Chapter 17

ORGANIZATION OF ARTS AND ENTERTAINMENT INDUSTRIES

RICHARD E. CAVES

Harvard University, USA

Contents

Handbook of the Economics of Art and Culture, Volume 1
Edited by Victor A. Ginsburgh and David Throsby

DOI: 10.1016/S1574-0676(06)01017-9

Abstract

The organization of the creative (arts and entertainment) industries rests on many types of contracts. These contracts govern collaborations between artists and other parties – at arm's length, or within an enterprise. These contracts' structures devolve from a few bedrock properties of creative work and creative products. Artists invest in developing their talents, presenting themselves before 'gatekeepers' who seek talents that can profitably be developed and marketed. Gatekeepers commonly function as agents for selecting artists and as match-makers between artists and complementary inputs. As an extension of the gatekeeping function, the participants in creative industries take part in a continuous ranking process that sets and revises the ranks of vertically differentiated talents. Real option contracts pervasively govern the sequential steps of developing a creative product. These can leave the artist an autonomous creative agent (pop musicians and record labels) or enclose artists' talents in an employment relationship (classic Hollywood studios). The transformation of the movie industry to 'flexible specialization' illustrates how changing basic conditions can transform the dominant form of organization. The scales of enterprise in the creative industries tend to be driven by the efficient scales with which creative goods are distributed (very large for record labels and movie studios, small for art galleries), and they tend to assort themselves into those focused on the distribution of creative goods ('promoters') and those concerned with identifying and nurturing creative talents ('pickers'). Large enterprises also include the 'entertainment conglomerates' which seek synergistic gains that depend theoretically on quite special conditions; foreclosure and its avoidance may be principal motives. Non-profit enterprises dominate a number of arts activities, apparently for two interrelated reasons. These activities incur high fixed but low marginal costs, pressing them to employ two-part prices and club arrangements to ensure fixed costs' coverage. When product quality is endogenous, however, non-profit status may be necessary for the manager credibly to foreswear degrading quality once the fixed payment is in hand. Non-profits supported by donation streams thus enjoy functional advantages.

Keywords

agglomeration, creative industries, gatekeepers, job-matching, joint ventures, motion picture industry, non-profit organizations, option contracts, publishing industry, recording industry, royalties, theaters, toys and games industry, vertical differentiation, visual arts

JEL classification: L11, Z11

1. Introduction: Organization and contracts in creative industries

The field of industrial organization is divided into two branches. The more traditional branch is concerned with how the structures of markets and the behavior conditioned by those structures affect their allocative efficiency. The second branch addresses the question of why markets are organized the way they are. This latter pathway proves highly inviting for study of the arts and entertainment industries, because they pose a richer array of questions about the logic of organizations than do most other sectors. Consider the task of explaining an industry's organization. Any unitary transaction can be carried on between independent firms, with competition among buyers and sellers determining the market's price and quantity. Or transactions can be bundled inside of firms, with quantities determined by administrative decisions. Theory identifies the strengths and weaknesses associated with each mode of organization. Empirical investigators commonly assume that the most effective mode of organization prevails by means of Darwinian survival, then test the match between theoretically predicted and empirically observed organizational choices.

This approach to the organization of industry, originated by Ronald Coase (1937) and Oliver Williamson (1985), has lately been much enriched by research on the theory of contracts. The alternative to internalizing decisions within the firm is to govern them by means of arm's-length contracts between independent agents. Williamson emphasized the hazards to which arm's-length contracts are subject as the key to understanding why decisions are internalized within the firm. Many arm's-length contracts, formal and informal, nonetheless persist. Moreover allocative decisions made within the firm do not automatically escape the shortcomings of contracts. Indeed they are governed by incentive contracts that ply various carrots and sticks in order to influence employees' actions. The firm is a "nexus of contracts", and the success of internalization depends on the performance of arm's-length contracts relative not to "administrative decisions" but rather to the efficacy of contracts drawn and implemented within the firm. In Darwinian fashion we expect the whole set of prevailing arrangements (extent of internalization, organization of firms, structures of arm's-length contracts) to reflect the relative efficiency of arm's-length and internal contractual dealings.

The arts and entertainment industries (hereafter "creative industries") provide an attractive site for applying this approach because they employ distinctive types of deals and intra-firm governance arrangements. While the volume of quantitative research on these organizational arrangements is small, a great deal of casual evidence exists, especially for the United States. When casual observation confirms the prevalence of a practice with a clear and apposite theoretical rationale, the news is worth reporting even where the niceties of controlled experiments and statistical inference remain out of reach.[1] Deciding when a theoretical model pertains to an empirical situation is, of

[1] Much of the theoretical analysis in this paper was set forth in Caves (2000), though some points get fuller development here. That study also assembled a good deal of diffuse empirical evidence that will not be cited or repeated here.

course, a tricky step on which judgments may differ, and researchers ought to leave their tracks uncovered. We take what can pretentiously be labeled an axiomatic approach, laying out some properties that seem common to all creative industries, or to some substantial and specific group of them. These properties were established inductively from a broad body of mostly descriptive evidence, but also with the guidance of the structure-conduct-performance paradigm that informs much empirical research on industrial organization. Thus these properties are hypothesized to be the "bedrock" elements of market structure based in tastes and technologies that determine important but endogenous aspects of structure – the organization of contracts and less formal deals, and the number, sizes, and activity sets of firms.

Creative industries combine inputs from various types of artists with other inputs to turn out some creative good or service intended for consumers' enjoyment. This production process may involve nothing more than the marketing of the artist's creation (the visual arts, for example), or it may entail substantial further manufacture (book publishing, music recording). Whether simple or complex, this activity is conditioned by two axiomatic properties. The first, *art for art's sake*, holds that artists' utility functions commonly contain two features that strongly affect their participation in contractual economic relationships. The first is a taste for undertaking artistic work for its own sake, which depresses the supply price for the artist's services below the pecuniary compensation expected from the artist's best alternative (non-creative) job. The second is preferences as to how the artistic task should be executed. The widely accepted nineteenth-century romantic view holds that the artist creates from inner necessity in order to realize some internal vision.[2] While the artist's low supply price facilitates in an obvious sense her cooperation with other inputs in a production process, the existence of tastes defined over the mode of production complicates the artist's contractual participation in a complex creative activity. If the exercise of preferences about the creative process were contractible, they could be traded off against pecuniary compensation in a mutually agreed manner. When they cannot be specified and contracted upon, and when the creative urge also refuses to respect time constraints or commitments, the completeness of contracts between artists and other inputs and on the subsequent governance of such contracts is substantially limited. (We refer to non-artistic inputs lacking these tastes as "humdrum".)

Another property that we impute to products with substantial creative inputs is great uncertainty about buyers' reservation prices for any creative output; this uncertainty persists until all costs have been incurred and the finished output placed before them. This property is widely recognized in entertainment industries, where large sunk costs give rise to highly uncertain returns, by the slogan *nobody knows anything* [Goldman (1984)]. The force of this property depends on the interaction of its two conditions – the sunkenness of costs and the uncertainty of the output's market value. When net revenue depends heavily on distinguishing good from bad projects *ex ante*, great effort is

[2] Studies of the training of art and music students show that these imperatives are built into the curricula and absorbed into students' attitudes. See Getzels and Csikszentmihalyi (1976) and Kingsbury (1988).

devoted to forecasting these outcomes by decision-makers who have invested heavily in knowledge about what failed and succeeded in the past. The *nobody knows* proposition is consistent with costly investments in forecasting by decision-makers who understand the wide variance around their point forecasts: a small improvement in the likelihood of distinguishing correctly between good and bad projects is worth a lot. Also pervasive in creative industries is the property of horizontal differentiation, associated with creative goods that seek uniqueness within sets of conventions that make many of them close substitutes for one another. We can call this property *infinite variety*. The closeness of substitution as an axiomatic property pertains to potential varieties of a creative good. Where it pertains to actual varieties depends on the incidence of fixed costs per variety relative to consumers' combined willingness to pay (overall, and for preferred varieties).[3]

Other axiomatic properties pertain to complex creative activities that require inputs from a number of suppliers each with *art-for-art's-sake* preferences. The resistance of artists to contractual commitments specifying their creative work complicates the organization of activities that demand the collaboration of several artists' inputs (along with humdrum inputs) – a *motley crew* of creative inputs. Creative inputs of any given type are differentiated vertically, that is, all agree that one artist's talent excels another's overall, although the better talent may not be worth its higher wage in every project. Artists' rankings are determined empirically in a costly consensus-based evaluation process involving the vertically differentiated artists themselves as well as others who employ, supervise or collaborate with them. This is the *A-list/B-list* property. It is closely related to another: that the ultimately perceived quality of a complex creative good tends to depend on each creative input performing at least up to some threshold level of competence. A handy way to represent this property is by means of a multiplicative production function: the failure or substandard performance of any input renders the project's whole output valueless. This is the *O-rings* property [Kremer (1993)]. Finally, the efficient execution of complex creative activities requires the close temporal coordination of key artistic and humdrum inputs, and this requirement complicates both the initial contracting and subsequent coordination of such projects (the *time flies* property).

