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Organizing the Finances of the Arts: An Overview

If the arts are to play their hoped-for role in the economy and culture of our cities, access to the arts must be broadly available to the public. This requires a fundamental rethinking about economic support of the arts and the responsibility that government and business bear toward artistic enterprise. While many of the traditional terms of economic analysis are usefully applied to arts organizations, others need revision. Some new insights on the financing of artistic endeavors can be provided by employing a supply/demand approach that is appropriate to the arts and, in addition, by applying the concept of public service budgeting. The result allows a new way of viewing and understanding the role that government and private groups should take as partners in financing the arts.

The Multi-Market Structure of the Arts

Arts organizations typically offer three interrelated classes of products and services. First, multiple products are associated with a single performance. The Founders Circle patron has a different experience than does the customer in the last row of the third balcony. The price scaling of the house is a simple manifestation of this multiplicity. Correspondingly in the visual arts, a corporate evening at the Treasures of Tutankhamun is a different experience than that of a viewer who stands in line for hours waiting for a chance to get inside. Second, many arts organizations provide a variety of merchandise which is somehow related to its image of mission. Museums are often more developed in this domain than are the performing arts. All products showing the affiliation of the patron to the arts event or organization are in this class, from T-shirts and tote bags to expensive recreations of ancient Egyptian jewelry. The demand for these products is highly dependent upon the market for the artistic output of the organization. Price for these products is more understandable in terms of the character of the arts organization than in terms of the price of somewhat comparable items distributed through other channels. The third class of products and services deals with the "market" of grants and contributions. For all not-for-profit, tax-exempt [501 (c) (3)] arts organizations, this

represents a legislatively-created market wherein the government provides indirect encouragement for individual and corporate consumers to "exchange" with the arts for what economists sometimes call the "psychic" value of the arts.

Arts organizations are created for aesthetic purposes. The accomplishment of their artistic mission is the primary reason the government grants them not-for-profit status. To continue pursuing an artistic mission, the organization must maintain financial solvency. The financial reality an arts organization faces is simply that in the long run, the total revenue it receives from delivering the three classes of products and services must exceed its total expenses.

In order for the management of an arts organization to deal adequately with the problem of long-term financial stability, the degree of interdependence of the markets for the three classes of products and services must be recognized. For example, consider the issues involved in establishing a price for a performing arts organization's most expensive seats. The Founders Circle of almost every major performing arts group is fully subscribed. If considered independently of all other exchanges, the point of revenue maximization would be found by increasing prices until the increase in revenue per subscription was balanced by the drop in revenue due to a decreasing number of subscriptions. Considering the broader class of performance-related exchanges, an arts organization may wish to fully subscribe the Founders Circle, even at a price less than that indicated by the revenue maximization procedure, in order to minimize unauthorized migration from less expensive seats to the Founders Circle.¹ Considering other interdependent classes of products and services, the organization might investigate such questions as: "How do increases in the price of the most expensive seats impact the contributions in excess of ticket price from that group of subscribers?" An arts manager need not make these complex pricing decisions on the basis of conjecture. In most arts organizations some relevant data are available or could be gathered. The point is that revenue decisions concerning products in one market have implications for revenues in other markets.

Interrelated Sectors

The multiple exchanges between an arts organization and its publics are complex and interdependent. The complexity at the micro level of an individual arts organization is mirrored at the macro level by the exchanges among sectors of the economy.

In considering the arts within the mixed economic system that we have in the United States, we need to be concerned with the market for exchanges among four sectors: (1) government, (2) for-profit enterprises, (3) the not-for-profit sector, and (4) the consumer. *Government* gets its wealth through taxation of all sources of revenue—land, capital assets and wages. It has a most elaborate, guaranteed and enforced cash flow system. *For-profit enterprises* encompass those enterprises which organize to respond to the rules of the economic market. Enterprises which profit tend to survive, while others do not. The *not-for-profit sector* is used here in the narrow sense to include just those organizations granted tax-exempt status by the federal government. This is the government's licensing mechanism which admits qualifying organizations to full competition in a market of exchanges involving grants and contributions. The *consumers* in this market are individuals, foundations, corporations and governments at all levels—when they allocate their resources to the arts or other not-for-profit organizations.

