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The Economic Approach to Public Funding for the Arts

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Abstract: This paper examines the rationales for public funding for the arts that arise out of economic models of markets, and market failure, specifically public goods and positive externalities. At the heart of the economic method is a reliance on consumer sovereignty: that individuals are the best judges of their own preferences and well-being, and that there is no disputing cultural preferences and tastes regarding consumption, and perceived benefits from public goods and externalities. Clarity is provided on what precisely would constitute externalities in the arts, and the challenges of trying to measure them. Consideration is also given to people seeking to change their own tastes, whether behavioral economics has implications for arts policy, and the concept of merit goods. The paper concludes by considering the rather stringent implications of the economic method for the practical allocation of arts funding.

Keywords: cultural economics, public funding of the arts, merit goods.

JEL classification: D62, Z11

This working paper is part of a larger project on the moral foundations of public funding for the arts, and represents work in progress. Comments and suggestions are very welcome

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Economic analysis is a tool that can be used to evaluate public funding of the arts: when it would be valuable, how it would be best allocated. It is but one way of thinking about the world, although it has become an especially powerful one in practice, for good or ill (Berman, 2002).

This paper looks at how economists look at the question of public funding of the arts, the moral assumptions that underlie their methods, even if often unstated, and the implications of following the economic method for how funding should be allocated.

Economic analysis is *consequentialist*: as the word suggests, it assesses policy initiatives, such as whether to increase arts funding, in terms of what the consequences would be, rather than in terms of rights and duties which might apply regardless of consequences. Further, and more restrictive, it is *welfarist*: the *only* consequences that matter are those that affect individuals' well-being. There is no room for "art for art's sake"; rather, welfarism restricts itself to "art for people's sake". Economic method is focused on individuals, i.e. a *methodological individualism*: it is individual well-being that matters, with the benefits of policy summed across all individuals, rather than any notion of a community of individuals which has its own social welfare greater than the sum of the individual parts. And economic method generally assumes, with some cautious exceptions that will be discussed later in the chapter, *consumer sovereignty*: individuals are their own best judge of what constitutes an improvement in their well-being, and of what constitutes a preferred choice.

In this paper I first outline the economic case for public funding as it is typically presented in handbooks and textbooks on cultural policy, and then turn to the implications. For the most part this chapter will focus on the *efficiency* rationale for public funding for the arts, or how arts policy could improve aggregate welfare, rather than considerations of *equality*, which will be considered in forthcoming work.

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THE POWER OF MARKETS

Economists approach the subject of *public economics* – the analysis of government taxation, spending, and regulation – from what might seem to be a surprising direction. Specifically, they begin by considering a world in which government is rather superfluous. In plain language, the *first theorem of welfare economics* holds that if markets are competitive, and there is a complete set of markets, then the equilibrium outcome of the market process will be efficient. This needs some unpacking.

By *competitive* we mean that in each market there are many buyers and many sellers, each of whom is well-informed about prices and the goods and services on offer, and each of whom can enter or leave the market as they prefer, and no single buyer or seller is so large with respect to the other traders that she has the power to influence market prices.

By *complete set of markets* we mean that every good that affects our well-being has a market price and is tradeable (we will see below that this is an important consideration for arts funding).

By *equilibrium* we mean the set of prices, and purchases and sales, to which markets will tend, and at which no person, given the set of prices, has any incentive to change what they buy or sell.

And by *efficient* we mean that there is no conceivable rearrangement of markets that could make at least some people better off without at the same time making at least some people worse off. This particular way of conceiving efficiency is known as *Pareto efficiency*. A change in arrangements which *does* make some better off while leaving no one worse off is known as a *Pareto improvement.*

The claim of the first theorem is a limited one. *Market failures*, either through lack of competition, lack of complete information, or simply the lack of a market at all, are commonplace in the real world. And a Pareto efficient outcome could be one with tremendous inequality of welfare.

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And yet at the same time the result is astonishing. Buyers and sellers, out and about pursuing their own interests (which need not be selfish ones), without any authority ordering them to buy more of this and less of that, to grow more rye and less wheat, are led as if by an invisible hand to generate an outcome that is efficient. If in my town of Bloomington the equilibrium competitive price for a basic haircut is $24, and about 21,000 haircuts are sold each month, there is no good reason for the state to question that outcome, to mandate a different price, or to say that the haircuts ought to have gone to others rather than to the people that actually bought them. In fact, as Hayek (1945) made clear, this decentralized method of markets is the *only* way to reach such an efficient outcome, since there is no way a centrally planned economy could possibly accumulate, update, and process all the necessary information about consumer and supplier preferences in haircuts, as well as the ever-changing conditions in every other market.

