

A New Institutional Economics
Approach to the Organization of State
and Provincial Arts Councils

by Michael Rushton
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The field of cultural economics has had as a central concern the question of public funding of the arts. In general there have been two streams of analysis, which I will call the *welfare economics* approach and the *public choice* approach. In this paper I want to suggest that each of these methods leaves many interesting questions unanswered, and that a *transaction cost* analysis, drawn from work in the new institutional economics literature, will provide the most fruitful avenue for further research on public funding for art in general, and for state and provincial arts councils in particular.

I will begin by reviewing briefly the central results of welfare economics and public choice when applied to public funding for art, and the limitations of each way of studying the question. I will then describe and assess the transaction cost approach. Later in the paper, I will use the Saskatchewan Arts Board as my 'case study'. I hope this single example will persuade readers of the possibilities for research in state and provincial arts councils, in terms of comparative analysis and possibly in terms of uncovering 'best practices'.

This paper will, I hope, raise more questions than it answers. The primary goal is to suggest a research framework, one that will have broad application to arts organizations in the public, nonprofit, and commercial sectors.

WELFARE ECONOMICS AND PUBLIC FUNDING

The starting point for the welfare economics approach to public policy is the assumption that individuals act in a self-interested way, that they know their own interests, and that social welfare is some function of the well-being of the individuals in society. Even though well-being is very difficult to measure, and practically impossible to compare across individuals, there is still something we can say about economics and well-being, a version of Adam Smith's 'invisible hand' argument, known as the first theorem of welfare economics. Abstracting from technical details, the first theorem states that in the absence of externalities, competitive markets will produce an outcome that is Pareto efficient: there will be no conceivable rearrangement of society's allocation of resources that could improve the well-being of one person without simultaneously making someone else worse off.

If one begins with this analysis, what then is the role of the state in the economy? One role focuses on income distribution. A Pareto efficient outcome might be one with unacceptable inequality in income, and individuals will want the state to engage in policies that help reduce inequality, either through transfers of current income from the rich to the poor, or through the provision of services like education and health to all regardless of their income, so that the poor are given a better chance at ultimately being able to obtain good jobs.

The second role is in the allocation of resources. In efficiency terms, markets will tend to under-produce goods that exhibit 'external benefits', where Albert benefits when Betty purchases a good produced by Charles even though Albert has neither purchased the good himself nor taken part in its production. Markets will also under-produce goods

that are, in the economist's sense, 'public goods', where once a good is provided additional users do not diminish the ability of others to benefit from the good, and where it would be difficult to exclude people from enjoying the good even if that were desirable. National defence is the textbook example of a public good. In either case, the welfare economics approach would say that there is a role for the state in either providing these goods for society, or at least in subsidizing the private provision of the goods.

Cultural economists working in the welfare economics tradition have found a role for the state in subsidizing the arts on both distributional and allocative grounds.

First, it is important that members of society have access to those goods that build independence and the capacity to be an active participant in the life of their communities. Cultural education requires access to cultural exhibitions and performances. William Baumol, countering claims that public support of the arts benefits primarily the well-off, wrote that "individuals who are unable to use the language well and who are unfamiliar with society's cultural heritage face marked handicaps in getting good jobs and advancing up the economic ladder. ...[C]ultural illiteracy has much in common with linguistic illiteracy" (1997, p. 10). However, there is more to culture than making us better and more productive individuals (Hughes (1992) claims this view of culture as uplifting is distinctively American). In 1942 John Maynard Keynes, at the time the world's preeminent economist, accepted the task of becoming chair of the Committee for the Encouragement of Music and the Arts, the forerunner of the British Arts Council. According to his biographer, Keynes "had long been of the opinion that in the modern world art required a new kind of support to take the place of the affluent classes of earlier times. ...In the time to come the mass of people should be able to enjoy the delights of

fine art which in the past had been reserved for the favoured few.” (Harrod, 1951, p. 518). So we should also consider that there is nothing wrong with the notion that the poor should have access to culture simply because they would enjoy it.