2. Simple creative goods

Simple creative activities involve a single artist (source of creative input) dealing with one agent or enterprise that combines the artist's input with humdrum inputs and distributes (perhaps through intermediaries) the creative good to consumers. This seemingly simple relationship raises several major issues of organizational choice. First, would-be artists offering their talents to the market appear to be in chronic excess supply, so that the distributor assumes the role of a gatekeeper, selecting some but turning many

[3] On the determinants of the equilibrium number of units of creative goods on the market, see Baker (1991).

others away. Second, creative and humdrum inputs could be combined in several organizational settings. The humdrum entrepreneur might represent the artist or take part in a joint venture to develop and distribute the artist's product (talent), or the entrepreneur might hire the artist and assume decision rights over her creative activities. Third, the physical location of creative activities is subject to agglomerative pulls that depend in turn on how the dealings between the artist and humdrum inputs are organized and governed.

2.1. *Supply and returns on investment*[4]

We suppose that the artist seeks representation and employment upon completion of training or apprenticeship. The training process itself takes the would-be artist before a series of gatekeepers. As in other tournaments, the would-be artist competes at first with a random assortment of local aspirants. Success at the first stage brings the candidate into competition with others who have survived a first round. This series of elimination rounds proceeds through elementary and advanced training and continues through apprenticeship and the quest for commercial success. For the would-be artist the pursuit involves a series of investment decisions made under great uncertainty. While positive local certification is more informative than none, its value for predicting success in subsequent rounds is very low. That is partly because the proportion of initial contestants who achieve some ultimate success is tiny, partly because a student/apprentice's ability to benefit from additional training, conditional on the certification already attained, is not accurately predictable.

The apprentice artist's investment in training eventually realizes some rate of return, which we can think of as becoming known when she faces a commercial gatekeeper. The gatekeeper seeks to judge whether suitable humdrum inputs combined with the artist's developed talent will create enough value to cover their opportunity cost. Gatekeepers will on average do no better than covering their opportunity costs if gatekeeping is a competitive trade. What reward will flow to the artist, though, depends not only on the competitiveness of gatekeepers but also on the correlation of their *ex ante* assessments of the proffered talents. The artist's gross return to her talent is learned only after a contract is reached with the gatekeeper (or other partner) and the market's ultimate assessment realized. Because training and apprenticeship costs are sunk, these realized rates of return will fall into three ranges. First, some contenders get the nod from no commercial gatekeeper; their investments are clearly lost (aside from future consumption benefits). Second, the more successful apprentices admitted by the gatekeeper find that the market's willingness to pay for their talents will yield a positive return on their investment after the competitive gatekeeping enterprise has taken its normal profit. Third, the less successful contestants realize returns that cover the gatekeeper's opportunity cost but

[4] For further discussion of issues raised in this section, see Chapter 22 by Menger and Chapter 24 by Towse in this volume.

yield a rent on the artist's talent insufficient to produce a positive return on her sunk investment in training.

Do all would-be artists, taking the successful and the unsuccessful together, earn a normal return on their training investments? No hard data exist, but the enormous ratios of arts students graduated from U.S. colleges to professionals entering successfully into careers in a given year make it seem highly unlikely. How should we interpret this behavior and the apparent misallocation of resources that results? A high level of expected utility from purely consumption benefits of training is one factor that helps to rationalize the pattern. Another interpretation invokes a form of risk-loving behavior embodied in the attitude that a high level of creative success yields untold riches in utility (beyond that due to the cash takings). However, the budding artist is poorly positioned to make a rational decision about expected returns to training. The romantic conception of the artist's calling encourages the student to regard talent as a god-given asset that deserves unstinting dedication and effort. Furthermore, the teacher who faces the task of sustaining the student's motivation through years of arduous training and practice has every incentive to emphasize the glory of artistic greatness once achieved, and none to mention the paltry chances of achieving it [Towse (1993)].

2.2. *Organizing supply of creative goods*

The gatekeeping process rations and allocates the humdrum resources available to supplement the artist's input, but it does not dictate the organization of the process, which can take several forms. Consider for concreteness the visual artist whose work requires humdrum assistance to distribute and promote it. The artist could become an employee in a humdrum enterprise, producing works of art at the manager's direction under a conventional employment contract. The artist could prepare works sprung from her own inspiration, to be sold (off the park fence on Sunday morning?) piecemeal to whatever dealer takes a fancy to them. Finally, the artist could be represented by a single gallery on the basis of an exclusive-dealing arrangement.

The last arrangement clearly prevails for simple creative goods – between visual artist and gallery owner, between pop musician (group) and record label, between soloist in classical music and impresario, between author and publisher. Why is this so? Continue with the visual artist. In the context of the romantic ideal, artist, consumers, and intermediaries and certifiers (teachers, critics) agree that what matters is the artist's ability to create a sustained body of work that cumulates to a lifetime career. This requires that both the artist and the distributor of her work undertake many actions that amount to investments for long-run returns. The artist develops a body of work that will sustain periodic shows in the art gallery. The gallery operator interprets the work and promotes it to collectors, museum curators, critics, and periodicals, and lends works for shows in museums and other galleries, etc. Maximizing the value of this joint venture to develop the artist's career requires each party to undertake these actions to optimal degrees. For this arrangement to beat out other ways to organize distribution of the artist's work, it must be consistent with *art-for-art's-sake* tastes, which it clearly is. Artist and dealer must be able to govern their relationship through explicit or implicit contracts. Formally, the dice are loaded against anything approaching a complete contract, which would require long-term commitments by both parties to ideal courses of action that are largely unknown in advance (dependent on random opportunities), incapable of formal contract and not practicably monitored by the parties even if contractible.

The arrangements prevailing in practice are simple (often handshake) contracts that divide gross revenues from sale of the artist's work between the two parties after certain costs are allocated to each. This contract falls short of an ideal incentive structure, which would require that each party exert effort up to the point where the last dollar's worth of effort adds just one dollar to the joint benefit. In practice the actual incentive for effort is weaker: each party expends effort only to the point where the last dollar's worth of effort adds another dollar to its share of the joint benefit. Categories of purchased inputs that are made one party's responsibility are likewise underfunded. However, any cost that is one party's responsibility, though reimbursed before revenues are divided, will be undertaken to the optimal degree (an action that maximizes revenue net of these assigned costs also maximizes either partner's fractional share of this revenue). Lacking a specific duration, these contracts run until either party chooses to end them, for example, when the artist's style changes in a way that eludes the dealer's sympathy. Reputation plays an important role in supporting the enforcement of the implicit terms, but contract failures do occur (for example, when the artist sells directly to collectors without compensating the dealer, or the dealer fails to report sales and make the associated payment to the artist). Evidently the contracts in these joint-venture type arrangements work well enough to dominate any fundamentally different organization of the distribution of visual art.[5]

The joint-venture types of contracts in the creative industries bear a relationship to the theoretical literature on incomplete contracts. The alignment appears neither neat nor simple, however, so we shall only point to some promising connections.[6] The first of these lies in the theoretical assumption that both parties to a relationship can observe and agree on the outcome of a transaction (or the quality of an input or state of nature that is occurring), but they cannot convey their understanding to a third party such as a court enforcing a contract. The assumption comports well with *art for art's sake* and other core properties of creative activities. The conditions in question are "observable but not verifiable". Under some circumstances – such as where the parties can observe each others' investments in the joint enterprise or the quality of intermediate inputs supplied – a first-best contract can still be sustained. Under others, only second-best is sustainable. The second assumption is that no asymmetry of information exists between the primary parties to the transaction. They possess the same information about actions

[5] A particularly interesting historical experience with the organization of the visual arts is the transformation of the French market around the time of Impressionism. An era of state certification through official salons gave way to a "dealer–critic" system of private certification and marketing. See White and White (1993), Jensen (1994), and Wijnberg and Gemser (2000).

[6] For background, see Hart (1989).

(investments) that either party has taken and the resulting quality of a product or level of its variable cost. Rather paradoxically this assumption aligns with the *nobody knows* property: the uncertainty around the values each party observes is great, but there is no general reason to expect one's accuracy or bias to differ from the other's. With this set-up, the theory of incomplete contracts may prove able to explain some empirical aspects of joint ventures in the creative industries: why they might contract on one variable (for example, a movie's screenplay and key actors) rather than another (the quality of the resulting film). It may also explain why one party reserves the right to decline to purchase a creative good (for example, the studio that chooses not to release a completed film), an action that both parties recognized as a possible outcome of their contract. Finally, the literature on incomplete contracts gives much attention to the possibility of renegotiation – think of the buyer's refusal to pay the agreed price for a finished good [Hart and Moore (1999)]. The creative industries illustrate the reputation mechanisms that so often seem effective for punishing those who violate understandings even where formal contracts and courts are not involved.

2.3. Prevalence of option contracts

The visual art market makes clear that the viability of an organizational structure compatible with *art-for-art's-sake* preferences depends on congenial long-term contracts and mechanisms that make them sustainable with only the lightest degree of formalization. Other arts and entertainment sectors depend on more formal contracts with distinctive recurring features. As in the visual art market, the creative product originates from some talent of the individual artist. It then goes through one or more steps (processes, transactions) before reaching the final consumer. The *nobody knows* property points to the great uncertainty about the ultimate reception of this product, both early and late in this series of fabrication stages. Because the right decision about fabricating a creative product can sometimes realize so much more value than a wrong decision, the participants find it worth investigating omens of successful or failure even if their information content is small. The incentive to make this investment in information and adapt to its message is at its maximum for the party next in line in the fabrication sequence to sink still-fungible resources into the project. Another key property is that inputs incorporated at any stage in the process (whether of creative or humdrum origin) are entirely sunk. With the input sunk, its supplier generally can make no further contribution to the value of the product; she might be asked for a rewrite (or the equivalent) when a partially completed project is judged to have gone off the rails, but that entails an additional contribution of resources and any allotment of decision rights tied to it. In general, the input sequence does not "cycle back".