How does this world of buyers and sellers lead to an efficient outcome? Let's stay with the example of haircuts. The number of haircuts per month that, in aggregate, people will want to purchase depends on the market price. With a higher price, at least some people (it doesn't need to be everybody) will wait longer between professional haircuts, or might even switch to just cutting their own hair at home. If the equilibrium price is $24, then while some buyers would have been willing to pay more than this (we call the difference between what a person would have been willing to pay and what they actually pay *consumer surplus*), there are buyers who are just on the margin, who find it worth paying $24 but no more. On the supply side, openings for haircuts are also a function of the market price: the higher the price, the more openings a barber will be willing to schedule, and the more people will decide to open a barber shop. If the equilibrium price is $24, then for most haircuts this is a good exchange for the barber; some might be willing to cut hair even if the price is only $20, but they are able to charge $24. But at the margin, there are some openings that are just barely worth it, and if the price were only $23.90 the barber would not stay open quite so many hours. If we put the two sides of the

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market together, it means that at equilibrium, the value of a haircut to the marginal buyer is exactly equal to the cost of providing the cut to the marginal seller, with each of these being equal to price. But in any optimization problem, we *want* a level of activity to the point where marginal benefits equal marginal costs, but no further. If Bloomington, owing to some external constraint, were unable to provide the equilibrium 21,000 haircuts per month – say the government imposes a quota of just 15,000 cuts – then some people will wish they could get a cut, and be willing to pay a price that some seller would happily accept, yet the mutually beneficial transaction is prohibited. That's not Pareto efficient, since by allowing the number of cuts to rise to the competitive equilibrium there are buyers and sellers who would mutually gain. Likewise, having more than 21,000 haircuts per month does not make sense, since that would take us to a level where the value of the cut to the marginal buyer is less than what the seller is required to receive.

At equilibrium in a competitive market, the marginal value of the good or service to buyers is just equal to the marginal cost to sellers of providing the good or service, and any departure from this outcome will make at least some people worse off.

THE ARTS AND MARKET FAILURE: PUBLIC GOODS

So why subsidize the arts? Aren't there markets for concerts and films and paintings? For economists, the standard story is that there are market failures, mainly of two types.

The first is what we call *public goods*. Economists have a very particular way of defining this: it means goods that are (1) *non-rival* – once provided to the public, any extra users do not diminish the benefits to anyone else enjoying the good, and (2) *non-exclusive* – once provided to the public, there is no practical way to keep people from enjoying the good, no feasible way to set up gates and a ticket booth. Public art generally fits this bill – sculptures and murals and other installations. My pausing to

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enjoy an outdoor work doesn't block anyone else from doing the same at the same time, and it would be impractical to try to sell tickets to see the work. We could also add non-commercial public broadcast radio to the list of public goods, as it is non-rival and non-exclusive. (Non-arts examples of public goods would be national defense, city streets and streetlights and sidewalks, small urban parks, etc).

Markets do not work well for public goods, since these goods entail a cost – for public art, this would include the space taken up by the work, the creation of the work itself, for which the artist must be compensated, and upkeep and maintenance – but since they are non-exclusive there is no easy way for the supplier to collect revenue. And yet it might well be the case than an addition to a town's collection of public art is worth more to people, in aggregate, than what it would cost to provide the addition.

As an exception to the general rule, we can think of cases where a public good can be financed privately without any problem. Consider three roommates sharing an apartment, and the microwave oven has reached the end of its useful life. All three roommates use the microwave, and they could (one hopes!) arrange to each contribute to the cost of purchasing a new one. If the microwave is worth buying at all, it must be that the sum of the benefits to the roommates exceeds the cost. If one of the roommates rarely uses the microwave, relative to the other two, it might be that she is willing to contribute to 10 percent of the price while the other two are each willing to pay 45 percent. If the benefits of the new microwave exceed the cost, there must be *some* possible allocation of the cost that leaves no one feeling worse off; in other words a Pareto improvement.

Finding an allocation of costs to fund public goods so that no one is worse off is going to become exponentially, impossibly high as we move from three roommates to the entire population of a city. The breaking point will be when the costs of getting all affected parties together and negotiating an arrangement become impracticably high. In larger groups, beyond one's roommates and friends,

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beyond one's social club or house of worship, people can be less-than forthcoming about the benefits they would receive from a public good, hoping to "free ride" on others who would step forward to offer to pay for it. And so public goods at the local, provincial, and national levels are funded from tax revenues.

Funding public goods, such as public art, thus has the problem that even if it is estimated that the total benefits from expanding the city's collection of public art, which would be the sum of the benefits at the margin to each individual, exceeds the cost of the additions, some people will be made worse off – they have no interest in the art, might even find it an eyesore, and yet are paying taxes to fund it. Rushton (2003) (drawing on Atkinson and Stiglitz (1980)) finds that the more people diverge in their preferences for public spending on the arts, the more likely we will have at least some of the population feeling worse off (just as the more consensus there is on public spending on a budget item, the more likely something close to an actual Pareto improvement is possible).

Note that the test for the funding of public goods - that the sum across all individuals of benefits from the good at the margin exceeds the cost at the margin of providing it - takes consumer preferences as given (discussed further below). And it assumes that the value of a public good can be expressed purely and exclusively as the sum of the benefits to individuals (this issue will be considered in more depth in forthcoming work).

And it is here that we come to a position taken in the economic method and cost-benefit analysis with very important moral implications: so long as the sum of benefits from a public good, or any other public spending or regulatory policy, exceeds its cost, it is justified, on the grounds that, mathematically, those who experience a net gain from the spending could, *in principle*, compensate those who experience a net loss in such a way that no one is left worse off. Importantly, *the compensation need not actually take place*; what matters is that it would, although perhaps very

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impracticably, be possible. This is known as a *Potential Pareto Improvement*, and also as the Kaldor-Hicks criterion, after the economists who proposed it (Kaldor (1939); Hicks (1939)), and is a foundation of contemporary cost-benefit analysis (see Sugden and Williams (1978) for example; also see Harberger (1971) for a defense of the method). It is a method that puts questions of equitable distribution to one side. This doesn't mean that a policy-maker would necessarily approve a policy that passed the Kaldor-Hicks cost-benefit test even though low-income people were most harmed and high-income people received the lion's share of the benefits. But the distributional considerations would be *separate* from the basic framework for evaluating spending on public goods (or, as we see below, subsidizing positive externalities).