On allocative grounds, there is a familiar list of reasons why the marketplace alone will not provide an optimal amount of cultural goods. Readers can refer to Frey (2000), Heilbrun and Gray (1993), O’Hagan (1998) or Throsby (2001) for more detailed discussion of the following list of factors. The essential allocative problem is that there may be externalities associated with the production and consumption of artistic works. This is for a number of possible reasons:

- people may feel national or local pride from artistic activities even if as individuals they do not directly take part;
- they may benefit from the innovation in non-artistic fields that results from artistic creation – this may include changes in social life more generally that are partly spurred by art with political dimensions;
- individuals may feel an increased sense of well-being simply because a vibrant arts community provides them with the *option* of one day enjoying its output; and
- there may be a desire to leave an artistic heritage for future generations.

In addition, there may be “public good” aspects to artistic activities, such as public sculpture. Finally, there are important educational aspects in artistic production. Individuals lead better lives when they have cultivated an appreciation and understanding of art, and this requires exposure to art. Smolensky (1986) claims this was the primary rationale for the municipal financing of art museums in the US since the 19th century, and Scitovsky goes so far as to claim that “the only valid argument for government aid to the

arts is that it is a means of educating the public's tastes, and that the public would benefit from a more educated taste" (1972, p. 68). It should be noted that economists are divided on whether the educational rationale for public funding should apply only to youths, and to adults who *want* to learn more about art; economists are wary about recommending the public provision of goods to rational adults whether they want those goods or not.

As useful as the welfare economics approach is in clarifying why public funding of the arts is a good thing, it has some significant limitations. First, it is going to be very difficult to determine *how much* public support is optimal. This is for a number of reasons. The values of the externalities are not obvious, very difficult to measure, and will vary across art forms and genres. Contingent valuation methods have been applied to the preservation of heritage sites, but that is for cultural goods that already exist, not for the funding of new works. Even regarding arts education for children, over which there seems to be less controversy than for other public funding for the arts, it will be challenging to determine what is the best amount of spending when it is set beside all of the other valuable areas of education from which children benefit.

Second, the welfare economics approach is silent regarding the mechanism by which a desire by taxpayers for public support for some kind of art is translated into the actual works of art that ultimately arise from the funding process. While to some degree this is true of all publicly provided goods, taxpayer preferences regarding which highways should first be upgraded are more likely to be closely satisfied than preferences regarding the various art forms and genres that are publicly funded.

PUBLIC CHOICE AND PUBLIC FUNDING

Like the welfare economics approach, public choice economists also assume self-interested, knowledgeable individuals. The point of departure is that individuals will advance their interests by political means, through strategic voting, attempting to influence other voters, and direct lobbying of politicians. Furthermore, politicians and bureaucrats are no different in character from others, and will pursue policies that advance their own interests, perhaps at the expense of the society as a whole.

There is no doubt that public choice economics can tell us something interesting about the public funding of art. Those who benefit most from state arts councils will consider the arts platforms of electoral candidates, and where one's livelihood is directly affected by the funding of the council there is an incentive to spend resources in an effort to affect funding levels – economists define *rent seeking* as the expenditure of resources with the goal not of producing goods and services, but of effecting a transfer of existing wealth. Rent seeking is socially wasteful, in that the resources used in the activity have an opportunity cost – the time could have been spent producing something valuable.

Grampp (1989) claims that the arts are particularly ripe for rent seeking behavior; with a demand for arts that is income elastic, increased prosperity means that less rent seeking effort is needed to obtain the desired transfers. Furthermore, given the general weakness of the arguments for state support of the arts generated by the welfare economics tradition, it *must* be the case that the funding we observe is simply the result of rent seeking (the same argument is made by Banfield (1984)).

But the public choice approach to the study of state and provincial arts councils has some significant gaps in the analysis. First, it is relatively silent on the *process* by

which lobbying activity results in arts funding and policy. *Why* should politicians listen to artists or arts administrators? Is the structure of arts councils completely explained by the preferences of artists?

