On the preservation of Australian content rules
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This submission presents an argument in support of Australian local content rules. It is a theoretical argument which supports a policy of local content in principle only. The argument applies to any form of entertainment broadcasting, though the examples discussed relate to film and T.V. There has been no attempt made to estimate how large these content requirements should be, nor indeed whether the current rules should be strengthened or relaxed. Part A of the submission presents the argument in lay terms. Part B presents it in terms designed to be understood by economists. Those intolerant of polemical writing should probably skip part A. A more formal argument along the lines of part B could be constructed, but it would serve little purpose since the assertions should be largely self-evident to most economists. Note also that this argument is almost certainly not new. I have, however, been able to find no formal presentation of it in the literature. But this just may be because it is so simple.

Part A: The argument in lay terms.

It is impossible to capture the full social value of an innovation in the world of entertainment. The reason being that it is too easy to copy the innovative ingredient in an alternative format, produce another show with that ingredient, add some relatively minor differences to avoid outright plagiarism, and create as successful a product. It is the nature of art that it builds on previous art. It is what people mean when they say art is a discourse or a dialogue. In the arts, innovators create huge benefits for future innovators, they also create these huge benefits for talentless copiers, and, in the process create even larger surpluses for future consumers. All of these surpluses are benefits that they are unable to capture when they sell their product to the network, for the simple reason that the network is unable to capture these surpluses when they broadcast the product.

Consider a scriptwriter with a new idea. She wants to try something innovative and has a hunch that people will like it. In a free market she would try to sell the idea to a production agency who, if supportive, may take it on, get funding, undertake production and then sell the product. If it sells enough, the company will be able to recoup their costs and perhaps even turn a profit. Everyone is better off; consumers have a new product which profits signal was valued, and the scriptwriter and production agencies have made a buck. Of course, for every idea that is made, there must be hundreds or perhaps thousands that never see the light of day, for every production which turns a profit, there must be numerous that make a loss. On the funding side, markets work pretty well, capital flows ensure that the blockbusters are outweighed by the failures, so that, on average, risk weighted returns on a dollar invested in movies should be no higher or lower than the same plunge on the stock market.

Economists do not advocate regulating other investments, why then should we regulate these? Well, consider our rare production successes. These shows strike a chord in the viewing population, a chord that can be struck again. Information about viewer's tastes is generated, information that the viewers themselves probably didn't have. Future producers can look at this information, and either shamelessly copy the successful ingredients, or incorporate them into their own shows. It is just not possible to protect most of the intellectual property generated by the first successful production. In the language of economists, this information is an externality.

The artists who have pushed the frontier, innovated and experimented to find a new source of pleasure that consumers did not even know they had, can get some reward for this in the market, but not a reward that is commensurate with the full value of what they have discovered. This is because there is nothing stopping others coming along and cashing in on their discoveries. We thus have an argument for why we should support innovative programming and production. An argument for why some artists should try to judge the artistic, and perhaps popular, merit of their peers' ideas, and allocate money which we have all chipped in for them to use. It is an argument for funding to the Australian Film Commission and the arts, but not clearly an argument for Australian content rules.

How then do Australian content rules help? In a world of imperfections they are a way to force a market for Australian product in the commercial networks. This raises the networks' costs, they could probably buy cheaper overseas produced shows without a considerable loss in audience and hence advertising revenue. By creating a market for the Australian product, we lower the level of expected loss that these funded Australian productions will make. We should subsidize new and creative Australian productions for the reasons outlined above, Australian content rules work to make sure that some of that subsidy is coming from the commercial networks, by lowering their bottom line. So it really is just a tax on the networks. Another way to raise this tax might just be to forget the content rules, and tax the networks' profits directly. This would make the incidence of the taxes equivalent. Furthermore this could then go into direct subsidies of Australian productions so that the beneficiaries would also be equivalent. There is, in fact, a powerful argument for just this sort of taxation to replace the content rules that is suggested by most elementary economic analyses. That argument runs along the lines that direct and non-distortionary taxes (like a profit tax) with direct production subsidies, are likely to be more efficient than a convoluted subsidy, like a content rule. Such direct subsidies, it is argued, would lower the net costs of Australian production and, if set right, would lead to more Australian content anyway by lowering its cost to the networks. However, there are some subtle differences weighing in favour of the content rules that I want to now consider.

