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Consumers, Citizens and Members: Public Service Broadcasting and the BBC

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1. Introduction

The current review of the BBC's Charter provides an opportunity to reconsider the role of the BBC and the provision of public service broadcasting. On previous occasions, the historical context has played a core part in such assessments. The initial development of television, the duopoly model and the creation of Channel 4 and BSkyB all changed the market context, providing new challenges to the BBC and offering the prospect of more pluralistic methods of delivering public service broadcasting.

In this review, the key 'new' issues are the coming of the digital era, and the convergence of telecoms, the Internet, satellite and terrestrial technologies, which offer the prospect of multiple channels and delivery mechanisms, and, with them, a much greater diversity of programming and information sources. The scope for consumer choice is widening significantly, as is the opportunity for producers to access the market. Physical entry barriers are falling.

To some, this cornucopia of new opportunities will usher in a new age in broadcasting and publishing, one in which new forms will emerge, existing ones

1 The author gratefully acknowledges the support and assistance of the BBC in preparing this essay. The views expressed are, however, entirely the author's own.

will have to transform themselves or wither away and new regulatory and institutional approaches will be needed. This new historical context has naturally led many to question: whether the BBC in its current form will be needed at all; whether public service broadcasting should be left largely to the market; whether the market failures will be solved; whether support for particular kinds of programme should be specific to any channel; and, whether the licence fee can be justified.

These questions are complex, and are unlikely to have simplistic answers. Answering them is made more difficult by the plethora of powerful vested interests in the broadcasting market. The BBC naturally wishes to defend the *status quo*, and particularly the licence fee. BSkyB has accumulated market power of its own, through vertical and horizontal integration, and would be a major beneficiary from any dismemberment of the BBC. ITV is sandwiched in the middle, and would face serious competition in the advertising market were the BBC to turn to commercial revenue. Commercial radio might benefit from a BBC forced to rely on the market to pay its way, though it would also face an advertising squeeze. For these reasons, the Charter Review is also the setting for a scramble to lobby for the economic rents which market power brings.

This essay assesses *some* of the main issues: the case for public service broadcasting, the likely operation of the market including the BBC, the financing options and the regulatory framework. In addressing these issues, the recent contributions by Ofcom (2004a and 2004b) will be critically assessed. It will be argued that market failure is only *one* component of the case for public service broadcasting, and it will question the claim that the digital revolution will 'solve' the market failures. It also presents the outline case for the licence fee as a membership fee for public goods, and hence argues a positive case for its retention (in a modified form), rather than as merely the least-worst option.

The scope of the essay is deliberately wide, but it is also a summary rather than a detailed analysis of each of the issues. As noted, the broadcasting market has been subject to decades of academic research, and the BBC's history has been written up in immense detail. There have been numerous reports and commissions. It is not the intention here either to summarise this voluminous literature or to add new empirical research. Rather, the aim is to sort out the arguments and bring them together into a coherent overall policy analysis.

The structure of the essay follows the lines of the argument. Section two discusses the grounds of the debate, and in particular what role economic considerations should play. Section three focuses on the multiple market failures, including market power and public goods. Section four looks at government and regulatory failure, the form of intervention and its impact on independence, and, in this context, the structure and role of the BBC. Section five considers the licence fee and the alternatives. Section six concludes.