An expanded set of rules, compared with those of the economic market, apply to the exchanges with not-for-profit organizations. In many ways these rules are closer to the ideal of free enterprise than are the rules governing the for-profit sector. As a consumer one may decide how much to allocate to the not-for-profit market, although government has imposed some rarely reached ceilings. One may decide with whom to exchange in the classes of general charitable, scientific, educational, public service, and arts and cultural organizations. These are the broadest of latitudes. Gone are the restrictive requirements of resource allocation in the profit sector. In the profit sector the guiding rule, though often ignored, is to seek to maximize profits. This is the generic mission and guiding direction of for-profit enterprises. The tastes and

values of people and corporations are much broader than that which can be rationalized in terms of the unidimensional criterion of dollar profits.

Here it is good to note that the classic "rational economic man" really thinks in one dimension. "Psychologic man" (if one may counterpose another facet of man) thinks and feels in many dimensions and "exchanges" with the environment across all of those dimensions. A genuine free enterprise system would certainly enfranchise as many exchanges in as many ways as possible. The very broadest class of exchanges would certainly include the "psychologic man's" many dimensions of exchanges as well as the "economic man's" one dimension of exchange. To assert that the free enterprise system is synonymous only with the organization of the profit sector is to narrow the concept of free enterprise. The market exchanges are limited. Government first knocks out what it calls "illegal" exchanges. Among the legal exchanges which remain are transactions which in some degree run counter to the rules of the economic market. Government then says, here is a set of organizations whose not-for-profit mission should be the primary determiner of their direction. They are free to proceed, *if* they can acquire sufficient resources from the exchanges they make. *goal* *disturb*

Most visual and performing arts have a consumable product of some sort and consequently compete for resources with the profit sector. The profit sector may respond that *its* rules should govern. That simply is not true in law or in fact.

The facts are borne out by a careful look at the economists' demand curve. In many cases, government is hampering the ability of the arts to exchange for all of the resources implied by the demand curve. We need to go back to the simple demand curve to see the nature of the resource problem of the arts.

A New View of the Demand Curve

Figure 2 presents a traditional economic display. *Price per unit* is the ordinate and *quantity demanded* is the abscissa. The chart gives an approximate representation of how demand changes with price per unit. When the price is low, as indicated by p_1 ,

the quantity demanded is high, as indicated by q_1 . As the quantity available decreases to q_2 , the price consumers are willing to pay increases to p_2 .

Economists traditionally explain the rise in price that consumers are willing to pay by alluding to the scarcity of the good or service. The scarcity explanation is based on a model of man which asserts that he receives economic value not only from the consumption of goods and services, but also by excluding others from doing the same.²

However, the principle of scarcity runs counter to the principle of access to the arts. It is thus incumbent on the arts to consider richer explanations of this phenomenon. When the demand curve is looked at as representative of individual behavior, it suggests that different people are willing to pay different amounts for the consumption of the same good. If the arts are able to develop other ways to get consumers to express their full economic valuation of artistic goods and services, access to the arts can be more fully realized. To a certain extent all arts organizations are currently attempting to do this, but a more systematic investigation of the demand curve and its implications can clarify and assist these efforts.

The quantity of services an arts organization should deliver cannot be determined from the demand curve in the same way that it is for products in the profit sector.³ Over a period of years, an arts organization experiments with the delivery of different quantities of services and experiences the resulting revenues and costs. The mission of the organization, the constraints of shared facilities and touring, the labor-management agreement, the diverse requirements for creative vitality of the artists, the responsiveness of local, regional and national communities, and a number of complex economic dependencies all enter into the deliberations concerning what quantity of services should be delivered. For convenience, and without loss of generality, we can let the quantity which results from the deliberations be denoted as q_1 . From the demand curve we can tell that if the arts organization prices its services at p_1 , all of that quantity will be consumed with resulting ticket revenues of $p_1 \times q_1 = r_1$. This revenue is represented by the sum of areas 3 and 5. A *public service budget* could be developed to determine what it should cost to deliver q_1 artistic services or goods when the organization is living up to its obligations and potentials and

exchanging fairly with its members. The total costs could be such that the organization would have to charge price p_2 for all q_1 goods or services to recover all costs (i.e., $p_2 \times q_1 = \text{total cost}$).