The Kaldor-Hicks criterion can be defended as follows, taking the example from Kaldor (1939): the repeal of the Corn Laws in Britain in 1846, freeing trade in grain. From this change in policy, landlords suffered a loss, and other manufacturers, and consumers gained. Can we say that *in aggregate* welfare improved? Economists can estimate the changes in incomes resulting from a policy change, and in this case aggregate *income* certainly rose. But economics gives no guidance on aggregate welfare, because it is unknowable how much the loss in income to landlords cost them in terms of well-being; we cannot compare *well-being* across individuals, I cannot compare my happiness to yours. All we can observe are changes in income. But, Kaldor points out, we can say that since national income rose as a result of the repeal of the Corn Laws, it is at least *possible* that those who gained monetarily from the change could compensate the landlords for their loss such that after the transfers *nobody* suffered a loss, and at least some people gained; i.e. there is a Potential Pareto Improvement. Whether such compensation *should* be paid is a separate question, and beyond the expertise of economics – it falls to morals and politics.

Using the Kaldor-Hicks criterion to evaluate a policy change is not a matter of economists saying the distribution of gains and losses does not matter. It is rather economists saying that the ethics of

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distribution is a question that goes beyond what economists can do within the economic method. If a new work of public art would cost five dollars in extra taxes from each resident, and some people would value the new art at more than five dollars, and some would value it less, but the total value placed upon it would exceed the total cost, then cost-benefit analysis, using the Kaldor-Hicks criterion, would advise going forward with the project. In essence, it values monetary gains and losses as if the circumstances of the winners and losers did not matter; a gain worth one dollar to Abdul is valued as equivalent to a gain worth one dollar to Benjamin, regardless of Abdul and Benjamin's relative income or welfare.

Note that the effects of arts policy on the overall distribution of income in practice are going to be slight. The distribution of income is far more dependent upon other policies: the tax and transfer system, the provision of health insurance and public education, the bargaining power of labor, competition policy restricting the formation of powerful monopolies and cartels, and macroeconomic policies that contribute to stable long-term economic growth.

Is this defense of the Kaldor-Hicks criterion adequate? Scitovsky (1941) draws attention to the implicit, unstated assumption behind the analysis that the distribution of income prior to the policy change is already at a desired level, achieved through various taxes and transfers that influence distribution:

> For instance, it might be argued that the abolition of the Corn Laws should not have been advocated by economists in their capacity of pure economists without advocating at the same time the full compensation of landowners out of taxes on those favoured by the cheapening of corn. Yet, in a sense, and regarded from a long-run point of view, such propositions are not independent of value judgments between alternative income distributions either. For, going out

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of their way to preserve the existing distribution of income, they imply a preference for the *status quo* (p. 79).

That said, Atkinson and Stiglitz (1976) show that if we have something of an optimal income tax and transfer system in place, optimal in the sense of balancing efficiency concerns with a judgment on how to weigh varying levels of income when calculating social welfare, then the Kaldor-Hicks criterion can be justified; since we have an optimal tax system, we have already solved the problem of an additional dollar to one person being of equivalent value to an additional dollar to another person. This suggests that the more we believe the actual tax and transfer system in play departs from an optimal one, the more cautious one would need to be in applying the Kaldor-Hicks criterion.

THE ARTS AND MARKET FAILURE: EXTERNALITIES

For the most part arts councils do not provide much funding for the economist's conception of public goods. Concerts, film screenings, museums, are all exclusive, it being possible, and common, to charge for admission, and to restrict from entering those who will not pay. When it comes to public subsidy for the arts, economists have tended to focus on externalities.

An *externality* occurs when activities of firms or consumers affect third parties in a beneficial or harmful way, and where there is no market or transaction in those third-party benefits or costs. In other words, the effect is *external* to the price system. These effects are also known as "spillovers". In arts policy, the claim has long been made in the field of cultural economics that there are possibly positive (i.e. beneficial) externalities from the arts, and this would warrant some form of subsidy.

Why a subsidy? Ordinary competitive markets are good at producing an efficient level of output, one that brings into equality the marginal benefits to consumers and the marginal costs to suppliers.

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With an externality, however, there are benefits (for positive externalities) or costs (for negative externalities) that are ignored by the market participants, who are simply seeking the best outcome for their own interests. With positive externalities, the social benefits at the margin for the good, which involve the benefits to consumers as well as the external benefits, are greater than the private benefits to actual consumers of the good, meaning from a social perspective we would ideally like output to be higher than what the market will yield. A subsidy, which could take the form of subsidies to producers of the good (in the arts, grants to artists and/or arts presenters) or to consumers (say in the form of "vouchers" for the arts that could be redeemed by consumers for eligible arts-related purchases), is meant to increase the production and consumption of the arts. It is important that the subsidy *actually do* something in terms of increasing the activity which is presumed to generate the externality; a grant to an orchestra that is mostly wasted on unnecessary internal expenditures, and that does not affect the artistic output of the orchestra in any way, is pointless, is not fulfilling the purpose of the subsidy.