2. The grounds of the debate

A starting point in considering the technological context and its implications for the future of public sector broadcasting is Ofcom's contribution to the Charter Review – in particular, its two published papers: *Ofcom Review of Public Service Television Broadcasting: Phase 1 – Is Television Special?* (Ofcom 2004a), and *Ofcom Review of Public Service Television Broadcasting: Phase 2 – Meeting the Digital Challenge* (Ofcom 2004b). Not surprisingly, Ofcom has taken a largely economic view of public service broadcasting, and described it primarily in terms of market failure. This is also the perspective taken by Gavyn Davies, ex-Chairman of the BBC (see Chapter 7). The difference between these contributions is that, for Ofcom, the coming of digital services will 'fundamentally alter the shape of the market' and, by implication, the role of the BBC.[2] This is because Ofcom argues that conventional market failures to provide what consumers are willing to pay for will be much reduced, and in consequence the extent to which there needs to be intervention for *this* reason is reduced accordingly. Davies sees the market failures as enduring – including the mainstream failures in relation to public goods, externalities and information. Indeed, he suggests that the risk of ever greater market power being exercised by BSkyB is an *additional* reason for preserving a licence fee-financed BBC.

In Ofcom's Phase 2 paper, a number of conclusions are drawn. Surprisingly, given Phase 1, Ofcom concurs with Davies that a licence fee-funded BBC is core to the delivery of public service broadcasting, but then goes on to suggest the creation of a new partial competitor as a 'Public Service Publisher' (PSP), challenging both the BBC's main broadcasting output, but also its web-based services. Thus, although the digital technology will usher in much more competition, it will not replace the need for major intervention and the competition will be insufficient, requiring a new competitor to be created as an act of policy.

The Ofcom and Davies approaches are overwhelmingly *economic* in nature, and contrast markedly with political and cultural perspectives. And, whereas the economic approach is largely within a well-defined paradigm, the latter are diffuse and less coherent. The starting point for most is the Reithian conception

2 Ofcom (2004a) p. 8.

of public service broadcasting, which has been overlaid with concepts such as 'values', 'citizenship' and 'democracy'. A decent society requires access to a culturally integrating media.

These are not necessarily mutually exclusive. The objectives of policy intervention are numerous and varied. It is widely acknowledged, including by most economists, that economic efficiency – the basis of the market failure approach – rests upon a very narrow value system. It treats people as rational utility-maximising agents, seeking out least-cost solutions. Human nature, and human values, are much broader, and concern for freedoms (positive and negative), equality and justice are also part of the public interest calculus. To argue that only economic efficiency matters is to rule out much of importance in political and social considerations.[3]

There is then no justification for an economic methodological imperialism in considering the case for public service broadcasting. Although Ofcom, in its first paper, is careful to allow for the concept of citizenship, it is not surprising that a predominantly economics-based regulatory body treats this concept as a form of residual market failure – and, indeed, its concept of citizenship is a narrow one. For Ofcom, the market failure paradigm is *the* perspective from which to analyse the broadcasting market, thereby reducing these plural sources of value to a special case, to be traded off against other market failures. Davies goes further, and sees the problem almost entirely in the economic context. But whilst anything *can* in principle be described as consistent with utility-maximising behaviour, and anything *can* be brought within the market failure framework, it does not follow that interventions *should* be based only on this framework. Markets, it can be argued, exist within a *social* context, with all its politics, freedoms and cultures, rather than the other way around. At stake here is something very fundamental. In discussing public service broadcasting, whilst economics and the market failure framework have a great deal to offer, their universalisation of the problem should not simply be assumed.

'Citizenship' as a central organising concept for these wider political, cultural and social concerns, while somewhat simplistic, has considerable merit, the key characteristics being *equal* status and treatment. Membership of the society is, in the citizen sense, not dependent on initial wealth or income. It accrues to each person *on the same basis*, and this in turn translates into the democratic ideal,

3 The literature on non-utility information is a vast and rich one, incorporating much of the discussion in moral philosophy concerning utilitarianism. In the economics literature, Amartya Sen's classic paper on 'Personal Utilities and Public Judgements' provides a core reference (Sen 1979). See also Cohen (1995), Chapter 2, Broome (1999), Chapter 2 and Dasgupta (2001), Chapter 4.

which gives each member of the society an equal say.[4] Much of the welfare state is designed on this principle of equal status: from health and education services, through to the nationwide definition of most entitlements.