To focus incentives efficiently, a contract governing such a processing sequence should allocate decision rights in a way consistent with the parties' opportunities to affect the final product's value. That is exactly the property of the real option contracts in widespread use among creative industries. Consider the deal between an artist (screenwriter with a completed script, for example) and an agent able to supply the next round of inputs to the process (film producer). The option contract between them has these features:

- The producer gets a period of time (six months perhaps) in which to investigate the possibility of filming the writer's screenplay. This investigation period may be renewable.
- Writer and producer agree on the full terms under which the writer will be compensated if the producer decides to purchase the script and make the film. Rights to modify and adapt the screenplay now pass to the producer.
- The writer is compensated for giving the option (forgoing other opportunities until the option runs out), often receiving a fraction of the agreed purchase price (the option payment likely credits against the purchase price if the option is exercised).

This contract provides an efficient structure of incentives because it respects the sunkenness of previously installed inputs in the creative good's production process and assigns decision rights to the party poised to decide whether and how to continue fabrication. However it does carry an odor of unfairness to the artist who supplies the initial and often defining input to the product, only to see decision rights about its subsequent fate pass to the hands of humdrum decision makers. This violates *art for art's sake* in the sense of putting the realization of the artist's conception in the control of other parties. The artist can bargain to retain decision rights, of course, as when a film director retains the right of "first cut" – assembling the raw film into a completed motion picture. However retaining decision rights over subsequent steps likely costs the artist dearly. That is because it conveys an unlimited opportunity to hold up collaborators deciding how to proceed subsequently with the project, unless the scope of the retained decision power can be clearly delineated (as with first cut).[7]

The most apposite theoretical analysis of this option contract appears to be Nöldeke and Schmidt (1998), who addressed alternative ownership arrangements for a project that involves sequential production processes undertaken in turn by parties A and B. Suppose that B holds an option to buy the project after A has sunk his investment but before the resulting surplus is realized. B's reservation value for the project increases with A's investment (effort). This provision strengthens A's incentive to invest, because underinvestment will deter B from exercising his option. But A also does not overinvest, because B becomes the owner of the firm and captures most of the benefit of any excess in A's investment. If B's ownership is sufficient to induce efficient investment by B, then the overall contract is first-best.

Other terms of contracts used in creative industries have related incentive and efficiency properties. Consider the advance against royalties commonly paid by publisher

[7] A few demonstrations can be found of trade-off between *art-for-art's-sake* preferences and the terms of financing creative work. Fee (2002) compared films financed by the major studio distributors ("production-finance-distribution deals") to those financed independently by foreign distributors, personal funds, etc. Securing independent financing is a considerable burden for the filmmaker, but leaves her creative control intact. Fee hypothesized and confirmed that films would be financed independently when the film-maker's *art-for-art's-sake* tastes were particularly strong. This he proxied by situations in which producer, director, and screenwriter are all the same person.

to author or record label to pop musician. The royalties subject to the advance implement a sharing of expected net revenues from the project between (say) publisher and author. However the royalty is literally based on sales revenue, so the publisher faces an impaired incentive to make promotional outlays that "buy" additional sales revenue that flows partly into the author's pocket.[8] A royalty is traditionally regarded as working capital to provide the impecunious author with bread while the creative throes proceed. However it has an important incentive property for the publisher. Until the advance is earned back from realized net revenue, the publisher retains the whole of the profit dollar elicited by its effort to promote the author's work. Since the publisher's promotional decisions typically matter more for the work's profitability than any contribution the author can make post-publication (e.g., book-signing sessions, appearing on TV talk shows), the advance improves the efficiency of the contract.[9]

The advance figures distinctively in contracts between pop musicians and record labels because it not only anticipates royalties on the record but also covers the musician's cost of recording the master tape – a substantial outlay when the musician favors elaborate electronic procedures that require costly studio facilities. The musician, prone to perfectionism *(art for art's sake)*, thereby gains a pecuniary incentive to make efficient rather than excessive use of studio time. The incentive may not work as intended, though, on a risk-loving musician prone to bet all available resources on the chance of a gigantic success.[10]

2.4. Agents and matchmakers

The artist–gatekeeper relationship frequently involves an agent who mediates between artists and the enterprises that realize the market value of their creations. These intermediaries perform several services, depending on the creative sector. One is matchmaking between artists with heterogeneous talents and creative enterprises with diverse capabilities and input needs. Another is negotiating terms between artist and gatekeeper. As a third, the agent himself functions as a gatekeeper when he selects artists to represent.

The service ostensibly provided by the agent is to represent the artist (author, say) to enterprises that might bring her work to market (publishers). This representation function is governed by an incentive contract that compensates the agent with a share (traditionally 10 percent but with upward perturbations) of the artist's gross earnings.

[8] Record labels rectify this incentive by charging some promotional expenses against the artist's royalties, which indeed induces the label to undertake excessive promotion (the artist pays, while label and artist share the additional gross revenue).

[9] Hansmann and Kraakman (1992) developed some related propositions about the efficiency of contracts carrying an advance; they can deter the publisher from opportunistically declining a manuscript when (bad) fresh news arrives at a later stage in the publishing sequence.

[10] Another distinctive feature of popular-music contracts is the incorporation of a series of "cheats" whereby the musician's contractual royalty percentage is nibbled away by costs (including wholly artificial ones) charged against royalties. Industry observers [Passman (1994)] conjecture that musicians gain utility from the right to brag of a high royalty rate, implicitly agreeing to its dilution.

This contract (including the 10 percent figure) was established in the nineteenth century at the inception of the agency business, quickly displacing a fee-for-services contract because of authorial poverty as well as its incentive value [Hepburn (1968)]. Besides representation, however, the agent performs a gatekeeping service that would otherwise fall entirely on the publisher. The agent can profitably undertake to represent an author only if the time (effort) devoted to seeking an outlet for her work is expected to reap sufficient compensation from the resulting royalties. The agent may also invest time (effort) in editing and improving the author's work, to the point where a publishing-house editor can appreciate its potential. Now consider the dealings that occur between established agents and editors employed by publishing houses. They interact repeatedly, which increases the editor's credence in an agent's pitch on its his author's behalf. The credence due to their repeated interactions is supported by the editor's inference that the agent will suffer a pecuniary loss from devoting effort to an author of indifferent promise – a substantial up-front opportunity cost with poor long-run prospects for compensation. For the publisher, relying on agents' representations (their gatekeeping skills and quality signals) substitutes for dependence on what can be picked from the "slush pile" of unsolicited manuscripts. That is likely a less efficient matchmaking procedure because the publisher pondering an unchaperoned manuscript lacks the information that the agent draws from personal contact with the author.

While the agent's gatekeeping and representation functions benefit the publisher, the agent's skill at negotiating on the author's behalf is adversary. Publishers offer somewhat differentiated bundles of services, but none capable of generating substantial rents. The author's unique manuscript is the one input into the publication venture with rent-yielding potential. Thus over the years the publisher's one-time share of subsidiary rights for paperback, cinema film, and other such derivative products has eroded, as the agent representing the author came to pre-empt the publisher and take over the auctioning of subsidiary rights. The publisher's gains from the agent's gatekeeping function thus trade against the publisher's reduced share of rents from subsidiary rights.[11]

Akin to the gatekeeping role of agents is the function of certifiers who possess or invest in skills at making fine judgments on the quality of artists or their works. Theoretical research has recently turned to characterizing the market for certifiers' services, including the vertical differentiation of their services [Hvide and Heifetz (2001)]. The critic's economic function in creative industries has not been much studied, but on casual evidence seems to possess some analytically interesting features. Major acquisitions of visual art excepted, the individual's decision to consume a creative good is too small a transaction to warrant a large outlay on an advisor's services.[12] So critical opinion is commonly bundled into magazines or newspapers along with complementary

[11] The hard-back publisher's one-time substantial share of subsidiary-rights income clearly had an incentive value for the publisher's promotional efforts. Apparently authors (and agents) have adjudged the value to them of that incentive to be less than their gains from redistributing the rent stream.

[12] Large investments may be made in personal search and inspection, however. It is no doubt difficult for the consumer to convey her tastes to the advisor.

sorts of information. The amount of criticism supplied then depends on its marginal attraction to consumers of the bundle relative to their marginal valuations of other content. Critical services seem subject to vertical differentiation parallel to the differentiated involvement of consumers in various arts and entertainment industries. That is, the utility one gets from consuming creative goods increases with one's accumulated "cultural consumption capital" – built up from previous experience and both specialized and general training [Stigler and Becker (1977)]. Individuals vary in both aptitude and desire for building such stocks of consumption capital. As a result they tend to distribute themselves between the poles of "buff" and "casual" in their involvement. The judgments offered by critics and certifiers tend to display a parallel vertical differentiation, with reasoned and contextualized evaluations provided for the buffs, while the critic servicing the casuals tends to internalize their standards and opine whether or not they will like the work.