But first, it is important to be clear on what is, and what is not, an externality. The third-party effects must be *external* to the price system. So, to take an example suggested by Cheung (1973), the fact that apple growers benefit from bees pollinating their crop does not in itself suggest a positive externality from beekeepers to apple growers, as a quick internet search in any region where apples are grown will reveal that in fact markets do exist for this service, and beekeepers will locate hives in one's orchard for a price. So there is no rationale on these grounds for any sort of subsidy to beekeepers.

With externalities, the key is that it is difficult to design a market. Ronald Coase (1960), in what became known as the Coase theorem, showed that as long as property rights were clear – who owns what, who is liable or not for damages – and transaction costs, being as the name suggests the costs of drawing up a contract, negotiating prices, monitoring the contracted performance, and all the other costs of engaging in a market transaction, are low, then the relevant parties would be able to come to an efficient arrangement of contracts and prices. Coase's point was not that the market would solve any

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externality problems. Rather, it was that the core of the problem is transaction costs, just as it is for the market failure of public goods.

One confusion that has arisen around externalities and the arts has to do with the distinction between the "intrinsic benefits" of the arts and "instrumental benefits" of the arts. Suppose I attend a live theatre performance. I enjoyed the play: it was well-written and well-acted, had many memorable scenes, and left me thinking about what I had seen well after I left the theatre. These have been called intrinsic benefits. But there were other things I liked. I had the chance to chat with other audience members, some of whom I knew but had not seen for some time, and it pleased me to re-connect. One of the people I met let me know about a job opportunity that had just come open that might be ideal for me; I never would have learned about this had I not gone to the play. I've been advised that I ought to get out more, that it is not good for me to spend so many nights at home. These are "instrumental benefits", benefits to me that were not strictly related to the work of art that I experienced, but were simply a function of "a night out at the theatre." But none of these instrumental benefits are externalities, since they are all benefits to me. There are no third-party effects. What happened was that the benefits of going to the theatre took many forms. But they did not benefit third parties at all. The intrinsic / instrumental divide does not give us much to work with when it comes to public subsidy; much more to the point is whether the benefits of my going to the theatre all accrue to me, or whether there are others that are affected.

An economic factor in the cultural sector, particularly (but not exclusively) so in the live performing arts, is "cost disease" (Baumol and Bowen, 1966). Neither does this constitute an externality. Cost disease is the phenomenon of different sectors of the economy having different abilities over time to adopt labor-saving technological advances. The *average* rate of productivity increase across the economy determines the growth in wages, and wage differentials across sectors for workers of roughly equivalent levels of skills and training cannot become too high, for if they did all workers would leave

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low-wage sectors for where the pay is better. This means that over time the relative costs of producing goods and services where labor-saving technology rates have been high will fall, and the relative costs of producing goods and services where labor saving technology rates have been low will rise. Examples of the latter would be education (one school teacher can have only a limited number of students in the classroom at one time, and the students can only learn so much at a time), many aspects of health care (there have been major technological advances in health care, to be sure, but there is a human element to care from doctors and nurses that cannot be replaced by technology), and the live performing arts. Manufactured goods, information and communication technology, transportation of goods and people, agricultural goods, have all had relative cost and price declines over the decades. Services that require a certain amount of person-hours of labor at a more or less constant rate – classroom instruction, haircuts, personal counselling, performances of *Twelfth Night* – have all become relatively more expensive. Recorded arts have generally fallen in price, in terms of the costs of obtaining recordings and the cost of good quality equipment on which to play it. Live performance is a different thing. But this is not an externality; there are no third-party effects lacking a functioning market. It does mean that some arts presenters are going to face challenges in balancing their budgets over the long term, but that is going to be true of any firm providing personal services. The relative price of my getting a haircut has risen faster than other prices over the decades, but that is not in itself grounds for subsidizing the hair-styling sector. Note that "cost disease" is an odd term, since it implies something gone wrong. But it is a result of the economy becoming *richer*, not poorer, a function of rising wages across the economy.

Finally, so-called "economic impacts" are not an externality, even though they are endlessly, and to me incomprehensibly, promoted as a rationale for public support of the arts. An "economic impact" study begins by calculating the total spending on a particular good, for example the entire creative sector, or perhaps just nonprofit arts organizations, for a particular city or region. It then uses input-output tables to generate estimates of how the incomes generated by that arts spending were

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subsequently spent by its recipients. That next round of spending becomes income for yet another group, and so on. Each round has a diminishing magnitude, resulting from people saving some of their income, and some spending being on imported goods. All these rounds of spending are called "indirect" effects, and when added to the original spending are called the total "economic impact." But there is no externality or other market failure in play here; this is simply a sum of different market transactions, one that we could calculate for *any* sector. One of the odd things about the use of the studies in advocacy for public spending on the arts is that rather than making a claim that the arts are different from other goods, it presents the arts as just another sector, no different from restaurants, accounting services, or barbershops. No economist takes these studies very seriously, and so we move on.

So what *are* the possible externalities from the arts? Here I draw from common suggestions of texts in cultural economics, including Cowen (2006), Frey (2000), Heilbrun and Gray (2001), Netzer (1978), O'Hagan (1998), Throsby (2001; 2010), and Towse (2010). Peacock (1969) is an early analytical piece on arts externalities.

It's helpful here to separate externalities from funding individual artists and externalities from funding arts presenters, like festivals, performing arts companies, galleries, and the like.