Contrast this with the economic model of market failure. Failures on the demand side relate to consumers' ability to gain utility from the spending of their income, and those on the supply side are set in the context of profit- or rent-seeking firms. In the economic marketplace, people are treated *unequally* – what matters is how much they are both willing and *able* to spend. In the democratic political market, ability to pay is not a relevant criterion.

The distinction is not just the well-known issue of income inequality – which can in principle be solved by redistributive social security policies.[5] It has much broader dimensions. These include the provision of goods rather than money, treating the problem not as one in which people need to be empowered to choose, but rather as something that ought to be provided in a particular form, separate from the choices people would make. Citizenship includes rights *from* society – rights to be informed, to be able to vote, and so on – and obligations and duties, many of which cannot be provided unless citizens are informed.

The implications of this distinction between the consumerist and the citizenship concepts of unequal and equal treatment are profound. Citizenship is not just another sort of market failure, it derives from a different set of values. As long as it can be shown that the media plays a core role in the functioning of a society, and access to it is a necessary condition for a well-functioning democratic society, then the level, content and charging basis for public service broadcasting cannot be encapsulated solely in the market failure paradigm. The economists' approach offers one – very important, necessary – facet of the case, but it is not, and could never be, sufficient.

3. Multiple market failures: public goods and monopoly

As a *necessary* part of the case, market failure does however give some considerable insights into specific aspects of public service broadcasting. It cannot dictate the optimal level of provision, or of financing, except in so far as

4 David Marquand's *Decline of the Public* makes this point and shows how it conflicts with what he describes as the '*Kulturkampf*' of the economic ideas of the 1980s and 1990s (Marquand 2004). Although he perhaps goes too far in playing down the role and vitality of market forces, the distinction between the public sphere – in which the BBC would undoubtedly be set – and the private is important to the public service broadcasting debate.

5 There is a role for some grading of the licence fee to reflect ability to pay, especially where some marginal viewers might be excluded from enjoying the public good of broadcasting, as we discuss below. However, this is an additional issue, and not a solution to the citizenship problem discussed here.

the efficient solution is sought in the narrow utility-maximising sense. It can, however, suggest the extent to which markets will provide public service broadcasting, and what the outcome might be of a laissez-faire approach.

Perhaps surprisingly, given the extensive literature, there remains considerable confusion about the market failures in broadcasting, and in particular how they influence the design of policy. While pro-market advocates downplay the failures and stress the extent of government failure, interventionists emphasise the opposite. In part, it is an empirical issue, beyond the scope of this essay. But it is also a conceptual muddle too, at the heart of which is the multiple nature of the failures and the public good characteristics of some forms of broadcasting.

Multiple market and regulatory failures

The first – and generally neglected – point to make about market failure is that it is typically *multiple*. Whereas most economic analyses take each market failure in turn for reasons of analytical simplicity, the policy problem is set in the context where these failures happen *simultaneously*, and indeed may reinforce or offset each other. In the broadcasting case, as we shall see, the interactions of market failures tend to exacerbate the inefficiencies of a purely market solution.

The second point is that market failures rarely point straightforwardly to state provision or *single-form solutions*. Markets fail *relatively*, not absolutely, and because the failures are multiple, so the policy instruments tend to be multiple too. Thus, if we see broadcasting as contributing to information, education and entertainment, then we have competition policy, educational budgets, direct arts support, academic funding of research, as well as the financing system for the BBC. Public service broadcasting – in its deep and full form – is not simply created and sustained through the licence fee. The licence fee is one of a whole range of interventions.