The fact that the networks are forced to buy Australian product means that the margin of profitability in Australian productions is moved out a little. Subsidizing productions in this way makes the decision about the profitability of an undertaking depend, at least in part, on the marketability of the final product. This is because, with a minimal content requirement, the networks still want to ensure that the Australian product they do show is as popular as possible. Contrast this with what would happen if subsidies to Australian production were financed by a tax, and then distributed by funding bodies. As with all arts funding decisions, this would eventually lead to the people with most peer respect (and perhaps political connections) deciding on who gets the funding. Ideally, the real artists, those individuals with a proven track record of creativity, and a solid body of work behind them, would eventually be making the decisions. This is because, in the coterie of people who make movies, those individuals are the ones whose work ultimately commands respect. I conjecture that what would then happen is that the type of product receiving a subsidy would fundamentally change.

There is a serious danger that Australian production would then become the source of Truffautesque type classics, which would be hits in art school but not with the public. This is because the work with the most critical value to the community of artists would be funded, and this would not coincide with the work that is currently being subsidized by local content rules. By subsidizing production through content rules on the networks, in contrast, an eye is kept on the market, and in turn, this guards against producing things full of artistic merit but without popular value. We should still have funding distributed by arts bodies: the genius work should get funded. But forcing commercial interests to buy Australian products also has an important role.

If you buy the argument above, then a natural question is why not just free-ride on the pioneering work of others overseas, like the BBC? That is, let them fund innovative productions, and risk the big losses. When they come up with something good, we'll just buy their product, or steal their formulas, and make them work here. In fact, there is an argument to be made for this sort of behaviour in the world of pharmaceuticals. Why should we come up with an Australian cure for the cold? Colds here are just like anywhere else, we should wait for smart scientists in other countries to discover a cure, and then buy it cheaply.

Well, apart from the fact that this is perhaps morally wrong, it implies that there is nothing different about Australians and British, in terms of viewing interests. That seems incorrect; entertainment goods are not like colds. The places where British artists are likely to search and explore when they push the boundary are not the same as the places Australians are. If we free-ride on their product and wait for them to innovate, we are failing to provide incentives for our local artists to discover things that mean something to us, and us only. I think this is the thing that most people fear when they imagine a world without Australian productions. They fear a world where the distinctive things that make us Australian will no longer be addressed, and will consequently eventually die. These content rules are a subsidy to Australian productions which incline innovators to look for things that will resonate with Australians uniquely. (The things that will resonate on a world market will get produced anyway, there is no need to subsidize them.) These rules create a value to this search activity which would be artificially low in the absence of content rules, due to the inability to protect one's valuable discovery. Because we are different than other cultures, these innovators will then necessarily look in places that overseas producers would not, and it is this search process which addresses our cultural differences (some would say serves to define them) which is the true source of externality.

Finally, it should be noted that the argument advanced here is distinct from the usual argument in favour of content rules based on a 'cultural externality'. That argument suggests that individual consumers are unwilling to pay the full social value of an Australian product. (I may not want to watch 'Sea Change' but I'm made better off by the fact that it is being produced here anyway.) Because of this, it is argued, the networks and radio stations do not find it profitable to play Australian shows, even though they are valuable to Australians, and if the full social value were paid, they would be broadcast. The argument made here instead identifies a different and more likely externality: successful new forms of entertainment tell us things about our own tastes which are valuable, which are not protected as intellectual property and which should be encouraged.

Part B: The argument in economic terms

The argument for Australian content rules forwarded here involves three distinct propositions.

(1) There exists a free-rider problem in the provision of entertainment or cultural goods necessitating a subsidy to local innovation.

(2) Australian content rules are a market oriented quota scheme promoting local innovation that overcome a political capture problem in the peer review process of funding for the arts.