Second, there is a significant amount of evidence (although Grampp disputes the point) that the general public supports state funding of the arts – this is not simply the case of a well-organized lobby taking funds from a mass of taxpayers unable to organize themselves to stop the transfer. Although there are many pitfalls involved in conducting surveys on public support of state funding of the arts, it is generally found that there is substantial support. Hansen (1997) found significant public support for state funding of the very specific good of the Royal Theatre in Copenhagen, even though only a small minority of those surveyed had actually attended the Theatre recently. Schulze and Rose (1998) find strong voter support for the state funding of orchestras in Germany. Throsby and Withers (1979) (in Australia) and Morrison and West (1986) (in Canada) find through their surveys that the level of support desired by the median voter is close to what is actually observed in those countries. Although there are large confidence intervals around the point estimates of the desired level of state support, the evidence seems to be quite strong that this is not simply a case of art producers obtaining transfers that voters don't want them to have. This is not to say that there is not rent seeking, or that there are divergences between what the public wants to fund and what is actually funded. But there is certainly a desire for *some* sort of public funding.

TRANSACTION COST ECONOMICS

Transaction cost economics is an approach to the subject that attempts to understand the economic and political *institutions* that we observe by considering the various *exchanges* that occur through the system, and the impossibility of regulating those exchanges through a perfectly functioning contractual system. *Transaction costs* are the costs of organizing, monitoring, and enforcing exchanges and contracts. The seminal work is by Coase (1937, 1960), who put forward the importance of transaction costs in explaining the scope of activities that will be organized within firms rather than through market exchanges between independent agents (in the earlier paper) and the inability of the marketplace to correct the externality problem (in the later paper).

Coase's analysis was extensively developed by Williamson (1975), who explained transaction costs as a result of four features of our economic and political world. First, we live in a world of inescapable *uncertainty*. Second, people have *bounded rationality*: there are limits to the time and resources we can spend in acquiring information, even if we use what information we have rationally. Further, there are limits on our language: we cannot communicate perfectly with each other even when we wish to. Third, individuals will exhibit *opportunism*: we often enter transactions with a lack of candor or honesty, especially when we know something that the individuals with whom we are interacting do not. Fourth, as we become engaged in economic or political relationships, investments are made that are irreversible and that have low value in alternative uses, thus leaving the investor vulnerable to tough negotiations with her trading partner; we refer to this as *small-numbers exchange relations*.

At first, transaction cost analysis was applied principally to understanding the institutions we observe in commercial markets – patterns of vertical integration, hierarchies in the personnel structure of firms, the structure of contracts, and so on. The techniques are brilliantly applied to the commercial art world in the recent book by Richard Caves (2000), which will undoubtedly encourage much future research into contractual relations in the arts.

But the method of analysis is also ideally suited to understanding *political* institutions. It can help us understand the structure of government bureaucracies as well as the employment relations in private firms. It can be a very useful tool in understanding the legislation we observe, and the degree of political oversight of bureaucracies. In commercial or political exchanges we can ask how institutions have evolved to economize on transaction costs. Nobel laureate Douglass North writes: “A transaction cost theory of politics is built on the assumptions of costly information, of subjective models on the part of actors to explain their environment, and of imperfect enforcement of agreements” (1990, p. 355).

Avinash Dixit (1996) has noted that transaction cost analysis is even *more* applicable to politics than to economics. The analysis is focused on exchanges and contracts, especially the necessarily incomplete nature of contracts; in politics contracts are likely to be even less complete than in commerce. A politician’s electoral promise to increase arts funding will generally be very vague. Furthermore, how do voters enforce a promise by a politician to increase arts funding? Transaction cost analysis also lends itself to the study of governance structures, but these are likely to be much more complex in the public sector than in the private sector. James Q. Wilson (1989) stresses the fact

that each government agency or bureaucracy is simultaneously answerable to multiple principals, who are trying to influence its actions in different directions.

An important insight of the transaction cost approach is that outcomes that at first appear to be inefficient are in fact the result of an institutional process that, all things considered, is the best mechanism for coping with the various transactional realities of our world. Williamson warns that in giving policy advice we need to follow what he terms the *remediableness criterion*, which “holds that an extant mode of organization for which no superior *feasible* alternative can be described and *implemented* with expected net gains is *presumed* to be efficient” (1999, p. 316). It is important when studying the outcomes of our arts policies that we do not simply criticize some isolated aspect of it, but instead suggest a feasible institutional change that on balance will produce better outcomes.