Multiple market failures prevail in most markets, though the combinations and interactions differ. In the publishing market, for example, there are many firms competing with each other. But it is not strictly a competitive market in the economic sense, since there are multiple interventions to address a number of market failures, including the public goods and citizenship concerns. Like broadcasting, the publishing market has evolved a complex set of institutions to address these. The production of books, journals and research materials is one that is far from being purely market-driven. Editors, journals and presses are often not-for-profit, backed by grants, subsidies and the support of the universities and their funding bodies, as well as a host of other grant-giving organisations, from the Arts Council to local charities. The publishing world has long since passed through the equivalent of the digital age, with multiple outlets, but interestingly, there is no evidence that the need to intervene, or the actual level of intervention, has gone down. Nor, interestingly too, has new competition led to an obvious decline in market power for the dominant incumbents. On the contrary, in those areas that involve public goods, concentration has arguably gone up.

These considerations set the policy context in a much richer and broader framework than simply public goods and monopoly market failures. As we shall see, the failure of market power in broadcasting is not an isolated one – it is intimately linked to the pervasiveness of public goods, which create the cost conditions that typically benefit size. Similarly, the pervasiveness of branding of bundles of programmes – which is what channels are – derives from economies of scope and scale. It is no accident that BSkyB, the BBC and other core broadcasters tend to be large and vertically integrated, nor, as we shall see, are there good reasons to think that this market concentration is likely to fragment with the coming of the digital age. For fundamental economic reasons, broadcasting tends to be oligopolistic.

Public goods

Normal economic goods – private goods – are supported by property rights, and markets allow these rights to be exchanged between producers and consumers. These property rights have two fundamental characteristics: they are *rival* and *excludable*. By contrast, a public good, in formal economic terms, is *non-rival* and *non-excludable*. It is non-rival because the fact that one person watches a television programme does not impair another's consumption simultaneously. The marginal cost of the additional viewer is zero. Consumers are not rivals, as they are for most economic goods and services. It is non-excludable because there is no obvious way to exclude people from watching a programme, unless some artificial barrier is created – for example, through a law that requires a licence to be bought, or some device giving access to a particular programme. But exclusion needs to be *created*, and hence a property right manufactured.

It is these two fundamental properties which distinguish public goods from private goods: in effect, there are two market failures occurring concurrently. If consumption were rival, but non-excludable, there would be externalities. If excludable, but non-rival, then we would have so-called *club goods*, and as we shall see, the licence fee in effect turns broadcasting into a club activity. Note, too, that there are other externalities in addition to those associated with the public good described here: production and consumption by some individuals affect others in ways that go beyond the fact that the marginal cost of consumption is zero and viewers cannot be excluded. Some of these externalities are part of the public service broadcasting requirements, since a well-functioning society is one where other people are informed and educated, and share common experiences and understanding. So, to complicate matters further, there are multiple externalities as well as the externality in public goods. This is important because 'solving' the public good problem is not sufficient to 'solve' the public service broadcasting problem; it is only necessary.

It is asserted by Ofcom in its Phase 1 report, and by others, that the coming of digital broadcasting largely 'solves' the public good problem in respect of consumer choice for programmes and broadcasting that they are willing to pay for. This is clearly not correct. Nothing in the digital world changes the basic point that the marginal cost is effectively zero. *Excluding people does not make a product rival*. What digital programming may do is to *fragment* the market, and therefore disaggregate the public goods. As a result, the number of people who enjoy the zero marginal cost output is reduced for each programme or channel, and therefore the number of people who might be persuaded – through charging – to contribute towards the fixed costs falls.[6] But since *any* charge will deter at least some consumption at the margin (those people who value the output just above the marginal cost of zero), this can have the perverse effect of raising the average cost to all those paying, hence removing more people at the margin.[7] (Indeed, it is this effect that bites most heavily into the citizen and equality-of-access arguments discussed above under the concept of citizenship.)

In practice, the public good arguments are much wider than the marginal cost of viewing. Programme production involves the creation of ideas, concepts and knowledge, which, once created, has zero marginal cost, and in a well-functioning society may need to be very widely distributed. There is a very large technical literature on intellectual property, R&D and public goods, and the incentive problems to draw upon, and it is notable that all developed countries have significant public support for research and cultural activities.[8]

6 There is a parallel with the 'natural monopoly' arguments in the public utilities, where the economic problem is to recover the fixed costs from users or taxpayers, given that the marginal cost is zero, except at congestion points.