It is necessary here to clarify the concept of *public service budget*. When the government grants an arts organization 501 (c) (3), not-for-profit, tax-exempt status, the standard formulas which produce equilibrium prices for goods in the marketplace do not apply in the same way. The cost is separated more completely from the revenue. Since a single marketplace does not account for all the revenues an arts organization may be able to garner, the marketplace does not provide cost guidelines for not-for-profit organizations to the same extent as it does for for-profit enterprises.

Public Service Budgets

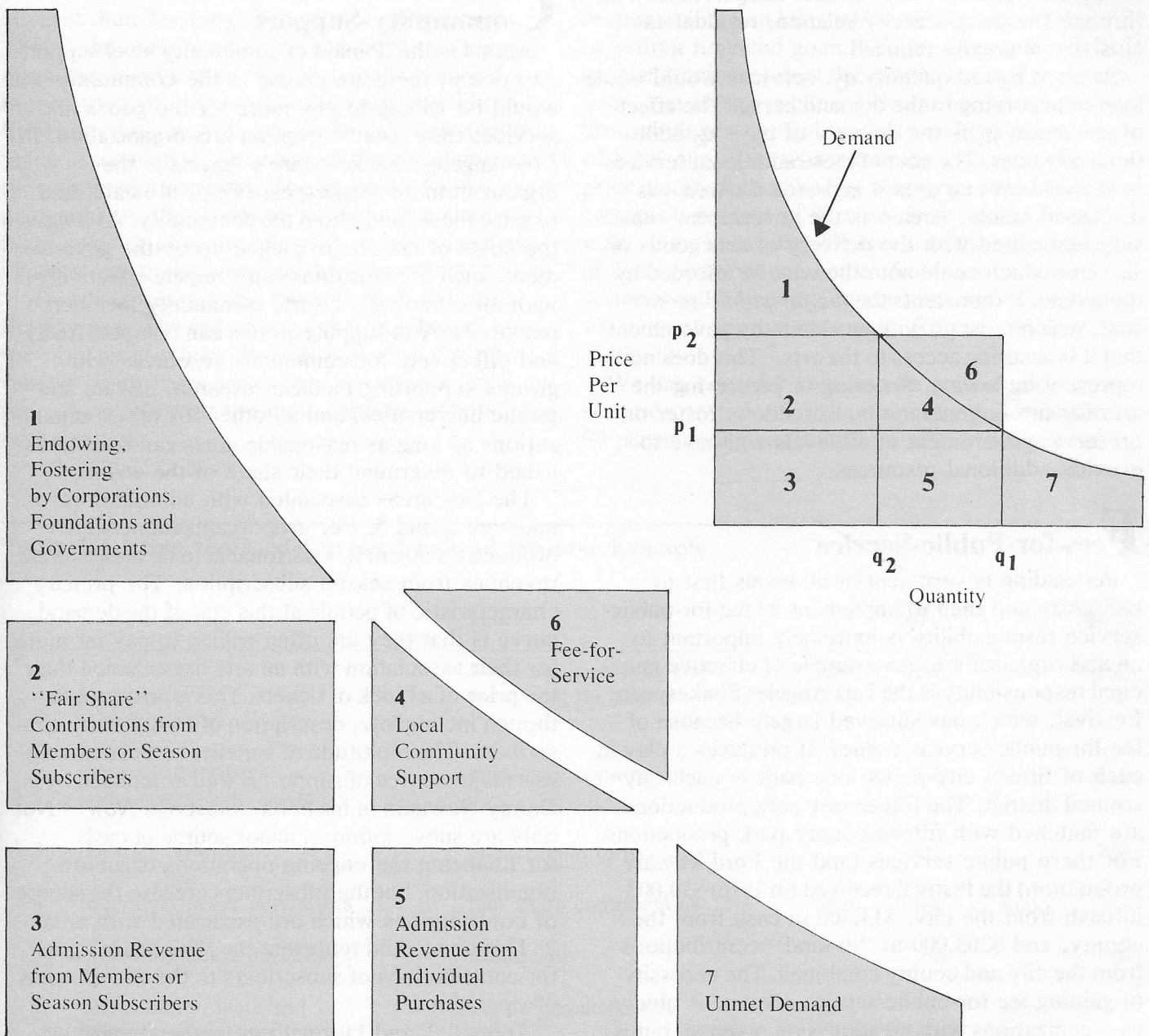
Interesting and appropriate cost guidelines for not-for-profit organizations are presented in *The Public Service Budget of Arts and Cultural Organizations: A Better Measure of Full Financial Disclosure*. The concept of public service budgets is introduced in the belief that:

“The real measure of a nonprofit organization’s effectiveness is not the bottom line of its financial statement, but the services it offers in relation to their costs. The books can always be balanced by reducing the quantity and quality of these services.”⁴

A public service budget tries to assign costs to the services the organization should be providing, “not in the best of all possible worlds, but as (the organization) ought to be in this world, if it were functioning at its normal and natural rate and living up to its obligations and opportunities.”⁵ Many arts organizations devour the resources they need to provide services. In order to meet budget demands, they postpone repairs and the physical plant deteriorates. Museums are forced to curtail their viewing hours. The American Ballet Theatre felt compelled to sell its Chagall sets. As stated in *The Public Service Budget*:

... the factor of invisible erosion can be costed out . . . in specific cases dollar figures can be put on activities which a reasonable and balanced scale of operation could require, but which at present are not being

Figure 2: Division of Cost Responsibilities



set in motion because of immediate budget limitations.⁶

While accepted financial records should be kept for reporting, public service budgets are much better suited for planning. They help an organization to see more clearly what is being and/or should be done and what that is and/or should be costing.

The public service budget determines the cost required to deliver q_1 . There are then seven areas of cost responsibility, represented diagrammatically in Figure 2. Area 7 represents unmet demand. Even at price p_1 , arts organizations will exclude some people who would attend if there was more quantity available and at a lower price. The extent to which even this level of exclusivity is tolerable

in a democratic society is not known. However, when the quantity of goods or services delivered by an arts organization is determined in line with the parameters of a public service budget rather than through the price-scarcity relation, residual exclusivity is greatly reduced.

At price p_2 and quantity q_2 , services would be delivered according to the demand curve. The effect of pricing at p_1 is the delivery of $q_1 - q_2$ additional services. The cost of these additional services is shared between area 4 and area 6. Area 4 is discussed below. Area 6 is the government subsidy associated with the delivery of arts goods or services which could not otherwise be afforded by the public. It represents the *fee-for-public-service* cost, which must go with any claim by government that it is assuring access to the arts.⁷ This does not represent endowing, fostering or preserving the arts for future generations. To endow, foster or preserve, government at all levels will have to provide additional resources.

Fees-for-Public-Service

Persuading government at all levels first to recognize and then to implement its fee-for-public-service responsibility is extremely important to an arts organization. An example of effective municipal responsibility is the Los Angeles Shakespeare Festival, which has survived largely because of fee-for-public-service monies. It produces a play in each of fifteen city parks, one park in each city council district. The fifteen city park productions are matched with fifteen county park productions. For these public services (and the Ford Theatre production) the festival received (in 1976) \$30,000 in cash from the city, \$13,500 in cash from the county, and \$208,000 in "in-kind" contributions from the city and county combined. The necessity of gaining fee-for-public-service revenue is obvious to organizations with no admission revenue, but is just as necessary for other arts organizations. Without such revenue, arts organizations are placed at a competitive disadvantage in gaining revenue from other sources of income discussed below. Governments must also realize that unless they respond to the legitimate fee-for-public-service requests of arts organizations which do charge admission, more and more arts organizations might appropriately conclude that they should drop their admission charges in order to get such revenues.