Although the transaction cost analysis has not been widely applied to cultural economics, there are some examples. Alan Peacock (1994) draws on insights from welfare economics and public choice, as well as his experience as past Chairman of the Scottish Arts Council, to raise questions about how well the current structure of arts councils solves the problem of improving the welfare of citizens. In particular he raises questions about the lack of accountability of arts councils, and of their “capture” by artists and arts administrators at the expense of arts consumers. Some of his specific recommendations are discussed later in this paper. Bruno Frey (2000) studies museum behavior from the perspective of the incentives and constraints facing museum directors, asks how state support for the arts will change the kind of art that is produced, and looks at the effects of having voters make direct choices about public art through referenda,

among many other considerations. The focus is on institutional design, and how well alternative organizational structures serve the goals that justify public funding in the first place.

Note that neither Frey nor Peacock rejects the welfare economics or public choice insights into cultural policy. The purpose of focusing on institutions, exchanges and contracts is not to ignore what economists working in the more standard tradition can tell us. The normative justification for public support of the arts that we derive from welfare economics, and the public choice insight that voters, artists, arts administrators, and politicians will behave strategically in the political process, are each retained in the analysis. But we wish to investigate more deeply the structures and outcomes we observe, and that requires an accounting for all of the factors that make exchange difficult.

WHY A TRANSACTION COST APPROACH TO THE ARTS?

The development of the transaction cost approaches to economics and politics was driven by the realization that many of the institutions we observe that govern exchange and contract can be explained by the ways real human beings differ from the hypothetical rational agents of theoretical models. But the features of the world noted by Coase, North, and Williamson are *particularly* obvious in the art world.

First consider the presence of uncertainty. While it is true for many goods that there is uncertainty surrounding how a product in development will be received by the market, for art it is especially true. Caves (2000) is fond of citing William Goldman's (1984) observation about films: "Nobody knows anything." This explains much of what we observe in the design of contracts in the commercial art world. But it applies equally

well to *publicly* funded artistic creation. Although there is uncertainty in all public projects, policymakers will be able to project much more accurately the use of an upgraded highway, or extra places in public universities, than the response to a publicly funded work of art.

Second, there is bounded rationality. The ability to critically evaluate proposals for, or finished creations of, art requires specialized knowledge that results from many years of study. It is not knowledge that is easily obtained by those who do not work on a daily basis with artists and their works. It is conceded that there are other areas of public funding that also involve great expertise: physicians' services in publicly funded health care, for example, or state funding of scientific research. However, in these examples while there is certainly specialized expertise required regarding the *means* employed by the specialists, at least most members of the public have enough understanding of the *ends* of the work: to cure the sick, or to increase our understanding of the physical properties of the world. But art has become so complex that the average citizen would have a difficult time articulating what art is *for*. This is not to demean the intelligence or aesthetic sense of ordinary people. Rather, it is a comment on the nature of art: that it defies easy understanding, and especially defies easy communication, of its quality or its purpose. In addition to the difficulties of evaluating art itself, the welfare economics underlying the rationale for public finance is itself complex. Externalities are difficult to quantify at the best of times, but for the arts it seems to be particularly hard, to the point that some would deny their existence at all.

Third, there is opportunism. People have the capacity to be dishonest, to be less than forthcoming with their true feelings and intentions, and to "spin" their

communications to others. This is not more or less the case in the art world, but an aspect of human nature found throughout economic and political institutions. However, given bounded rationality in the arts, the possibilities for using opportunism are increased. It is more difficult for individuals not well versed in the arts to evaluate the recommendations of arts boards or peer review panels, which increases the ability of those who are presented as experts to mislead. This problem is discussed in more detail below.

AN APPLICATION TO ARTS COUNCILS

Figure 1 lists a series of transactions that occur when art is public funded through an arts council.

Figure 1

Transactional Relations in Public Arts Funding

Citizen/Taxpayer

?