7 Myles (1995) Chapter 9 provides a succinct summary of public goods theory and the implications of the Samuelson rule for the optimal provision where the sum of the marginal rates of substitution is made equal to the marginal rate of transformation, thereby gathering together under the demand curve all the consumer surplus that has any positive value.

8 These market failures are well recognised in British policy. See, for example, HM Treasury (2004), for a flavour of the scale of interventions.

The exclusion component of public goods is typically 'solved' in the economics literature by one of three mechanisms: state provision (as, for example, in defence, police, and fire services); by a mix of state and voluntary contributions (for example, coastguards and organised religions); or by the creation of property rights – in particular, the creation of 'clubs'.[9]

Although there are many international examples of direct state provision of broadcasting, these are vulnerable to bias and state propaganda and hence fail the test of *independence*, to which we return below. Voluntary public provision of broadcasting has a long tradition, but tends to be restricted to specific interests rather than public service broadcasting in general, and is liable to capture. Religious broadcasting is perhaps the best example here.

That leaves clubs – a much under-researched approach to public service broadcasting. Club goods, in economics, are those that are non-rival to members: each member pays a membership fee, and then has non-rival access to the service. Since the membership fee is fixed independently of actual consumption, the marginal cost of consumption *for members* is zero. Hence, not only is non-rivalry preserved, but at zero marginal cost. The non-excludability is solved by the criterion of membership, and it requires enforcement. Non-members must not be able to benefit. The membership fee itself recovers the costs of providing the club good, which is not zero. In the case of broadcasting, the marginal cost of consumption may be zero, but the fixed costs of production are not. Note here that the conventional idea of variable costs is not relevant: although a broadcaster can increase or decrease its costs, once a programme is made, the output 'exists' – it is broadcast, and the marginal cost in respect of an individual consumer is zero.

The way in which the fixed costs are spread across club members matters because, for efficiency reasons, it should not distort the marginal consumption decisions of its members. Typically, a uniform charge is applied, equal to the total costs divided by the number of members. Even here, however, there is a disincentive effect.

Clubs are imperfect solutions, in that, although the marginal cost of use is zero, the club may still exclude some with small positive utility: some people are deterred by the cost of the membership fee and hence are excluded. Clever pricing, such as discounted membership fees for the elderly and young, and those on benefits, can minimise the impact.

9 For a survey of club goods, see Sandler & Tschirhart (1997).

Since there are many activities in the economy with public goods characteristics, and because state and voluntary provision suffer from drawbacks and limited funding, it is not surprising that the club solution is a pervasive form of providing public goods. Clubs abound in a host of activities, from professional services (common standards), to sporting activities (common facilities), to Visa cards (common networks). Breakdown services (common back-up networks), journal subscriptions (fixed research costs), childcare clubs (common facilities), the RSPB (common reserves) and the National Trust (common properties) are yet more examples. Most people's wallets and bags are full of membership cards, and direct-debit statements typically list membership fees.

The relevance to public service broadcasting is obvious: the licence fee represents a membership fee for the services of the BBC and other channels. It excludes those who do not pay. Yet, once paid, the cost of viewing programmes is zero, and hence it maintains the non-rival quality.

Clubs differ from subscriptions in an important way, which affects the ways in which markets may fail to overcome the public goods problem. Subscription to individual programmes or services tends to raise the marginal cost of consumption. The narrower the subscription is to the programme, the greater the violation of the non-rivalry zero marginal cost criterion. Subscription to a whole channel is more efficient, and subscription to broadcasting as a whole is even better from an efficiency perspective.

The practical impact of this bears directly on the design of the licence fee. Narrowing it to the BBC will raise the hurdle slightly; moving to subscription fees for particular services makes the market inefficient; and a per-programme charge is the most inefficient outcome from a public goods perspective.