For individual artists, there are two principal market failures. The first is in investment in human capital. A young person wishing to pursue a career in the arts needs time and guidance in building skills and an artistic vision. The hoped-for return from this investment in human capital are the rewards that come from working as an artist. But financing human capital investment is very different from financing investment in physical capital; one cannot borrow against highly uncertain future earnings. A young person can more easily acquire financing for a car than a year at art school, since the finance company will insist the car is insured against damage, and the car can be repossessed should the borrower fail to repay the loan. Personal investment in printmaking or cello technique cannot be repossessed in such a

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manner. This is why governments almost universally subsidize higher education and training: private capital markets do not work efficiently when it comes to investments in persons. Note this is true for all skilled professions, and is an argument for subsidizing the education of future financial advisors and arc welders as well as painters and musicians. The building of an artistic career requires years beyond the conservatory, and so support for artists trying to become established post-graduation can also be justified on the grounds of it being very difficult to finance in the market.

The second market failure involving individual artists is in the realm of intellectual property. Copyright gives the opportunity for artists to earn a return on their investments in creating their works. But copyright only protects specific expressions of an idea or inspiration – the text of a novel; the lyrics and musical phrases of a song – but does not protect a new *style* of writing fiction, or songs, or painting, new styles that can inspire other artists (and commercial firms) in their own art and design. Innovative artists create works which are only to a degree covered by copyright, but also contain elements of what immediately becomes a public good. Firms investing in research and development have a similar issue; patents protect specific aspects of design, but not the new ideas they spur in other firms. So, just as many governments subsidize firm spending on research and development through various tax expenditures, so there is a case for subsidizing new creative ideas in the arts.

I now turn to arts presenters, and the possibilities for positive externalities. First, there might be in some individuals a sense of regional or national pride in its arts presenters and their traditions and renown, that exists even if they do not themselves attend (remember, a person who does attend the theatre and enjoys it for a variety of reasons, including some reasons not directly associated with the experience of the art, does not in itself constitute an externality, which relies on benefits from *other* people attending). Although this possibility is commonly mentioned in cultural economics textbooks, the evidence for the externality, particularly in the subsidized arts sector, is not immediately obvious.

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Second, it might be that people believe that society is made better by people participating in the arts, that literature, theatre, music and visual art aid in mutual understanding and empathy between individuals, and this makes life better for all, even those who do not directly participate themselves. Evidence on this question is mixed: there do seem to be correlations between measures of empathy and the reading of literature, but we cannot tell if people who are generally empathetic to begin with are drawn to literature, or if reading literature is a cause of the empathy. Carey (2007) believes that literature alone has the ability to enable this sort of perspective-taking, while it is very difficult to see how other arts have this capability; see Rushton (2017) for a review of this literature. We also have to be wary of believing in positive externalities from art in terms of community and empathy without recognizing there might be art which has the opposite effect, reinforcing biases towards others rather than ameliorating them (Goffin and Friend, 2022).

Third, there is concern for future generations, and concern for our future selves. “Option demand” is the idea that one benefits from others attending the ballet, for example, even if not attending oneself, on the grounds of wanting the art form, and the presenting organization, to survive into the future so that the option of one day beginning to attend will be preserved.

Arts conservation is an externality if one gets personal satisfaction, even if not attending the arts, that it is being preserved for the future. Scheffler (2018) asks us to consider the world depicted in P.D. James’s (1992) novel *The Children of Men*, in which the entire human population of the earth has become infertile, and is gradually dying off; at the time the novel is set the youngest humans are in their late teens. The England she portrays is a melancholy place, to say the least, where people can listen to a record, or view a painting, knowing that in a few years’ time there will be no one left to enjoy that music or painting, it will have come to an end. A part of the value we place on art is that it will last for generations yet to be born, whom we will never know.

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There is also the question of our *obligations* to future generations. Welfare economics, and the utilitarian tradition generally, has held that it is wrong to discount the well-being of future generations as being of lesser importance that the well-being of the current generation. We discount our own personal consumption, in preferring goods now to goods later, and we might take account of the likely probability that future generations will be materially richer than this generation, through ongoing improvements in productivity. But future well-being still matters as much as our own. This moral claim is in the seminal work on saving and investment for the future (Ramsey, 1928), through Parfit (1984), and in contemporary work on the economics of climate change: “there is no serious ethical argument in favour of pure-time discounting” (Stern, 2022, p. 1279). I return to the question of “ethical preferences” below in the section of this chapter on merit goods.

CONTINGENT VALUATION

The arts have a positive externality not because cultural economists have thought of plausible ways in which they might, but because individuals *actually place a value* on these external effects, just as they do for public goods. The value of public art and arts externalities, if any, are in the eye of the beholder. But how could they be measured?

The problem to be overcome is that there are no market prices to guide us in calculating how the public values government spending on the arts. I can learn, at the margin, how consumers value haircuts, blueberries, and hats, simply by looking at market prices; the data sits right in front of us. For some public goods, there are no direct market prices to see, but there are related prices that can give us some indications. For example, if the state department of transportation is looking at spending on an upgrade to a highway, and wondering whether the expenditure would be worthwhile, it can obtain estimates of how many people typically use the existing road, and relevant alternative routes, how

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much driving time each driver would save with an improved road, and, based on wage levels, how much people value time, how much safer the new road would be, and based on other markets how much people tend to value safety improvements, and so on. But how would one measure the value of new sculptural works to be placed along the city's main bicycle path, or of the external benefits that come from the local orchestra?