2.5. Agency and intermediation

Several unanswered analytical questions bear on how the agent's function is organized. The agent's primary function is analogous to intermediation or job-matching. A good deal of research has been done on the theory of intermediation.[13] It focuses on the factors giving the intermediary a productivity advantage over search by the individual primary sellers and buyers. It also addresses the determinants of the intermediaries' price-cost margin, which include their number and mode of competition with one another. In this literature the productivity of intermediation stems from transaction-cost advantages, inventory-holding advantages, and/or advantages in ascertaining quality and warding off adverse selection [for example, Biglaiser (1993)]. Unfortunately, none of this agrees very well with what seem the basic properties of matchmaking in the creative industries. Because *nobody knows*, impacted information seems not to be a problem, although collecting information in order to match the attributes of heterogeneous buyers and sellers involves significant costs. Also, explaining the equilibrium market price of the agents' services cedes place to the problem of explaining why a long-established revenue-sharing arrangement between agent and artist-client should seem conventionalized and immune to supply and demand disturbances. Consequently the following theoretical propositions are advanced tentatively.

Suppose that authors are to be matched to publishers. Members of each group possess a given set of differentiated attributes that are objective and can be determined at a cost by another party (no hidden information). Assume that the value created by pairing any author and publisher depends on the attributes of the two together. Assume that some optimal allocation of authors to publishers exists and can be calculated by any agent who has acquired information on every candidate party's attributes. Because the parties' haggling over terms holds no special interest, we assume that each author's outside

[13] Spulber (1999) provided a survey.

reservation price is zero, and that matched parties always reach a Nash bargaining solution. In these conditions the agent's matchmaking advantage is a natural monopoly: the attributes of each author and publisher need be collected but once by the agent who determines the optimal allocation, while decentralized match-making requires repeated collection of the same information. The gain from a central agent might be compromised by bounded rationality or its temporal equivalent – costs of delay while a central agent collects and processes all parties' information. Any such source of diminishing returns will tend to increase the number of agents and make the equilibrium population of agents an increasing function of the numbers of authors and publishers to be matched and the cost of gathering information from each. The average quality of the matches of course declines.[14]

It can matter who employs the match-making agent. If authors and publishers were like right and left shoes, the agent could simply enter the market as an entrepreneur, purchasing isolated rights and lefts, matching them and reselling pairs at a profit. Where units of human capital are being matched, this procedure clearly fails, and some party must recruit the agent and serve as principal in a governance relationship. This need for governance seems to inject an intrinsic asymmetry into the agent's activities. Can the agent work at random for parties on either side of the market? At first glance that arrangement seems viable but it is probably not. The marriage broker representing both brides and grooms has an incentive to provide a groom with a bride on his representation list, which need not maximize benefit to the groom (or the couple together). The agent negotiating a dowry incurs a clear conflict of interest if he represents both parties. Even without these governance problems, economies of specialization call for the agent to work for parties on only one side of the market. That being the case, we can ask what asymmetries or differences between the types of entities to be matched affect the question as to which of them more efficiently takes on the task of employing and monitoring the agent.

Let us return this question to the context of author and publisher. Suppose that publishers' attributes and policies are readily inferred from their backlists and reputations with authors for capability and integrity; authors' qualities on the other hand are more costly to identify. If the transacting parties on one side of the deal are represented by agents who pool information and economize on its transfer to the other side, pooling the more costly assessments of authors and their manuscripts beats pooling the less costly assessments of publishers' traits on behalf of authors. The same logic applies to the differential importance or value of the information to the other side. A publisher loses heavily if a celebrity author's book flops, but the celebrity might be nearly indifferent about which of several mainline trade publishers issues the book. Intensive collection of information about authors is then more valuable and lays claim to the agent's services, and the collection of information about publishers gets left to individual authors.

[14] The effect of costs of gathering information should depend on whether agents can segment the market's population and avoid duplicating collection costs.

Other influences also weigh in. Suppose that it costs the same for a publisher to size up a prospective author as for the author to evaluate a prospective publisher. Even after the gatekeeping agents have swept out the losers, the authors remain more numerous than the publishers (think of each house serving as exclusive publisher to a number of authors). If agents are to pool information on one side of the market only, they should pick the more numerous authors, thereby consolidating more information than if they represented the less numerous publishers.[15] The agent's gatekeeping function, which excludes many authors, is really a special case of this "differential numbers" effect.

Only descriptive information is available to provide empirical evidence on these predictions. Natural-monopoly tendencies were evident long ago in the booking of variety and vaudeville acts into local theaters [Poggi (1968, pp. 11–26); Sanjek and Sanjek (1991, Chapters 2, 3)]. The booking of big bands in the United States during the 1920s through 1940s provides a particularly interesting case because it illustrates the factors that served to cast up a near-monopoly intermediary, Music Corporation of America (MCA), to undertake the matching of bands to venues. Its dominance was owed, however, not so much to scale economies in matching as to two other factors: scale economies in managing bands' travel arrangements, and the credence value of a large organization with substantial fixed assets for ensuring the intermediary's responsibility in adhering to contracts and remitting payments [Walker (1964, Section 2, Chapter 5); Stowe (1994, pp. 103–106)]. MCA may also have benefited from forcing exclusive dealing on venue operators, requiring them to book only MCA bands if they obtained any of them [McDougal (1998, pp. 108, 128, 224)]. Finally, descriptions of the internal operations of large Hollywood agencies such as Creative Artists Agency (CAA) show that their individual agents work for limited numbers of artists, consistent with the hypothesis of size limits stemming from individual agents' bounded rationality and time costs. Scale economies stem importantly from the unfettered exchange of information among agents working for the same firm and the opportunity to assemble projects as packages of the various talents represented by a given agency [Slater (1997)].

2.6. Internal organization of gatekeeping firms

The gatekeeping process influences the internal organization of firms in creative industries because the gatekeeper (subject to the top manager's review) selects the projects undertaken by the firm and thereby makes its fundamental investment decisions. While the gatekeeper's primary qualifications presumably lie in detecting the potential of the artist's talent and perhaps working with the artist to ripen its fruits, the task of implementing the firm's investment decisions implies a wider scope for both responsibilities and incentives. An efficient compensation scheme will reward the gatekeeper for a good pick and penalize a bad one. The decision-maker responsible for selecting a project

[15] We neglect the plausible outcome of specialized agents on both sides of the market: plaintiffs' attorneys and defendants' attorneys.

therefore has an interest in the proficient performance of the subsequent processing steps that will affect the venture's final profitability. The implications of this organizational logic have worked themselves out in the U.S. publishing industry in modern times. The editor who performs the gatekeeping function was once just that – the party responsible for selecting the manuscript and polishing it to lapidary perfection. Promotional campaigns for books with the potential for wide popularity ("blockbusters") have emerged as a central function of the publishing house, so the payout of the editor's pick becomes heavily dependent on the prowess of the promotional campaign, which therefore logically displaces copy-editing as the editor's primary entrepreneurial task [Whitesides (1981)]. Editors' compensation does not seem closely related to projects' profitability (as it might be for a sales representative or securities trader). However successful editors do realize important rewards (such as boutique labels of their own), and those who pick a run of unsuccessful projects can expect to be seeking new opportunities. Their counterparts in some other creative industries – motion-picture and Broadway stage producers, for example – receive explicit profit shares of successful ventures while being largely protected from the pecuniary downside of a failed project. That asymmetrical form of incentive compensation is likely optimal when the gatekeeper is risk-averse and the project's success highly uncertain even after the gatekeeper's best entrepreneurial efforts.

The logic of the gatekeeper's function – as editor, record-label talent scout, movie producer, etc. – also implies something about the external contacts of these persons and their mobility among firms in a creative industry. These patterns were first noticed by sociologists interested in the communication that occurs among skilled project-runners employed in different firms [Rogers and Larsen (1964); Powell (1985)]. Economists commonly assume that firms vigorously protect from prying eyes all information on their internal activities. Leakage of this information presumably allows competitors to copy the secrets of the firm's productivity or forestall its strategies in the market. However, creative industries deal with vast numbers of potential projects that will ultimately not go forward *(infinite variety)*, and many others that are pursued but ultimately fail. Information on what projects have failed for a given firm, and what projects look promising but are not right for the firm considering them, largely lacks this value of confidentiality. Its access by a competing firm creates potential value for that firm without imposing any direct cost on the firm that divulges it. Proprietary information therefore becomes valuable trading stock among the gatekeepers employed by competing firms, for whom a transfer of useful information today creates a claim on some reciprocal tidbit in the future.[16]

Parallel to this mobility of information among a creative industry's gatekeepers is mobility of the gatekeepers themselves. Their human capital is not firm-specific, in that the differences among firms lie not in systems or technologies outside the gatekeeper's

[16] There appears to be room for theoretical research in this area. For a possible approach, see Baron and Besanko (1999).

control or authority but in the selection strategy that the gatekeeper himself implements. The gatekeeper's personal goodwill assets arise from his recurrent dealings with agents, artists, and other gatekeepers through the informal trade in information, and mainly resist appropriation by the firm that employs him. Accordingly gatekeepers in creative industries exhibit high levels of job mobility. Among publishing houses and record labels this mobility appears as simple job-hopping. In cinema films and TV programs the gatekeeper (producer and writer-producer, respectively) is usually an independent agent or the proprietor of a small firm who may reach a housekeeping deal with a large firm such as a movie studio. Such a deal provides the agent with a base for operations and seed money for developing new projects, while the host obtains the right of first refusal over the agent's projects for a period of a few years.