Legislator

?

Executive Branch

?

Arts Council

?

Peer Review Panel

?

Artist

?

Citizen/Taxpayer

In this section I will consider each transactional relation, and pose questions that one might ask regarding the effectiveness of the institutional design in translating the

desires of the citizen/taxpayer regarding public funding for art into the actual works that will be enjoyed by the public.

Citizen/Taxpayer ? Legislator

To use the phrase of Hofferbert and Urice (1985), state arts funding is a “small-scale policy”. The National Assembly of State Arts Agencies reports that in fiscal 2001, state legislative appropriations to arts councils was \$447 million, about \$1.57 per person in the US. Economists have noted that “contracts” between voters and the legislators they elect are very vague, and not easily enforced. Elections do not allow for voters the chance to pass judgment on how well their elected legislator kept each of her many promises – the vote is a very blunt instrument. Furthermore, if a legislator had promised to seek increased funding for the state or provincial arts council, and the increased funding never occurred, voters have great difficulty in knowing whether this is because the legislator reneged on her promise, or if unforeseen circumstances – perhaps a need for emergency funding elsewhere, or administrative problems at the arts council that require sorting out – made it good public policy not to pursue increased funding. In other words, like *all* the transactional relationships involved in public funding of the arts, there is a great asymmetry of relevant information between the principal, in this case the voter, and the agent, in this case the legislator.

Voters have little incentive to investigate the matter further, because it is such a small-scale policy issue, and a salient issue only to a very small minority whose well being is directly tied to levels of funding.

Yet it is important for sound policy that legislators have some idea of what voters want. Note that this applies not only to levels of funding, but to *what* art is funded. Rushton (2000) notes that whatever is the justification for state support for the arts in the first place, whether it be to solve the externality problem, to ensure that poor young people have a chance to acquire cultural literacy, or to strengthen community or national bonds, the preferences of voters on the amount of funding and on the nature of the art they wish to fund must be included.

Economists are divided on how well our electoral framework does the job of translating voter desires into legislative action. North (1990) stresses the inefficiencies: legislators only have an imperfect idea of what outcomes voters want, they have differing ideas of the most effective means of reaching agreed upon ends (because of differing models of the economy, or the bureaucratic process), and accountability to the voter is very weak. A very different picture is drawn by Wittman (1989), who claims that principal-agent problems are no worse in the public than in the private sector, and that the lack of information held by voters is an overstated problem; voters only need to be well informed enough to make a *choice* between candidates for the system to work. Just as we do not need to know all of the details involved in producing a can of soup to be able to make a choice of one brand over another – we just need to know enough to know we prefer one to the other – so it is the case when we compare candidates for election.

Practically, one would have to have *very* strong feelings about arts policies to think that constitutional changes are needed regarding how we elect our legislators. But Frey's (2000) evidence that voter support for public funding of art tends to *increase* when voters have a greater say in which particular projects are funded has some important

lessons. First, it weakens the case that state support for the arts is simply the result of an effective lobbying effort by artists to obtain transfers from taxpayers. Second, it highlights the importance of organizational structure. The more extensive the chain of transactions from citizen/taxpayer to the work of art, the less well are citizen preferences going to be represented, and so the less desire there will be by taxpayers to fund the system.

Legislator ? Executive Branch

Legislative oversight of the executive branch of government is very different between the United States and parliamentary systems such as Canada. Almost all of the “rational choice” (i.e. economic) political science literature on legislative oversight is American, understandably.

In Canadian provinces, the executive branch is the Cabinet, drawn from the majority party elected to the legislature, which acts through the authority of the Lieutenant Governor. The legislature’s oversight of the executive is through the principle of *ministerial accountability*: for each branch of executive government there is a Cabinet Minister who must be prepared to answer for his bureaucrats’ actions to the legislative assembly. For example, the legislation governing the Saskatchewan Arts Board includes the clause that “...” (arts board act, 1997). However, in practice party discipline is very rigid, and so the governing party, and the Cabinet it provides, are never under serious threat of defeat on any issue of importance when it comes to the legislature for a vote. In other words, the executive branch is very powerful, and the opposition party in the legislature is left only with the capacity to bring to public attention matters that might

embarrass the government. As Wilson (1989) remarks, ... See Haggard and McCubbins (2001) for a general discussion of the behavior of parliamentary and presidential systems.