Contingent valuation is a method of opinion polling in which a representative sample of the population is asked: what if there *were* a market for public art, and externalities from the arts? What would be your willingness to pay for these goods? The central difficulty with the method is that people are being asked a question of valuation that they almost certainly have never considered before. I shop at the grocery store a few days a week, and have long observed how prices in the fruits and vegetables section fluctuate week to week, season to season, and am very used to making judgments over whether a particular good is worth buying this week, or that its current price is too high, such that I should seek out a substitute. I am used to market prices for ordinary goods, and make purchases accordingly. Even in the arts, I am used to making judgments on prices: is this play, this used vinyl record, this art book, worth buying or not? But I don't think about the personal monetary value of public goods or externalities because I never have to make a decision about them. The contingent valuation survey taker is asking me something very new, whether how much I value the Royal Theatre in Copenhagen (Hansen, 1997), or a Scandinavian music festival (Andersson, Armbrecht, and Lundberg, 2012), or libraries in England (Fujiwara, Lawton, and Mourato, 2019).

Contingent valuation has stirred an extensive literature (especially in the field of environmental policy, where it was first applied; valuation of the natural environment and the cultural environment have a lot of issues in common), on best practices, and on whether the difficulties in getting accurate information from respondents are simply insurmountable; see Diamond and Hausman (1994), Carson (2012), and Hausman (2012). These practical issues are important, but the primary interest here is the

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concept: that the values people place on public goods and externalities are to be found through the thought experiment of imagining a market where none currently exists, and invoking the principle of consumer sovereignty in that imaginary market. Responses to the survey are taken as data, and there is no ”correct” answer as to whether someone who does not use public libraries in England values them at five, twenty, or forty pounds.

MERIT GOODS

The economic approach to public goods and externalities takes consumer preferences as given; the preferences are assumed to be “rational”, which here has the narrow definition of consistency (If I prefer the blue tie to the red tie, and prefer the red tie to the green tie, rationality means I must therefore prefer the blue tie to the green tie, but does not imply much else), and does not question the *ends* for what the consumer buys. Economics also works on the assumption that individuals are the best judge of their own interests, and so does not question what choices are made, again so long as they are consistent.

There are a few angles from which we could question this working assumption. The first is the recognition that people might take efforts to change their own preferences. The second is that there might be levels of preferences, where whatever we might decide to do on impulse, we would see in the cool calm of reason is not actually in our best interests. The third is that people might make decisions against their own best interests even when they have had time to reflect. And a fourth is that we might have preferences over community outcomes that are entirely separate from our personal interests. We look at each of these in turn.

People often take actions to change their own preferences. Suppose there is a genre of art that you really have never quite understood, and yet you know that there are many people who are

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knowledgeable about it and seem to get a great deal of satisfaction out of it. I grew up in a household that was relatively rich in music, but where no one knew much about or was very involved in visual art. As an adult, I took it upon myself to read about it, attend gallery openings, and make a point of going to museums when I visited cities, in order to understand better the history and contemporary state of visual art, and in turn have something new in my life that was enjoyable and stimulating. I also made a point of trying to see classic films, in the hopes of being able to get a deeper pleasure out of watching great movies. In E.M. Forster's novel *Howards End* (1989 [1910]) Leonard Bast hopes that enough exposure to high culture will lift him to a new plane of understanding. Reading John Ruskin, "he felt that he was being done good to, and that if he kept on with Ruskin, and the Queen's Hall concerts, and some pictures by Watts, he would one day push his head out of the grey waters and see the universe" (p. 62).

Economists, maybe not surprisingly, have formalized this notion. Gary Becker and Kevin Murphy's (1988) theory of "rational addiction" supposes that an individual gets pleasure from ordinary goods, and also some goods where the pleasure received from them depends on our history of consumption of it. Knowing this, we might begin to consume a good, say opera, even if it doesn't immediately yield a lot of pleasure, on the expectation that eventually it will, and the future pleasure will be more than worth the initial cost of sometimes being befuddled or bored by what is happening on stage. People who have done long-distance running for many years will advise someone just getting started that at first it is hard to feel motivated, that one might be tempted just to stay in if feeling tired, or the weather is inclement, but that eventually what you want will change, and that you become addicted to your daily run. Everybody is different, and so will perceive the beneficial possibilities of various possible addictions (and note their paper is mostly, though not exclusively, addressed to *harmful* addictions) differently. People who do not heavily discount future benefits are more likely to try to develop a beneficial addiction (and less likely to cultivate a destructive one). The theory follows from the

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method of Stigler and Becker's (1977) "De Gustibus Non Est Disputandum" in that it posits a stable utility function, where changes in behavior are the result of changes in relative costs and benefits.

Importantly, there is, at least to this point, no market failure, no opportunity for a beneficial government intervention. Mr. Bast can simply go on reading his Ruskin, and listening to Beethoven at Queen's Hall.

Now consider that we might have different *levels* of preferences, that people make some decisions on impulse, or through an habitual short-cut in reasoning, that is at odds with what they themselves would recognize as their best interests. We procrastinate on tasks to a degree that makes us worse off than if we had simply got the task done when it was presented to us (for academics, grading papers is a familiar example). We choose default options on complicated transactions without looking closely at what our actual best option would be. In the *Nicomachean Ethics*, Aristotle writes that a man can be unjust towards himself by allowing the irrational part of his soul to frustrate the desires of the rational part, and (echoing Plato) the rational needs to rule over the irrational within us just as the ruler of a state must govern the ruled (1138b). Economists have long recognized that we have different levels of preferences (see Pigou (1938), for example), but the question has remained what if anything ought to be done about it.