As we shall see, the club goods perspective on the licence fee has very considerable implications not just for the way the public good is provided, but also for the governance of the BBC. If licence fee payers are *members* of a club, there is a corollary in their ownership and control of its activities. We return to this below in section four.

Monopoly and market power

Much analysis of markets starts with the competitive paradigm, and considers whether a particular market is, or could be, competitive. Competition, in this usage, is treated as an absolute criterion. Such thinking surfaces in the Ofcom Phase 1 report. In its application to broadcasting, it is argued that the coming of the digital age will reduce entry barriers, creating the opportunity for a large number of companies to flourish. Market forces, in the context of many competing companies, will then, it is argued, deliver what people want – including many of the niches that public service broadcasting aims to serve. The conventional consumer choice issues will be solved, leaving only *some* residual citizenship failures.

Competition is, however, a complex phenomena. No markets are 'competitive' in the sense of the perfect competition ideal of textbook economics. Markets display varying degrees of competition and there are many dimensions and kinds of competition. The policy question is whether there is *enough* competition to negate the need for intervention and, in the broadcasting case, whether in fact the digital age will bring forward yet more entrants to challenge the incumbents.

The Ofcom Phase 1 report is remarkably optimistic in this regard. But the underlying economics may point in a different direction: the economies of scale and scope in broadcasting are pervasive, and there are powerful reasons why vertical integration may be efficient. Rather than a fragmentation with hosts of new competitors, the digital age may turn out to be characterised by a small number of dominant, vertically integrated players, with very significant barriers to entry.

Why might this be so? First, consider the structure of market access. A small number of platforms dominate access. These are supported by high fixed and sunk costs. The only 'revolutionary' method of access is the Internet, and here, too, there may be concentration in access to delivery. The incumbents seek to protect their sunk costs through vertical integration (a strategy which most infrastructure network businesses have traditionally pursued). They vertically integrate with suppliers – film and sporting rights (where there is also concentration) – and with customers. They create brands which package programmes together. Techniques such as margin support and deep discounting are used.

Given that sport and films tend to play a critical role in attracting viewers, entrants may need access to these in order to develop a market offering. As demonstrated in the sports market, the large broadcasters have very great dominance over the popular sources of programming, to the practical exclusion of entrants. Indeed, so important have sports rights become that there have even been attempts by broadcasters to vertically integrate into sporting companies, notably in football.[10] There is no convincing evidence to suggest that the digital age is likely to radically change this link and its impact on market power.

10 For an overview of the economics of the sport market, see the special issue of *Oxford Review of Economic Policy* (2003), and, in particular, Szymanski (2003).

Because markets are concentrated around channels and brands, market share greatly affects the economics of both advertising and subscription. Advertising is a sunk and fixed-cost production activity, averaged over the audience. There are therefore powerful reasons for targeting mass audiences and encouraging broadcasters to focus their programmes accordingly. Programme production may have some elements of economies of scale too, as do many sporting activities. These markets have also concentrated, again with football as an obvious example. Though there are many fringe film companies and independent programme makers, these activities, too, have many of the characteristics of oligopolistic competition.

The economies of scope and scale in production, the fixed and sunk costs in platforms, and the sunk costs in advertising will – both separately and in aggregate – mean that the market will not produce optimal diversity. Rather, the oligopolistic competition for market share which results will tend to reduce diversity both in the type of programme and in scheduling. Programme schedules will tend to converge in both content and broadcast timing. These pressures are witnessed in the claims about 'dumbing down' and the perception that, despite the number of channels, the choice is quite limited – hence, the emphasis on 'choice' and 'diversity' in debates about the future of broadcasting.