Good management sense shows us the danger of relying too heavily on a single source of revenue.

Community Support

Area 4 is the domain of community level support. At price p_1 there are people in the community who would be willing to pay more for the goods and services they receive from an arts organization. In Los Angeles, Shakespeare's Angels is the organization the Shakespeare Festival established to raise these funds from the community. As long as the costs of area 6 are picked up by the government, such organizations can compete effectively with all other pulls on the community members' resources. Arts support groups can compete freely and effectively for community resources with groups supporting medical research, private and public universities, and all other 501 (c) (3) organizations as long as reasonable goals can be established to determine their share of the costs.

The two areas associated with admission revenues are 3 and 5. For arts organizations which produce a season, it is reasonable to tie area 3 to the revenues from season subscription. The primary characteristic of people at this end of the demand curve is that they are often willing to pay far more for their association with an arts organization than the price of a block of tickets. This is an accurate, though incomplete, description of most season subscribers. The multitude of benefits associated with this major source of support is well articulated by Danny Newman in his book, *Subscribe Now!*⁸ Not only are subscriptions a major source of cash for financing the ongoing operations of an arts organization, but the subscribers are also the source of contributions which are associated with area 2. This area could represent the "fair share" goal for contributions of subscribers to the overall costs of operations.

Areas 1, 2, and 3 formally correspond to people who would be willing to pay prices greater than, or equal to, p_2 for the goods and services of an arts organization. While this certainly includes wealthy individuals in the community, it is worthwhile to recognize that great wealth has shifted to include the collectivities (i.e. corporations, foundations and governments). Arts organizations need to retrieve revenues from these collectivities in order to achieve a financially stable revenue balance. Since area 2 is already associated with

individuals, it is somewhat arbitrary but useful to associate area 1 with the collectivities. This is the area in which governments express their desires to endow, foster or preserve the arts above and beyond their fee-for-public-service obligations. This is the area in which corporations and foundations can exhibit their sense of social responsibility—their desire to build the quality of life in their communities—as well as the judgment that the value associated with support of the arts is greater than the costs incurred. This is where local governments should return to the arts a share of hotel taxes equal to the role of the arts in attracting visitors and their capital to the city.

Area 5 represents the revenue from individual ticket sales. The individual ticket purchasers are the pool from which the vast majority of future season subscribers are drawn. An unsold ticket represents a loss to the public and to the arts organization.

An Illustrative Budget

If we ignore the impact of merchandising revenues, we can illustrate how this division of cost responsibility can be used by an arts organization in setting financial goals.⁹ Take, for example, the case of a major resident theater producing five plays a year. Let us say it has a 555-seat house which is around 90 percent full for forty-eight performances of each play. Let us assume the average ticket price is ten dollars and at that price the theater covers 50 percent of its costs from admission revenues. If we know that 70 percent of the attendance at each performance comes from season subscribers and 30 percent comes from individual sales, we can set approximate goals for each area in Table 11.

We can consider area 3 to be season sales. Subscription costs for five plays are fifty dollars and at 90 percent capacity there are 350 subscribers at

Table 11: Using the Model to Set Goals—A Theater Example

Area	Source of Revenue	Reason		Goal at 90% (000's)		Goal at 99% (000's)
1	Foundations Corporations Governments	Fostering, endowing and preserving the arts	min	\$180	min	\$162
2	Season subscribers and wealthy individuals	Fair share contributions		840		756
3	Season subscribers	Subscription to five plays		840		924
4	Individual ticket purchasers	Fair share contributions	max	180	max	162
5	Individual ticket purchasers	Admission		360		396
6	City, county, state and federal governments	Fee-for-public-service	min	180	min	162
7	Unmet demand			0		0
Approximate gross revenue				\$2,580	\$2,562	
Surplus (deficit) of revenue over total operating expenses				180	162	
Surplus (deficit) as a proportion of total operating expenses				.075	.068	

each of the forty-eight performances. These 16,800 subscribers produce \$840,000 in attendance revenues. Because we assumed that 50 percent of costs were covered by admission revenues, area 2 is equal to area 3. The theatre should try to raise another \$840,000 from season subscribers and other wealthy individuals in the community.