3. Structures and contracts in complex creative industries

A useful if rough distinction can be made between creative industries that rely on the works of a single class of artist and those whose products combine several of them. Producers of diverse creative inputs may interact in complex ways that would generally not occur among humdrum inputs. Artists may have *art-for-art's-sake* tastes that embrace preferences over how the common creative task is performed. Bringing several sets of divergent preferences into consonance poses a thorny bargaining problem, as the preferences likely defy exact codification and negotiation to reach a mutually satisfactory contractual agreement. Indeed accounts of the development of cinema films and stage plays and musicals commonly refer to disputes among artistic personnel over competing visions of the end product. These get resolved through the application of "muscle", the dominance of the preferences of whichever participant would most harm the project's prospects by withdrawing. The threat value of withdrawal is likely related to the participant's track record of superior performance (success) and/or distinctive and irreplaceable skills or attributes [Rosenberg and Harburg (1993, Chapter 7)]. In a creative project a compromise among several coherent but disparate conceptions of a creative project incurs an obvious danger of becoming a failed mishmash, whereas one or more of the pre-compromise visions might have succeeded on its own.

3.1. Integration and disintegration

Among creative industries the U.S. motion-picture industry in the twentieth century provides a striking example how an industry's organization can be determined by the relative feasibility of different structures of contracts interacting with consumers' valuations of various types and qualities of creative goods. The major Hollywood studios emerged in the 1920s, integrated vertically from the production of films through their distribution and exhibition, and retaining under contract or regular employment many of the creative and specialized technical skills needed to produce cinema films. The efficient deployment of these film-making inputs under contract required that films be turned out at a regular pace in order to keep the distribution and exhibition pipeline full, and each studio's portfolio of films was composed so as to make full-time use of the costly talents under contract. This assembly line rolled out a well-defined product – films relatively standardized in quality and style, even though varying in their reception by audiences and critics. A distinction was regularly made between "A" and "B" pictures, the latter of lower quality and shorter running time, intended to play as second features on a movie house's double bill. The B pictures were made by separate units of the major studios as well as by independent studios, and they served *inter alia* as training grounds for novice movie talents.

Contracts between the studios and key actors and other artists took the option form explained in Section 2.3 above. An actor was bound to the studio for a maximum period of seven years in half-year steps, with the studio holding the option either to renew (with a salary increase) or terminate every six months. The studio was thus motivated to make a substantial investment in the career of a promising performer, as it could collect the resulting rents over what was likely to be a substantial proportion of the actor's career. The studio retained decision rights over major creative choices such as which roles the actor undertook. Apparently the actor's pay was often renegotiated prior to her contract's expiration when she rose to star status, and stars gained access to the perks for which Hollywood is legendary. However even stars got no control over what roles they undertook. A device that no doubt helped to resolve the disputes arising under these contracts was that of lending out the performer to make a single picture at another studio. For this the contracting studio collected not only the fee due the performer but also a premium for its own treasury. Beyond its use in resolving disputes and tensions due to long-term option contracts, the loan-out procedure relaxed the constraint on film quality that was inherent in the studio's presumption that each film would be made by those inputs it had under contract and currently available for work.

The studio system was transformed in the 1940s and 1950s into a completely different organizational structure bound together by different contracts. It is a striking example of how the optimal organization of an activity can make a large, discrete switch following an exogenous disturbance affecting demand for the product and/or the feasible (legal) set of contracts. Several factors precipitated this change, and their respective necessity and sufficiency are not entirely clear. One was the introduction and diffusion of television, which provided to movie-goers a low-quality but cheap and convenient substitute for cinema films. With TV entertainment available at no pecuniary or travel cost, the cinema film (especially the B picture) faced formidable competition. The industry made the theoretically predictable adjustment of reducing the quantity of cinema films produced and raising their quality in the sense of employing costly inputs and elaborate special effects that distanced the cinema film from its small-screen competitor. Another major causal factor was the antitrust case *U.S. v. Paramount Pictures* 334 U.S. 131 (1948). Its principal consequence was to terminate vertical integration of the Hollywood studios into exhibition, which had been implemented mainly through ownership of then first-run downtown movie palaces. Although no studio by any means exhibited its films only in its own cinemas, this forward integration had effectively mandated a pace of movie production to permit regular weekly changes of bill at each theater [Conant (1960)]. Disintegration tended to reduce the optimal rate of film production by the studios, and each film came to be marketed individually for exhibition in each city.

The mandated divestiture of exhibition and vertical differentiation led to the complete reorganization of studios by means of the divorcement of film production from exhibition. The central change was that each film was now assembled *à la carte* from the most suitable inputs available anywhere in the Hollywood talent pool. This change was congenial to the vertical differentiation of films from TV fodder, because it relaxed the constraint of reliance on the single studio's talent pool, and it facilitated the production of films differing widely in scope and ambition. Numerous fixed facilities were dismantled – each studio previously had its own production lot with pre-built sets, its own symphony orchestra, etc. Now, these and many other inputs and skills were hired temporarily as needed.[17]

The subsequent transformation of Hollywood's organization was traced in a series of papers by Christopherson and Storper [Christopherson (1992); Christopherson and Storper (1989); Storper (1989); Storper and Christopherson (1987)]. The following changes are documented in their research unless other sources are cited. Film production shifted away from the major distributors (studios) to smaller distributors and independent firms. Different bundles of inputs tended to come together for each film, with little "repeat business" [Lazarus (1985, pp. 94–95)]. Other packagers of film inputs such as talent agencies got into the business of organizing film production [Slater (1997)]. Many specialized independent service firms arose to provide film-making services on demand, and these firms diminished in average size as they became more numerous. The great increase in the number of arm's-length transactions involved in making a film entailed transaction costs that were mitigated if the input suppliers clustered closely in the Los Angeles area, and this centripetal force was evident. Personnel came more typically to work part-time for several employers, and the craft unions that had long siphoned substantial rents from the major movie studios found themselves unable to control access to competitive supplies of skilled labor. The factors explaining the year-to-year variation of studios' profits shifted from what stars they had under contract and theaters under control to the quality of films produced [Miller and Shamsie (1996)]. Independent markets for the exhibition of completed films sprang into existence in North America (Sundance, Toronto) as well as abroad (Cannes) [Donahue (1987)].[18]

[17] Other exogenous changes played minor roles in this transformation. During World War II high personal income-tax rates encouraged individual stars to form their own production companies to rent their services to a studio on a per-picture basis, and this tax dodge became a precedent for the later regime of one-off deals. Changes in camera technology made shooting films on location much easier, reducing the usefulness of studio lots. Also, when the *Paramount*decrees expired in the 1980s, there was no substantial return to the vertical integration of distribution and exhibition. Regarding the relative importance of these exogenous changes, it is noteworthy that the British film industry underwent the same disintegration as the American; the British filmmakers also faced rivalry from TV, but they encountered no *Paramount* decision, suggesting the sufficiency of competition from television as explanation of the British disintegration.

[18] A somewhat similar disintegration has occurred in the television programming market in Great Britain; see Starkey, Barnatt and Tempest (2000).

3.2. Contracts for complex creative goods

When a complex creative industry's organization is transformed from extensive integration to "flexible specialization", we expect that a congenial set of contractual arrangements will emerge to govern the now-independent dealings. The motion-picture industry provides an attractive case study, along with its adjunct the market for TV program series. Cinema film projects usually start from a speculative script or a literary source from which a script is to be developed. Real option contracts provide workable governance for the producer (a film's entrepreneur) who seeks to develop a script. A series of steps is defined – a treatment (synopsis), a full draft, revision, polish, and so forth – with the writer paid for each step and the producer holding the option to continue with the next step. The screenwriters' organization, the Screen Writers Guild, supervises an arbitration procedure to determine the allocation of screen credit in the common case where a script passes through the hands of several writers.

With the script developed, the producer seeks to assemble the creative and technical inputs needed to make the film and to ensure that they are available at the right times for a closely coordinated series of sequential steps. This task can encounter hold-up problems. The last input committed to the coalition acquires some hold-up power due to the sunk negotiation costs and foreclosed alternatives already incurred by the other participants. Participants with high opportunity costs may insist on play-or-pay contracts that require them to be paid for their availability at a particular time even if the film is postponed or canceled. Play-or-pay commitments, though, can be renegotiated or traded off to another producer. Films sometimes fail because of defects in this contracting process, as when the coalition is assembled before all problems with the script are resolved or a key participant obtains a commitment to gratify some whim or preference that proves fatal to the film's overall success. However the process seems about as orderly as is feasible for investment decisions about which *nobody knows*, and the Hollywood studios at any time have hundreds of projects at some stage of development, so that those actually "greenlighted" have for better or worse survived an arduous winnowing process.