(3) Local tastes differ from the rest of the world, thus, unlike, for example, pharmaceutical products, it is not optimal for Australia to free-ride on innovations elsewhere.

Part (1): One can imagine the production decision of an innovator in the world of entertainment as being to choose their point of location along a continuum that represents the distribution of consumers' preferences in the population. Of course, reducing the myriad variables in production and the heterogeneity of preferences to a single dimensional continuum is a gross simplification, but it helps in fixing ideas. At some points on the continuum the density is already well known. That is, it is well known that locating at some points will find no consumers while at others there will be a relatively large market that is already well supplied. However, there are also other segments of the continuum where there is no information about the density of consumers' preferences. The innovation problem can be thought of as an attempt to find new mass points along those segments. This is a risky and costly process since it involves producing, marketing and distributing the product before the information is revealed. These are large fixed costs which, in the case of failure are largely non-recouped.

Whether successful or not, the location decision reveals a huge degree of information about the state of the market. If a points is found to be unsuccessful, no other producer will try there for a while. If a mass point is found, others will enter and locate right on top of the original innovator, stealing market share. Can this stealing be stopped? In the case of entertainment, clearly not. Even minor differences in appearance are sufficient to overcome copyright laws. One cannot steal a script or song outright, but stylistically, new producers can come terribly close. This inability to protect the information generated about market location gives rise to a free-rider problem.

Part (2): The free rider problem in (1) implies inefficiently low levels of experimentation in equilibrium. A corrective subsidy targeting domestic production should thus be undertaken. However the allocation of subsidies through a process of peer review risks capture by a set of individuals whose tastes do not coincide with the individuals along the continuum. In particular, it is highly unlikely that those individuals deciding on funding, usually successful artists themselves, will have tastes reflecting the general population. The local content rules overcome this problem by forcing the networks to implement the subsidies through their purchasing decisions. The networks, being motivated by profit, do not care about the artistic merit of productions, instead they buy products which they estimate will gain largest market share, and hence largest advertising revenue. In this way then, local content rules align the subsidizing decision with the preferences of the general population. This is actually a remarkably market oriented form of subsidy targeting, and it is unlikely that such an alignment would be achieved through the process of peer review. Note, however, that peer reviewed subsidies are also valuable in their own right. Society is enriched by works of creative genius, and they should be subsidized, but that is a different argument.

Part (3) Why not free-ride on innovative activity in other countries?
The simple answer is that the distribution of consumers on the Australian continuum differs from that in other countries. Of course this is not true for all dimensions of preferences. Australians might have very similar preferences to Americans over documentaries, but differ in their tastes over situation comedy, or have similar preferences on comedy to the British but differ on drama. It is in this sense that cultural goods differ from more standard goods like pharmaceuticals for example. In fact, there is a good argument for the major health providers to exert monopsony power in driving down the price of pharmaceuticals in Australia, since most of these are purchased from overseas providers whose incentives to innovate are not affected by the price they obtain in Australia. But pharmaceutical goods are relatively homogeneously valued across countries whereas cultural goods are not. This is an empirical assertion that seems undeniably true to me. In fact, it coincides with what we mean when we say places have different cultures. If we believe that Australia actually does not have a distinct culture from the major overseas sources of cultural goods, then the argument here has no value.

Note that this argument has nothing to do with 'cultural externalities' which are a bad argument for local content rules in my view. There does not exist some mysterious wedge between the social valuation of a product and the price consumers are willing to pay for it in the argument I have outlined. Instead, cultural innovations create non-excludable informational externalities that can be readily profited from. These give rise to a free-rider problem which means that they are under provided without countervailing government intervention.

Finally, a note to the regulators: all that it seems anyone can state here is arguments made on the principle of content rules. I have argued for the rules in principle, of course there are powerful counter arguments against them. In particular, it could be argued that taxes and subsidies be as transparent and direct as possible. Given no clear guidance provided by theory, the question of whether the rules should be strengthened or weakened is thus an empirical one and should be determined by estimation of their true social value. There seems to have been a distinct lack of such estimation so far.

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