On the average, 150 individual admissions are purchased for each performance. Over the forty-eight performances of five plays this amounts to 36,000 individuals. This number would undoubtedly contain some repeats. But while this group is in the minority at any single performance, in total it is much larger than the season subscription group—in fact, almost twice as large. A theater cannot expect this group to contribute as heavily as the season subscribers, but less than a five dollar contribution per attendance will meet the maximum goal of \$180,000 for area 4.

Because the demand curve is negatively sloping, area 6 is somewhat larger than area 4. This theater should seek a minimum of \$180,000 from government at all levels as the fee-for-public-service which allows for wider public access. The contributions of individual ticket purchasers and the government's fee-for-public-service total \$360,000—matching the revenues from individual sales.

The standard economic rationale holds that for an arts organization to be economically worthy of either public or private support, area 1 must be larger than area 6. Although this model does not rely fundamentally on this rationale, for strategic purposes we can set area 1 to be at least as large as area 6. However, there is every reason to guess that area 1 is actually considerably larger than area 6. This indicates the theater in this example should seek a bare minimum of \$180,000 from corporations, foundations and governments to endow, foster and preserve the arts.

While this completes the example for a 90 percent full house, we can ask how the picture changes if the theater increases its audience to 99 percent capacity. This kind of expansion has a minimum cost associated with it since there is no increase in the number of performances. Ignoring the minor costs associated with the production of more printed programs and possibly slightly greater maintenance services, we can see how cost responsibilities are now divided among the areas.

If there is uniform expansion of season and individual sales, the number of subscribers increases

to 385 per performance. This results in \$924,000 in subscription revenue. Individual sales are up to 165 per performance, leading to \$396,000 in revenues. This means attendance revenues total \$1,320,000 or 55 percent of total operating costs (\$2,400,000). The total cost rectangle allocates 70 percent of the operating deficit to season subscribers (\$756,000), which reduces the goal for their contribution by \$86,000. A maximum of 15 percent of the deficit is the goal set for contributions of individual ticket purchasers. This indicates their fair share contribution is reduced to \$162,000 at a maximum, or just over four dollars per attendance. The fee-for-public-service is a minimum of \$162,000, with an equal minimum contribution from corporations, foundations and governments. These latter categories should be urged to go beyond minimum contributions, since at the minimum the theater will experience an \$18,000 reduction in gross revenue. All of these goals and comparisons are summarized in Table 11.

As clear as the cost responsibilities appear to be in this portrayal, there still exists fundamental confusion. The federal and state governments created, through legislation, all the markets of exchange except ticket revenues. This rationale has two foci. For the possessors of wealth, it gives them a greater degree of control over the allocation of their resources. Instead of giving some revenues to the government, they can direct those revenues to efforts they wish to support. On the government's side, the legislation provides an excuse. Governments usually can claim that they are providing tax incentives for private sources of wealth to fund these activities. Such a claim can be offered only to the extent that private wealth accomplishes public goals. But private wealth rarely provides access to the arts. Governments can provide such access by living up to their fee-for-public-service responsibility. The tax laws provide no excuse for governments to ignore this responsibility.

There is one fascinating possibility which arises when all parties involved in providing resources for the arts live up to their respective responsibilities. If the revenues associated with areas 1 through 6 are returned to the arts organization, they might possibly make a profit. Being a not-for-profit organization means that no person can pocket this surplus. It will be turned into resources the arts organization can use for increasing access and for improving quality, proving there is no incompati-

bility between democracy and high artistic standards.