Motion-picture contracts commonly specify contingent compensation for major participants, bestowing shares of gross rentals received from exhibitors, net profits, or some variant on these. The exact incentive content of these deals is the subject of controversy. Participants sometimes take revenue or profit shares rather than straight compensation in order to assert their conviction about the project's merit. Contingent pay may also serve to induce effort, for example for the principal actor in the *n*th film of an action-adventure series [Chisholm (1997)].[19] However the compensation of highly-paid participants might be contingent simply because a gigantic fixed fee (the alternative) would shift enough of the film's overall risk on the other claimants to the film's cash

[19] Whether or not incentives are important in contingent motion-picture contracts, they are prominent in other contracts used in the industry. Goldberg (1997) showed how various contingent contracts reflect the timing of the opportunities open to various parties that can enhance the value of a deal.

flow to drive up their reservation prices substantially [Weinstein (1998)]. Whatever reasons for its use, compensation based on net profits suffers from the fact that the studio that distributes the film keeps the books in which net profits are determined. While the elements of creative accounting that enter studios' profit determinations generally have cogent economic bases, the studio has great scope for moral hazard by inflating judgmental costs and allocations that favor its own stake and invade the stakes of other participants – the notorious Hollywood accounting. The participants seek to avoid this moral-hazard problem by pre-negotiating the definition of net profits or demanding a share of gross revenue rather than profit, but transaction costs by themselves impair the use of contingent compensation.

3.3. Vertically differentiated talents

Complex creative industries employ teams of functionally differentiated creative talents, but their vertical differentiation – the *A-list/B-list* property – is also important for the industry's organization. Questions arise about how entrepreneurs selecting creative inputs and outputs deal with differences in inputs' quality. The obvious assumption is that the quality of a creative good perceived by the market generally increases with the quality of its creative inputs. An input's quality is optimally raised until the expected increment to revenue from the project falls equal to the incremental cost of quality. Another production relationship encountered in creative industries is that inputs' qualities interact multiplicatively rather than additively in determining the market's expected valuation – the O-rings production function. In these circumstances the failure or substandard performance of any one of them shrivels the value of the whole project. Also a high-quality input added to a project staffed with other high-quality inputs generates more incremental value than if it were added to a low-quality project. Faulkner and Anderson (1987) provide evidence supporting one implication: that the more successful producers, directors, and cinematographers tend to work together with significantly more than random frequency.

The importance of vertical differentiation in creative inputs raises the question as to what mechanism evaluates and records quality rankings of competing creative inputs. This is not quite the question of whom the gatekeeper admits and excludes, although admitted talents (visual artists, musicians, authors) undergo a ranking by critics' and consumers' evaluations. In complex creative industries such as cinema films, an economic mechanism underlies an evaluation process that continuously ranks the members of a given creative group. They rate each other's performances on professional prowess independent of the overall success of projects in which they participate. Each talent profits from having accurate knowledge of her own position on the quality scale: it reduces transaction costs and opportunity losses associated with competing for projects slotted above her quality ranking, or accepting projects targeted below it.[20] Knowledge of the prevailing rankings may generate value in other ways as well. For example,

[20] Analogous to the profit gained by a Cournot competitor from knowing accurately its variable costs relative to those of its rivals [Shapiro (1986)].

composers providing background musical scores for films sometimes become overcommitted and need to subcontract jobs to newly arrived and/or lower-ranked talents [Faulkner (1983)]; hence there is also economic value to the talent from participating in the random interchanges with peer talents in which rankings are discussed and assigned and the emerging consensus reported. Furthermore, interest in the *A-list*/*B-list* ranking of a given class of talents extends to other types of talents who participate in the common set of projects. Each needs to know the talent rankings in other specialties in order to infer correctly the quality ranking of the project as a whole. Thus the whole system operates to create and update a consensus judgment on creative talents' rankings that is available to producers when they select inputs for a project.

3.4. Distributing complex creative goods

Complex creative industries, like other fabricating activities, face the problem of efficiently distributing their product to ultimate consumers. Distribution here embraces informing consumers about the varieties available as well as making them physically accessible. Creative industries such as publishing and sound recordings face distinctive problems due to two underlying structural features. First, the creative product is an "experience good" that cannot be accurately evaluated by final buyers short of actually consuming it. The supplier therefore faces a problem of how to disseminate information that will hold some value for signaling a match to consumers' tastes. Second, the product line offered by an industry embraces a large number of individual differentiated goods that are bought at retail in small dollar amounts. The marketplace must solve the problem of efficiently distributing many small units and holding them in inventory to await the exercise of consumers' uncertain demands.

A distinctive factor for book publishers and record labels is that retail inventories themselves perform a promotional function, because consumers learn about potential purchases through browsing in retail outlets. The retailer captures part of the extra sales revenue generated through enlarging his inventory and makes inventory decisions in light of that partial reward. The publisher, who shares this revenue, has reason to induce the enlargement of retail inventories. The publisher could use several policies to achieve this goal, and two of them hold particular importance in practice. One, employed by U.S. publishers since the 1930s, is to allow the retailer free return of unsold books. This privilege reduces the retailer's cost of holding inventory and increases its level. The retailer still incurs the cost of packing and shipping unsold books for return, but this bite out of net revenue is likely less than the alternative of knocking down the retail price until the book is sold. The publisher incurs costs of printing and one-way shipping of returned books as well as dealing with the returns (pulping them, or disposing of them through specialized discount booksellers). An alternative policy, common until recently in countries outside the United States, is resale price maintenance (RPM), by which the publisher's contract with the retailer requires that books not be sold below the publisher's suggested retail price. RPM increases the bookseller's gross profit margin on books that due to retail competition might otherwise be sold at a discount – presumably "best sellers". It thereby increases the retailer's optimal inventory of best sellers. It could increase the equilibrium number of retail bookstores, but it does not directly promote enlarged inventories of less popular titles. Thus, free returns and RPM both rectify what are regarded as market distortions from the publisher's point of view, but each is prone to generate further distortions of its own. From society's viewpoint there is no presumption about which policy to prefer.

The promotional role of retail inventories holds another implication for the distribution of creative goods. The retailer's shelf space itself holds value for the publisher or record label because of the extra profit generated by additional copies sold to customers acting on impulse. That potential profit opens an opportunity for the retailer to charge the publisher for exhibition space in highly visible locations within the store, such as tables near the front door. Such "slotting allowances", also familiar in grocery retailing, similarly apply to other distinguishable forms of promotion that the retailer undertakes [Shaffer (1991)]. To the publisher, paying the retailer directly for the value generated by these promotional policies is a partial substitute for the free returns and RPM already mentioned.

When failures occur in contracts between producers and distributors, a classic remedy candidate is vertical integration, which substitutes administrative direction for arm's-length dealings. Integration has seen some use in creative industries, notably between record labels and wholesale distributors during the 1970s. It apparently arose from the labels' need to coordinate the distribution and promotion of those pop recordings with the potential for large sales. For example, when a musician tours in order to promote a new recording, large stocks of her new release and past hits need to move in timely fashion through the distribution sector and into retail stores in cities on the tour. Without integration the label cannot readily induce independent wholesalers to stock at levels that will maximize their joint profits.[21] The solution of vertical integration has important implications for concentration among the record companies that are discussed in the next section.

Thus, the producer of creative goods such as books and sound recordings faces interrelated problems of informing consumers and efficiently distributing many small units of differentiated creative goods. The available instruments, including free returns, resale price maintenance, slotting allowances among others, are substitutes for one another in some settings, complements in others.

3.5. Structures of creative industries

Many observers have noted the high concentration of sellers in several creative industries – in the United States, and also for some worldwide. Concentration has been rising

[21] The scope and role of independent book wholesalers has changed repeatedly, reflecting in an interesting way organizational changes in both publishing and retail bookselling, as well as underlying costs and technology; see Miller (2003).

in some sectors, long stable in others. It shows no signs of transience. In motion-picture distribution roughly five to eight major distributors have dominated the industry since the 1920s. Although the market shares of individual distributors fluctuate considerably from year to year with the success levels of their films, the group's combined share is quite stable. Sound recordings have become concentrated since the 1970s, with the largest five or six companies recently accounting for about 80 percent of shipments worldwide and with more concentration in prospect. In book publishing, once unconcentrated, the largest four U.S. publishers in 1993 accounted for 30 percent of wholesale revenue.[22] A common explanation for concentration lies in the scale economies and sunk costs of the physical distribution system. The evidence for sound recordings was noted in the previous section. For motion pictures the distribution system manages the promotion of new films, negotiates exhibition contracts with individual theaters and carries out the physical distribution of prints of each film. Compelling circumstantial evidence holds that distribution systems determine the concentration of these creative industries. In motion pictures the disintegration of both exhibition and production left the distribution systems in place and unchanged in their concentration. In sound recordings the concentration of production coincided with vertical integration into distribution [Belinfante and Johnson (1982)]. In book publishing physical distribution plays a less central role, but the promotion of blockbusters is a function that fosters large-scale firms [Whitesides (1981)].