The field of behavioral economics represents an effort to incorporate various aspects of that "irrational part of our soul" into the field of economics, to better understand why people make the choices they do, and perhaps to find public policies that improve our well-being. Thaler and Sunstein's (2003) paper on "libertarian paternalism" led to their book of recommendations *Nudge* (2009), where "nudges" have now entered the policy lexicon. Does the term "libertarian paternalism" make sense? Suppose we define "paternalism" (following Le Grand and New (2015)) as a government intervention to address individual failures of judgment, for the individual's own good. A "libertarian paternalism" would

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not *force* individuals to make a particular choice, or pay them subsidies to do so (or to tax them to steer them away from particular choices), but would simply design the *architecture* around which we make choices to favor what most individuals would agree is in their long-run interest. So, for example, people have a tendency to assent to what is presented as the status quo option. If people agree that saving adequately for one's retirement is a sensible thing to do, then companies that make enrollment in the company pension plan the status quo option for new employees, though where they retain the right to opt out, is a superior design to a company that requires new employees to *opt in* to the pension plan. A cafeteria that puts healthier food options at the front of the line, and puts desserts at a separate table, will induce people to choose a better lunch, while still allowing people to pick from the offerings whatever they want. State regulations that enforce a "cooling off" period for major financial and legal transactions also serve to lead people to better choices without actually restricting their choices.

It is important to note that these "nudges" are meant to steer people towards choices *they would agree* are in their best interests, but might not choose under different choice architectures. Nudges are not about getting people to do what they would not choose under careful reflection. They do go somewhat further than simply providing information – a sign put up by park authorities that a particular trail is so infested with ticks that hiking is not recommended is useful information, since most hikers might not realize this, but it is neither paternalism nor a nudge (once in southern Indiana I chose to ignore this warning, as I was free to do, and came to regret it).

Are there implications for cultural policy? These nudges are not about externalities; they are concerned with individuals' personal well-being. Coate and Hoffman (2022) provide a review of the possible implications of the findings of behavioral economics for the field of cultural economics, but the policy implications remain unclear. The key problem is: to what decisions do we think people ought to be nudged? Proper retirement planning, a healthy diet, are uncontroversial goods that most everybody's rational self would agree to. But what does the rational self want regarding the arts that the

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irrational self will thwart? Rational, positive addictions are more likely to be developed when we have a low rate of discounting future benefits, and one aspect of our irrational self can be a tendency to adopt discount rates higher than we rationally know make sense. So maybe we could nudge people towards developing rational addictions to the arts. But what art, exactly? How could people be nudged in this direction without an explicit paternalism that holds *this* art form is difficult and takes time to appreciate but is worth it in the end, and continuing to wallow in *that* art form, popular and catchy, will in the long run fail to generate the same pleasures? The arts are more difficult than decisions over savings and health, where the ends are much clearer.

Next consider a third possible departure from standard economic analysis, that even with deliberation and full information people make decisions that are contrary to what is truly in their best interest. Richard Musgrave (1959) introduced into his work on public economics the concept of "merit wants" (also known as "merit goods"). He was looking at goods supplied by the market, but which were so "meritorious" that they warranted public subsidy to increase production and consumption beyond what the market would provide. He was careful to distinguish merit wants from externalities (which would also warrant subsidy, although for different reasons), and claimed that "the satisfaction of merit wants, by its very nature, involves interference with consumer sovereignty" (p. 13). He went on: "A position of extreme individualism could demand that all merit wants be disallowed, but this is not a sensible view " (p. 13). He advocates paternalism over some goods, recognizing that this might be subject to abuse by an authoritarian state, but which could be permissible in a democratic society.

> While consumer sovereignty is the general rule, situations may arise, within the context of a democratic community, where an informed group is justified in imposing its decision upon others. … The advantages of education are more evident to the informed than the uninformed. … In the modern economy, the consumer is subject to advertising, screaming at him through the media of mass communication and designed to sway his choice rather than give complete

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information. Thus, there may arise a distortion in the preference structure that needs to be counteracted. The ideal of consumer sovereignty and the reality of consumer choice in high-pressure markets may be quite different things. (p. 14).

Musgrave (1959) does not specifically mention the arts in his discussion of merit wants. Revisiting the topic almost thirty years later, Musgrave (1987) tries to set out more details on what merit goods could be. He notes that many policies we see are in fact paternalistic. In the United States, aid to poor families with children is partly through "food stamps", which are income supplements that not only must be spent on food, but on particular sorts of eligible "appropriate" foods (note that libertarian Milton Friedman (1962) opposed this, saying that if we wish to help the poor by increasing their purchasing power, a cash transfer is called for, and the poor ought to be as trusted as anyone to make their own spending decisions). There is a call for treating the arts as a merit good (although he does not use the term), from Tibor Scitovsky (1972): "The only valid argument for government aid to the arts is that it is a means of educating the public's taste and that the public would benefit from a more educated taste" (p. 68).

The field of public economics never really "took" to this paternalistic idea (although the very "soft" paternalism (Kirchgässner (2017)) of nudges has been at least slightly better received). Musgrave claims paternalistic interventions can be justified in a democratic society, but democracies are very imperfect vehicles, subject to all manner of irrationalities in public voting, in legislation, and in bureaucracy. Who decides how the public's taste ought to be changed? Scitovsky was explicit: Americans ought to listen to more classical music. But how can that be justified without stepping far beyond the bounds of economic analysis?