Policy Implications

Much of the product of nonprofit arts organizations represents a public service, the cost of which may or may not be covered by a government contract or grant. Indeed, some part of the funding which comes in the form of a grant may actually be a now-disguised fee payment for such public service, although this is not recognized either by the organization or the granting agency. Thus, governments need to differentiate their fee-for-public-service contributions from those grants which are meant to endow, foster or preserve. When government contracts for a concert in a prison or a hospital, this exchange is on a fee-for-public-service basis but it does not endow the orchestra. Yet, at least a portion of the regular season of a performance organization is a public service, and governments cannot fulfill their fee-for-public-service responsibilities to the arts simply by contracting for "run out" concerts or other special services. More study is needed in order to be able to estimate this fee component in arts organizations which do not have performance seasons and subscription sales.

Although the aesthetic mission of an arts organization sets its basic direction, organizational management must recognize the multi-market exchange system in which arts activities take place. Management needs to understand the complex interrelationships and interdependencies among these submarkets and to adopt financial plans which make reasonable demands for revenues from each identified market.

Footnotes

¹Cheung, S. N. S., "Why are better seats underpriced?" *Economic Inquiry*, XV, 513-533, October, 1977.

²A reviewer of a draft of this chapter pointed out that the high price of scarce goods does not necessarily result from the desire to exclude others from consumption; rather, the widespread desire to consume something which is scarce leads to its being rationed among a few using price as a basis, and even if wealth were distributed uniformly, scarce items would be higher in price than items that are in plentiful supply. The reviewer conceded, however, that there is perhaps some truth to the idea of the desire to exclude,

especially as it applies to the arts, as in the case of "limited editions" of art works or signed versus unsigned lithographs. Space does not permit further development of the topic of the historic, exclusionary relation between art and wealth. The interested reader may refer to: Cooper, L. G., "Implications of the Historic Relations between Art and Wealth." Working paper. Study Center for Cultural Policy and Management in the Arts. Graduate School of Management, University of California, Los Angeles, 1978.

³The proper generalization of the single market equilibrium pricing procedure for determining the quantity of products and services of an arts organization would be enormously complex. If there were n_1 products associated with performance, n_2 products associated with merchandizing and n_3 products associated with grants and contributions, then an $(n_1 + n_2 + n_3 + 1)$ dimensional space would be associated with the demand. The problem would then be to find a vector of quantities $(q_1^*, q_2^*, \dots, q_{n_1 + n_2 + n_3}^*)$ which corresponds to a vector of prices for products $(p_1^*, p_2^*, \dots, p_{n_1 + n_2 + n_3}^*)$ such that total revenue $\left(\sum_{i=1}^{n_1 + n_2 + n_3} p_i^* \times q_i^* \right)$ was maxi-

mized. Such an endeavor is beyond the current capability of equilibrium pricing techniques. Further, the cost of gathering the needed information is so high that such an analysis is extremely unlikely to be carried out in the foreseeable future.

⁴Farrell, J., Larrabee, E., and Nelson, C. A., *The Public Service Budget of Arts and Cultural Organizations: A Better Measure of Full Financial Need*. (New York: Associated Councils of the Arts, 1976), p. 2.

⁵Ibid, p. 5.

⁶Ibid, pp. 4-5.

⁷There is a much more complex explanation which is minutely more accurate, but leads to the same conclusion for all practical purposes. It deals with the fact that the delivery of q_2 goods or services might cost more than the sum of area 2 and 3. Figure 2 allocates fixed and variable costs uniformly over each unit of quantity. The reality of most arts organizations is a high cost to open the doors and a relatively lower cost of each additional performance. Until our ability to measure demand increases dramatically, the difference is not worth worrying about.

⁸Newman, D., *Subscribe Now!*, (New York: Theatre Communications Group, 1977).

⁹Obviously, not all arts organizations have a season. But balanced analogies to the proposed revenue pattern may be developed for less traditional arts organizations.