This hypothesis about concentration and its roots in creative industries is usefully probed by examining the responses of these oligopolies to major disturbances. The toys and games industry, with many marks of a creative industry, shows a noteworthy contrast to films and sound recordings, with their stable populations of dominant distributors and churning fringes. Toys and games exhibit the same scale economies in the promotion of blockbuster toys, where indeed the degree of dominance of the most popular designs if anything exceeds that of other creative industries. In toys and games, however, there are no substantial sunk assets in the form of production facilities, distribution systems, or promotional organizations. Manufacturing is generally contracted out. When a toy succeeds wildly, sales of the firm that introduced it can suddenly expand greatly, but no new fixed facilities or lasting goodwill assets result. When a toy expected to be popular fails in the market, or even when the popularity of a continuing success declines unexpectedly, quite large toymakers can run losses and disappear overnight [Stern and Schoenhaus (1990)]. The record industry's responses to major stylistic shifts in popular music provide a valuable laboratory experiment. When rock 'n' roll first came on the scene, it offended the ears of the established artist and repertory (A&R) executives, who kept their companies out of the business. The result was increased churning in the weekly Top 10 records and deconcentration of the record industry. The incumbent leading firms learned a lesson, however. They became much more open, starting or acquiring new record labels to exploit new musical styles as they emerged, making use of

[22] *Billboard*, January 21, 1995, p. 42; *Book Industry Trends*, 1995, quoted by Greco (1997, p. 58).

the firms' distribution and promotion capacities and raising the industry's concentration to its current high level [Peterson and Berger (1975); Lopes (1992)].

This source of concentration in creative industries clearly reflects one distinctive underlying feature of their structures, the proliferation of differentiated creative goods *(infinite variety)* and the associated scale economies in their distribution. More subtly, it reflects another – the incompatibility of the romantic concept of the artist, as the autonomous creator working from inner necessity, with the requisites of collaboration in a large and hence bureaucratic business organization. The typical creative industry contains large-scale firms organized around promotion and distribution, but also a large number of small firms organized around the gatekeeping functions of selecting and nurturing promising artists. The latter activities require personal rapport and suffer diseconomies of scale in effectiveness when organized on large scales. The large firms whose sizes are driven by scale economies in promotion and distribution can be labeled *promoters*, the small firms specialized in gatekeeping and nurture are *pickers*. The advantage of their separation lies quite simply in keeping artists and bureaucrats out of each other's hair. The picker/promoter distinction clearly appears in motion pictures, TV films and programs, first-run TV syndicators, record labels, art galleries, and book publishing. Mezias and Mezias (2000) identified essentially this distinction in the early (1912–1929) motion picture industry between the generalist firms vertically integrated in production and distribution and the innovative specialist firms operating at only one of these stages. It also appears in creative industries that fail to exhibit levels of concentration that are high by common standards. Picker art galleries are typically run by individuals with strong sympathy for and involvement in creative processes in the visual arts, hence well-attuned to dealing with artists. Promoters tend to represent artists who have achieved some measure of success and can be attracted away from a picker gallery by the offer of more effective promotion on a larger scale.[23] Agencies representing classical musicians similarly divide into small-scale units that take a hand in their artists' personal development and large-scale units suited to the job-matching tasks of assigning the top performers.

Another factor explaining differences in the organization of creative industries is the way in which the cost of quality varies with the quantity of output produced. If quality is a variable cost, high quality will enter into marginal cost. Firms offering different quality levels at correspondingly different prices will likely survive in the market. If quality is a fixed cost, however, it does not enter into marginal cost, and a high-quality firm will tend to undercut lower-quality competitors. The market will be highly concentrated with little variation of price with quality; where quality is a variable cost, more competitors will survive, and a range of qualities will be offered at diverse prices. Berry and Waldfogel (2003) showed that this difference in the variance of prices holds between two local creative industries – restaurants (quality enters into the meal's marginal cost)

[23] An important feature for the viability of these two classes of enterprise is the ability of the pickers to realize capital gains on works created by successful artists before their prices were lofted by large-scale promotion.

and newspapers (tabloid and "newspapers of record" incur the same marginal printing costs). Fixed costs of quality contribute to explaining many important features of creative industries, including the "superstar effect" [Rosen (1981)] and the dominance of the United States as a supplier in the world market for cinema films [Wildman and Siwek (1988)].

3.6. Multi-activity firms in creative industries

Large firms in creative industries commonly engage in numerous activities, earning them the label of "entertainment conglomerates". The term is deceptive, however, because their parts are assembled in ways intended to generate rents – extra net revenue over what the same activities could earn if organized as free-standing single-business firms. Synergistic gains claimed by managers bent on merger often come into question when subjected to economic analysis.[24] One business model of gains from diversification stems from the observation that core creative works can yield rents from their embodiment in a number of different forms. The novel that arrives on the doorstep of a trade publisher is first issued as a hard-cover book. Then it appears in paperback. It is turned into a screenplay for a motion picture. The motion picture is "novelized", the screenplay turned into a book with still photos from the movie. The soundtrack score is issued as a recording. A television series is conceived as a spin-off from the movie. The simplistic account of organizing these transactions holds that the firm possessing a business in each product line can simply pass the core creative input along from one of its divisions to the next, with cash gushing forth at each step. The problem with that program, of course, is that the author of the primary book manuscript is the legal owner of the core intangible asset, and she (or her literary agent) can readily stage an auction of this literary property in each of the markets where rents can be generated. Standard hard-cover publishers' contracts have sought to divide the rents from subsidiary rights evenly between author and publisher. Indeed, that distribution might be agreeable to (optimal for) a novice author whose novel lacks manifest signs of major subsidiary-rights potential, so that the value of these rights depends substantially on the publisher's efforts to develop and promote the work. However acceptance of that arrangement is the author's option. If the author chooses to stage her own auction of subsidiary rights, it is not obvious why bidders affiliated with the hard-cover publisher should be able to wring more value from the project than independent bidders and therefore to prevail in the bidding. An auction is a highly efficient device for extracting value from bidders and a successful conglomerate needs some special trick to generate more value than independent firms bidding in the author's auction.

[24] That risk-spreading is not featured to explain the diversification of firms in creative industries may seem surprising. The case for imputing a risk-averse preference function to the publicly-traded firm is always shaky, and little empirical evidence ties the entertainment conglomerates' behavior to risk aversion. Smaller firms in creative industries, whose uncertain cash flows directly affect the welfare of potentially risk-averse individuals, commonly behave as if they are risk-loving due to *art for art's sake* (see Section 2.1 above).

This is not to deny synergistic gains for entertainment conglomerates, but rather to point to the stringent conditions for realizing them. When core creative elements can be embodied in many different forms, some ways to create value may not be fully exploited by sequential independent auctions. The cash-flow streams of the diverse embodiments likely are interdependent. Coordination at the outset in styling the element for its first use raises its value in subsequent uses as well. Outlays to promote one embodiment yield spillover benefits for others that must be taken into account in order to maximize value. Internalization can facilitate this coordination, which is likely difficult at arm's length.

Another feature of creative industries that promotes multi-activity firms grows from the public-good character of some core creative products. The cinema film, the television sitcom series, the pop song or recording once created can be used repeatedly at no marginal cost, or at only a small incremental cost of putting the good in another form. However the creative good must earn rents in these various uses if its original fixed cost is to be recovered. No matter how many creative goods compete for any given use, nor how closely competitive are their providers, the equilibrium price must exceed the zero marginal cost.[25] This property of all information-type goods creates incentives for vertical integration between businesses that provide creative content and those that distribute it. Consider one of the vertically integrated firms that account for most U.S. television networks, say, Disney and ABC. If ABC shows a film from (say) Paramount's library, the payment is a cost to ABC and a rent to Paramount. If ABC instead draws from Disney's library, any payment is purely an internal transfer, and Disney/ABC incurs no cash cost. The incentive to internalize the transaction applies to Paramount-UPN and any other integrated firm comprising a content provider and distributor. The individual firm's incentive to internalize this rent transfer might be augmented by a strategic consideration. A non-integrated firm that depends on vertically integrated rivals for content or distribution feels itself vulnerable to foreclosure by its integrated rival. Foreclosure and refusal to deal are by no means necessarily profitable to an integrated aggressor, but states of nature can occur in which they would be; in such vertically related oligopoly industries firms commonly explain their actions as if they believe that the likelihood of a costly hold-up is substantial.[26]

This incentive to internalize transactions and ensure against foreclosure would apply in any industry that produces information, or any other good with a fixed but no marginal cost. It holds further significance in creative industries, though, because of two of their distinctive properties: the great uncertainty about consumers' valuations of a yet-uncompleted good *(nobody knows)*; and the prevalence of large numbers of products (movies, sitcoms, pop recordings) that are close but imperfect substitutes *(infinite variety)*. When the ABC network restricts itself to showing Disney programs and

[25] If competition between vendors of creative goods drives their prices below average cost, equilibrium requires that some sellers exit until a price no less than average cost is sustainable.

[26] For a rigorous demonstration of how a firm could gain by vertical foreclosure, see Ordover, Saloner and Salop (1990). A connection to incomplete contracts is made by Bolton and Whinston (1993).

movies, it narrows its choices and presumably offers viewers a less attractive menu than if ABC picked freely among all studios' offerings. This is a real cost of the internalization, though (with close substitution) likely a small offset to Disney–ABC's business-stealing gain from internalization. Another real cost arises from the internalization because the distributor of programming probably has some useful experience for assessing the prospect of new entertainment investments. Dealing at arm's-length with content providers, the distributor might create some value by occasionally warding off a turkey-in-the-making. If Disney instructs ABC to take program series produced by Disney, this critical input is stifled unless the distribution arm can preserve considerable bureaucratic autonomy in the face of the basic incentive to steal business from rival content providers.[27]

4. Role of non-profit enterprise[28]

An important aspect of industrial organization in the U.S. creative industries is the incidence of non-profit organizations (NPOs). They dominate the performing arts (except for Broadway theater) and share dominance of "cultural storage" activities – museums, libraries – with public-sector firms. Substantial fringes of NPOs appear in other sectors such as publishing, music recording, and broadcasting. This pattern invites an explanation why NPOs appear where they do. Two distinctive features of creative industries, interacting with each other, seem to offer one. The first is the combination of high fixed and low marginal costs that prevails in many creative activities. The second is the prevalence of *art-for-art's-sake* tastes, particularly those pertaining to the quality and variety of creative goods.

