least expensive. (See Fig. 8.6 – QS 1 and QD1)

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Chapter 8 – Economics and the Arts

Part 2: Applying Economic Principles to the Arts

Elasticity

Economists define **elasticity** *as the responsiveness of one variable to the change in another, both changes expressed in percentages.* **Demand elasticity** is the *responsiveness to changes in the quantity demanded to a change in the price.* **Supply elasticity** is *the responsiveness to changes in the quantity supplied to a change in price.* (See Box 8.2, Elasticity Change Formulas)

Economists say *demand is elastic* when a percentage change in the price produces a greater percentage change in demand. *Demand is inelastic* if the percentage change in price produces a small or no percentage change in demand. *Unitary elastic demand* means the percentage change in price is matched by the percentage change in demand.

Knowing how sensitive audiences are to price changes can help an arts manager with creating a range of ticket prices for their programming. However, the prices charged by other arts organizations also can limit the ability to raise prices in local markets.

Supply, Demand, Elasticity, and Revenue Maximization

An arts manager may face competing goals: offering affordable programming vs generating enough revenue to sustain the organization. Understanding the *willingness to pay* (WTP) of audiences or members is critical to setting price points that maximize revenue while maintaining affordability. Tables 8.2 and 8.3 show examples of various approaches used to estimate demand and set prices. Price points are also effected by the fundraising capacity of the organization. Ticketing software is available to help estimate demand and dynamically adjust prices per performance or hours of the day.

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Chapter 8 – Economics and the Arts

Part 2: Applying Economic Principles to the Arts

Demand-Based and Dynamic Pricing

Demand-Based Pricing

The key ingredients in successfully selling more tickets and generating more revenue are connected to when the tickets go on sale, the top and lowest prices, price points between high and low, and incentives offered to motivate buyers. Making seating available in phases (not putting all the seats on sale) makes it possible to gain insights into how well an event may sell before opening. In the museum setting, knowing hour by hour what the flow of attendance is can help shape a whole host of pricing options to help increase demand (discounts for off-hours).

Dynamic pricing has become a common method used by arts organizations to mitigate the problem of having a fixed number of seats and time constraints associated with performances or the museum's hours. (See Table 8.4 and Box 8.3 for examples of variable and dynamic pricing at the Children's Museum of Indianapolis and the Indianapolis Zoo.)

However, these same pricing practices can also undermine initiatives to lower barriers of entry to underserved audiences and expand community participation and engagement. Offering extraordinary access and preferential treatment to patrons, fans, and customers with financial means is common in the arts. (See Box 8.4, *The Velvet Rope Economy*.)

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Chapter 8 – Economics and the Arts

Part 2: Applying Economic Principles to the Arts
Behavioral Economics and the Arts

In theory, consumers try to rationally maximize their expenditure decisions to satisfy their needs and wants. However, in practice, we often make purchase decisions without considering all the options available. Behavioral economics studies how our states of mind, moods, and emotions can lead us to make costly decisions that may harm us, others, or our organizations.

Ariely's *Predictably Irrational*, Kahneman's *Thinking Fast and Slow* or Thaler, and Sunstein's *Nudge: Improving Decisions about Health, Wealth, and Happiness* offer helpful insights into how people make choices and what factors influence their thinking and purchase decisions. Here are five concepts arts managers should be aware of:

- Priming – Perception can be prompted by cues (e.g., how much people enjoy x program)
- Anchoring and Adjustment – Pick an initial price estimate, and then reframe that estimate on whether you think the item is worth the price
- Framing – Every decision is typically framed by a linguistic context (e.g., limited supply)
- Inertia – People have a bias toward the status quo (e.g., frictionless subscriber renewals)
- Loss aversion – People dislike losses more than an equal gain

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For more resources for Chapter 8 go to www.managementandthearts.com

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What's Ahead . . . Chapter 9 – Control: Operations, Budgeting, and Finance

Learning Outcomes

9.1: Summarize five factors used in designing an operational control system

9.2: Be able to apply the four steps in the operational control process to an arts organization

9.3: Analyze and demonstrate how input standards and output targets are used in an arts organization

9.4: Apply MBE and MBO quantitatively and qualitatively in the operation of an arts organization

9.5: Recognize and diagnose when an arts organization's performance appraisals system achieves its outcomes

9.6: Explain what an MIS is and how it works in arts organizations

9.7: Summarize the types of budgets and describe the budgeting process

9.8: Summarize the responsibilities of a CFO in an arts organization

9.9: Explain the three components of an FMIS and its application in monitoring businesses

9.10: Summarize the difference between cash and accrual accounting systems and assets and liabilities

9.11: Describe the difference between a balance sheet and a statement of activity

9.12: Be able to determine the fiscal health of an arts organization by using ratio analysis

9.13: Describe the investment approaches taken by arts organizations in creating reserve funds