The literature on legislative oversight of the executive in the US is immense, and here I will just attempt to give a flavor of the issues relevant to state arts councils. The problem is to design an oversight system that ensures effective public service, but one that follows the direction set by the elected members of the legislature, and does not engage in “bureaucratic drift” towards the goals desired by either the bureaucrats themselves or by the interest groups they must deal with. Institutions must cope with the usual problems that generate transaction costs: the combination of uncertainty, bounded rationality, and opportunism. Particularly relevant is the very limited time and resources available to the member of the legislature, who must deal with a very large and diverse range of issues. McCubbins and Schwartz (1984) provided a description of the choice of institutional framework that seems quite relevant to arts councils. *Police-Patrol Oversight* is “comparatively centralized, active, and direct: at its own initiative, [the legislature] examines a sample of executive-agency activities, with the aim of detecting and remedying any violations of legislative goals and, by its surveillance, discouraging such violations” (p. 166). This may involve holding hearings, commissioning studies, and the like. *Fire-Alarm Oversight* is less centralized, active or direct. Instead, the legislature “establishes a system of rules, procedures, and informal practices that enable individual citizens and organized interest groups to examine administrative decisions (sometimes in prospect), to charge administrative agencies with violating [legislative] goals, and to seek remedies” (p. 166). These procedures may take the form of ensuring that citizens have access to information and the ability to challenge bureaucratic discretion, and generally

more detailed statutory constraints on government agencies. On the assumption that members of the legislature want to take credit for benefits gained by their constituents, and avoid the blame for their losses, and that there are high opportunity costs for the legislator's time and effort, increasing the problem of limited knowledge, fire-alarm oversight comes to be preferred. Politicians will get little credit from voters for attending "police-patrol"-type meetings, and violations of legislative direction will still occur and often go undetected even with regular committee oversight, but with fire-alarm oversight only those issues that matter to constituents will be brought to the attention of the elected member. The state legislator can then take credit for fixing a problem in a visible way, without himself having to bear the cost of uncovering the violation. Extensions of the McCubbins and Schwartz model are proposed by Kathleen Bawn (1995, 1997), who notes that when members of the legislature are able to be on the relevant oversight committees they are more willing to forgo statutory constraint, by Calvert, McCubbins and Weingast (1989), who stress the important role of who gets to appoint administrators, and McCubbins, Noll and Weingast (1989), who give a more detailed analysis of how rules on administrative procedures are an important device for "fire-alarm" oversight. (See Moe (1997) for a helpful survey of the literature, and Epstein and O'Halloran for an extensive empirical test of the hypotheses using the US Congress).

For state arts councils, the interesting questions would surround how the discretionary behavior of the councils is limited by statute, and whether differences in the activities of arts councils can be explained at least in part by the nature of legislative oversight. To what degree are arts councils constrained by the possibility of citizens pulling a fire alarm? To what degree do arts councils attempt to provide information

about their activities on their own initiative, to deflect the possibility of citizens raising concerns to their elected members of the legislature?

In particular, it would be interesting to compare the reporting practices and the behavior of provincial and state arts councils. Does the difference between the Canadian and US political systems affect what the councils fund, and are Wilson's observations that ... borne out in the arts?

Executive Branch ? Arts Council

When a state or provincial arts council is described as being "arm's length", what exactly is meant by the phrase? The Saskatchewan Arts Board (SAB) is described as such, but it does not mean that it can do anything it likes.

First, the legislation that governs the SAB sets its mandate:

Second, the appointments to the Board itself are made by the government:

Third, the budget of the SAB is set on an annual basis. Lobbying. Advocates.

Low-powered incentives.

Freedom of expression.

Questions.

Arts Council ? Peer Review Panel

Peer Review Panel ? Artist

Artist ? Citizen/Taxpayer

CONCLUSION

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