4.1. Non-profits and governance in creative industries

High fixed costs pose a problem for any industry if sellers are constrained to charging a single linear price. In order to cover average costs, the equilibrium price must substantially exceed marginal cost, even when large numbers of sellers compete. Indeed, if fixed costs are sunk at the outset in a two-stage market game, the maximum viable number of sellers may be limited to the few that can cooperate and avoid price competition in the second stage (after the fixed costs are sunk). The gap between price and marginal cost inflicts a deadweight welfare loss, and high-fixed-cost industries have an incentive to avert it by means of non-linear prices or price discrimination. Non-linear pricing involves charging each customer a combination of fixed and variable prices, with the variable component ideally equal to marginal cost and the fixed component

[27] See Caves (2005, Chapter 7) on the consequences of removing regulations that limited the internalized ownership of TV program series.

[28] For further discussion of this topic see Brooks' Chapter 15 in this volume.

high enough that total revenues cover total costs but without excluding any customer willing to buy at marginal cost. In addition, or instead, the enterprise may be able to align prices with customers' diverse levels of willingness to pay. This might be done by allowing customers to choose different bundles of services (à la carte admission fees or an annual membership – second-degree price discrimination). It might be done by charging prices aligned to individuals' differing levels of willingness to pay (discounts for seniors and students – third-degree price discrimination). All these devices of course turn up in many markets dominated by profit-seeking enterprises. What is it about creative industries that pushes them toward NPO status when high fixed costs are present?

The answer seems to lie in the difficulty in creative industries of managing the contracts that implement non-linear prices in an enterprise run by a profit-seeking manager. The fixed charge (membership fee, say) must be committed at the start of the season before the product (performance) is actually on display. The consumer's willingness to prepay depends on the expected variety and quality of performances to be offered during the coming season. The list of plays to be performed might be contractible, but not the myriad stylistic and quality-related choices involved in presenting them. What then keeps the manager from promising high quality, offering lower quality, and pocketing the profit? The manager's *art-for-art's-sake* tastes may come to the rescue, if the organization is non-profit and the manager can credibly display a preference for high-quality and innovative performances. Moral hazard is then kept at bay. This mechanism may also facilitate the contract between the manager and performing artists, whose own *art-for-art's-sake* tastes make them willing to sacrifice pecuniary compensation for the opportunity to reach for artistic innovation and excellence. Their employment precommitment may turn on the manager's shared tastes, like the audience members' season tickets.[29]

The NPO is thus hypothesized to succeed because the manager's publicly espoused tastes mitigate the governance problem facing consumers, when they are asked to cover the fixed cost now and enjoy the performance later. The mechanism seems even more persuasively coherent when we think of the ongoing NPO in which the manager mounts this season's performances and then passes the hat for contributions as well as requesting membership renewals. Audience members' enthusiasm for the preceding season's offerings presumably determines not only the incidence of renewal but also the generosity of donations.

4.2. Two-part pricing in practice: The donor-supported non-profit organization

The specific form of organization that provides the empirical embodiment of the NPO is the donor supported NPO, characterized by a self-perpetuating board of directors.[30] Its

[29] Hansmann (1981) developed the theory behind this model. For an empirical study of the alignment between regional theater directors' values and outside interest groups, see, Voss, Cable and Voss (2000).

[30] Sociologists get credit for identifying this form [DiMaggio (1982, 1986)] and researching the mechanisms that make it effective [Ostrower (1996), Odendahl (1990)].

board consists chiefly of wealthy consumers of the NPO's services, whose board memberships reward past financial contributions but also carry the expectation of continuing support. These persons are not necessarily effective monitors or managers of what may be a large and complex organization, but they are strongly motivated to ensure the viability and success of the organization by a sort of "social equity" that they hold, and that yields a return of esteem when the organization performs well and loss of face when it does not. Studies of such NPO board members show that their fund-raising efforts and administrative service to the organization are important relative to their role as personal donors [Ostrower (1996)]. This institution arose in nineteenth-century America, and the symphony orchestras, museums, and other such cultural enterprises organized in this manner were markedly successful in delivering "quality" in the organization's product relative to the for-profit enterprises and cooperatives that preceded the NPOs.[31]

Research on the ecology of donor-supported NPOs confirms this model of governance and its implications for the population of these firms. The model implies that donations should function as a regular, planned component of the organization's resource intake, as distinguished from an emergency topping-up when the organization suffers a negative fiscal shock. Financial flows over time indeed do behave as if both direct box-office revenues and donations maintain a stable average relationship to the organization's costs, subject to random year-to-year shortfalls and surpluses. Negative shocks may well occasion special flurries of fund-raising, because the NPO generally has no equity capital to absorb such shocks (an endowment, of course, may perform this function). Other relevant research deals with variations in the population of NPOs from city to city. The weight of fixed costs for such organizations implies that no market can efficiently support a large number. When small and large metropolitan areas are compared, the number of NPOs in a given class tends to increase with city size, though less than proportionally, and where larger numbers of NPOs of a given type tend to persist, they are commonly differentiated in their functions, reflecting in turn the cultural diversity of the city in question [Blau (1986)]. Finally, the aggregate U.S. population of arts and culture NPOs has grown over time at rates responsive to major changes in tax policy and in the ecological niches opened by the growth of the national economy [Bowen et al. (1994)].

5. Conclusions

A standard research line in industrial economics seeks to explain the level of or changes in the number and size distribution of business units within an industry. Some of our conclusions follow in that tradition. Like others, the creative industries' structures tend

[31] Symphony orchestras in nineteenth-century America provide a particularly interesting case study. NPOs competed with and vanquished other organizational types, i.e. for-profit firms and cooperatives [Hart (1973); Shanet (1975)].

to be driven by the efficient scales with which creative goods are produced and distributed (very large for record labels and movie studios, small for art galleries). Firms tend to sort themselves into those focused on the distribution of creative goods ("promoters") and those concerned with identifying and nurturing creative talents ("pickers"). Large enterprises also include the "entertainment conglomerates", which seek synergistic gains that depend theoretically on quite special conditions; foreclosing others and avoiding foreclosure by them may be principal motives.

What distinguishes the organization of the creative industries, however, is the prevalence of distinctive types of contracts. These contracts govern collaborations between artists and other parties in arm's-length relationships or within an enterprise. These contracts' structures devolve from a few bedrock properties of creative work and creative products. Two broad types of contracts hold particular importance in the creative industries. Some amount to joint ventures in which artists and "humdrum" inputs (perhaps one of each, perhaps many) collaborate simultaneously to obtain some valuable output. When these production processes occur not simultaneously but in sequence, real option contracts pervasively govern the sequential steps. Option contracts can leave the artist an autonomous creative agent (pop musicians and record labels) or govern the use of their talents to an employment relationship (classic Hollywood studios).

Our interpretation of these contracts and patterns of enterprise organization invokes the self-interested economic actors adapting to the fundamental elements of tastes and technology that characterize creative industries. That statement might appear in any analysis of an industry's organization. Indeed, it usually does. The creative industries are striking, though, for possessing specific properties of tastes and technologies – the axiomatic properties listed at the start of this chapter – that supply theoretically coherent explanations for the structures of contracts and organization of enterprises. It has not been feasible to frame these interpretations with formally testable hypotheses, but the many points of agreement between casual empirical evidence and predictions based on these basic properties are certainly encouraging.

Besides deal structures and enterprise populations, the organization of an industry also embraces the prevalent type of firm – in this case, the role of non-profit enterprises. They dominate a number of arts activities, apparently for two interrelated reasons. These activities incur high fixed but low marginal costs, pressing them to employ two-part prices and club arrangements to ensure the coverage of fixed costs. When product quality is endogenous, however, non-profit status may be necessary for the manager credibly to foreswear degrading quality once the customers' fixed payments are in hand. Non-profit organizations supported by donation streams thus enjoy functional advantages.

While the creative industries are no fecund source of data bases, they do provide many opportunities for further research. The following list is confined to points that received rather conjectural treatment in this survey – theoretical propositions that could change greatly when formally worked out, or readings of qualitative empirical evidence that might turn out to be faulty generalizations.

- The organization of agents' activities and their roles as matchmakers and intermediaries have been little studied. The existing literature on intermediation does not match up well with the empirical questions that arise in the creative industries.
- Sticky, conventionalized prices present a puzzle. Are they really sticky, or do "list" and "transaction" prices diverge? If the stickiness is real, do the theoretical conjectures offered here stand close examination?
- The recent wave of vertical integration in the "entertainment conglomerates" suggests issues of foreclosure, especially in industries with zero marginal costs, that have not been worked out.
- The talent guilds that prevail in the creative industries arose long ago in response to contract failures. However it is not clear how their objectives in the ongoing entertainment industries might be characterized.
- The literature of contract theory assigns great importance to renegotiation, and renegotiation (shading into repeated interactions) seems to play an important role in the ongoing balancing of equities in the creative industries. Can empirical evidence be developed and related to theory?

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