Finally, a consideration of an aspect of merit goods that Musgrave introduced in his (1987) *New Palgrave* entry, that of "community preferences." These are also called "ethical preferences" by

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Harsanyi (1955) and in Head's (1991) review of the literature on merit goods, and "commitment" by Amartya Sen (1977). Suppose I don't really have much interest in attending the symphony, but I do support government grants to it. Why might I do that? One possible reason is externalities; I might feel benefits from the existence of the symphony and people attending it, even if I do not attend myself. But suppose I don't sense any externalities, I don't feel in any way affected by symphony concerts that other people attend, and yet regardless I believe it is the *right* thing for the government to support the symphony. It is important for the well-being of others that there is live classical music beyond what the market alone could support, that it may be especially important to a small number of people, that it is an obligation to preserve classical music for future generations, and that in a fair and just world this is something that ought to be funded. There is a cost to me in terms of my taxes being used to fund this, and no "egoistic" benefits to me (as there are with externalities), but it is something I want to see happen. It is not uncommon for us to make choices out of a sense of duty than out of personal benefit; for example, we take on the cost of voting in elections even when the chance of our ballot determining the outcome of the vote is vanishingly small. Textbooks on cultural economics frequently raise the preservation of the arts for future generations as an externality. It certainly does rank as a reason for subsidy, but it would seem to arise from "ethical preferences" rather than direct gains to personal welfare.

It is difficult to disentangle externalities from ethical preferences. As West (1991) notes in his commentary on Head (1991), when he surveyed people about public funding for the arts (West, 1985) there was at least some support for arts funding even by people who never attended the subsidized arts, though whether this was from personal benefits through externalities or rather through a sense that it is simply the right thing for government to do is hard to determine.

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Reflecting ethical preferences in public funding is not paternalistic at all, it is reflecting the preferences of voters. But the question of how to recognize where this is the case, or what levels of arts funding would be appropriate given all the various alternative uses of funds, remains a challenge.

IMPLICATIONS FOR PUBLIC FUNDING OF THE ARTS

Consider the following thought experiment: suppose, contrary to what critics believed would ever be possible, all of the problems that beset contingent valuation estimates were solved, so that we could ascertain with a great deal of certainty how members of the public, on careful consideration, truly value public art, and the external benefits of people other than themselves attending the arts. Should those estimates guide the allocation of public funds to the arts?

To answer "yes" to this question, one would be accepting the following foundations of economic analysis:

- That any arts spending should be judged on its consequences for individual welfare, and only for individual welfare;
- That individuals are the best, indeed the only, judges of their own welfare;
- That individual preferences regarding arts policy are taken as given, and while people might themselves choose to engage in activities that will change their preferences, it is not up to the state to do this, or to rank particular tastes as being better than others;
- That the benefits to people from arts spending are represented by their willingness to pay for it through higher taxes, and that spending is worthwhile only if at the margin the benefits across all individuals exceed the costs of the arts subsidy;

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- That some people will almost certainly be made worse off by arts spending policies, being taxed more than they believe the spending is worth, but that is an acceptable outcome so long as aggregate willingness-to-pay exceeds the costs of the arts spending;
- That how subsidies are allocated is to be guided by the preferences of the public in terms of what they believe is worth spending money on; the value of positive externalities is what the public thinks it is. *Specific* allocations from an arts council could still be determined through a traditional peer review, arm's length process. But the *criteria* to be used in review depends on what the public actually values.

It might seem surprising to see arts policy framed in this way, although it is the standard set of assumptions that would be used in ordinary cost-benefit projects, such as an upgrade to a highway, or a flood control project. For any advocate of public spending on the arts to invoke positive externalities is to not only rely on public perceptions of the value of those externalities, but also to direct spending in those areas where the externalities are seen to be significant. This is an implication worth remembering; if, for example, the principal externality from the arts that people believe exists is that certain works of art can help build empathy between diverse members of society, then there ought to be a preference for funding those artists and presenters whose works seem to best fulfil that function. Arts councils need to have *some* criteria for how to allocate funds; a reliance on externalities as the rationale for funding points to particular criteria to be used.

The economic method restricts public funding to where there are market failures; the term "neoliberalism" can be difficult to define, but the idea that competitive markets are efficient, that market failures are the justification for public spending, and that public spending should reflect how

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people would choose to spend themselves if there *were* a market, is perhaps useful as a working definition, and that is what sole reliance on economic method yields.

A final point needs to be made regarding the economic way of thinking: not everyone trained as an economist (as I am), and I will guess not even the majority of those trained as an economist, believes that the economic method is the sure solution to every policy problem. The method has a working set of assumptions that can be very useful in constructing explanatory models, models that often have very good predictive power about consumer and firm and market behavior. But there is no oath economists must take that commits them to unwavering belief in methodological individualism, or universal consumer sovereignty.

David Throsby (2003) gets to the heart of the issue: there might be "cultural value" in the arts, "their aesthetic properties, their spiritual significance, their role as purveyors of symbolic meaning, their historical importance, their significance in influencing artistic trends, their authenticity, their integrity, their uniqueness," that cannot be captured in estimates of "economic value" even with the most sophisticated techniques for determining the monetary values the public places on public goods and externalities. This means arts-policy makers will sometimes face a trade-off between stated economic values, calculated through the methods described in this chapter, and other values that exist outside of the economic method.

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