So what will happen with digitalisation? Market developments are uncertain, and hence no policy should be designed on the assumption that one possible outcome will arise. It is in the nature of competition that there will be surprises. The uncertainty should condition public policy. It may be that the market does turn out to be richly competitive in many dimensions (as Ofcom believes), or it may turn out to continue to be dominated by an oligopoly. If intervention continued to support public service broadcasting in the current way, but Ofcom turned out to be right, and digitalisation led to the competitive outcome, intervention could then be gradually withdrawn. But now suppose the opposite, that there is a tendency towards concentration, but policy assumes competition. In this case, the licence fee and the BBC might have been dismantled, reinforcing the concentration in the market. It would be very hard *ex post* to dismantle an even bigger BSkyB, or to resurrect ITV if it were squeezed out of the market.

Thus, although it is beyond the scope of this essay to provide detailed cost analyses or predict in detail how digitalisation will shape the market, there are some good *general* reasons for thinking that concentration has underlying economic motives and that the dismantling of one competitor (the BBC) will not necessarily be replaced by several new ones. The digital age will bring many surprises, and may lead to an explosion of competition. But it may not, and if policy allowed a round of consolidation and at the same time reduced the status of the BBC, it would probably be irreversible.

The conventional 'solution' to market power is competition policy: many markets display market power and are subject to the constraints of competition law – not to engage in anti-competitive behaviour or to abuse dominance. These constraints will apply here too, but they are unlikely to be sufficient, since the issues relate to structure as well as conduct, and there is little evidence that the competition authorities are willing to contemplate the unbundling of BSkyB. The public good characteristics are one of the major reasons for market power (because the marginal costs are very low, relative to the average costs), and hence have structural implications. Competition policy focused on conduct will not make the underlying economics of structure go away, and hence some form of sectoral policy will be needed to reinforce general competition law.

It is therefore not surprising that Ofcom pulled back from the more conventional economic model that pervaded its Phase 1 report, and in the Phase 2 report opted for a more limited approach instead. Rather than tackling the structure head on, it proposed two incremental additional elements of competition: the new PSP with a focus on new delivery systems, and a greater role for independent productions in the BBC's outputs.

As checks on the BBC's market power, neither element is likely to have significant impact. But having rejected substantive *structural* change, Ofcom opted to constrain the BBC's output towards public sector broadcasting, in effect suggesting that the BBC should exit mass markets that others in the digital age can produce. According to Ofcom's approach, the BBC should retreat from core film and sports markets. Such recommendations not only have the incidental effect of *increasing* BSkyB's market share (and hence may not actually increase anything in the market *as a whole*), but also reflect the narrow economic concept of public service broadcasting, which was criticised above. Add to this the suggested cost squeeze, and the net impact would be for a *gradual* erosion of the BBC's role, and, with it, the *gradual* marginalisation of public sector broadcasting.

The final consideration is how the public good failures interact with market power. Will dominant companies produce the diversity and richness that the citizen and public good arguments point towards? In part, this is a competition issue too: Ofcom rightly points to the benefits of a large number of independent producers challenging the incumbents' programme-making. However, there is also the issue of the brand as a whole, and whether the BBC in particular is able to cross-subsidise within its portfolio of programmes to focus on those with significant public service broadcasting content, even if, as a result, smaller minority audiences are catered for at the expense of mass audiences. The answer depends in large measure upon the method of finance: whether it is licence fee-based, as opposed to being based on advertising or on per-programme charges. This is examined in section five below. But, before we turn to finance – and its relation to market failures – we first need to consider governance and regulation.

4. Government and regulatory failure: the design of intervention and the role of the BBC

The fact that markets fail does not, in itself, mandate intervention. All markets fail: the issue is whether the market failures are greater than the costs of intervention. These costs, referred to as government and regulatory failure, in turn depend upon the design of the intervention.[11] In the broadcasting market, the main interventions are the BBC's institutional structure, the licence fee and the ancillary regulatory framework.

The BBC is a unique institution, designed for a quite different pre-Second World War context, where competition was absent. The broadcasting technology was new and the ways it would evolve uncertain. It was set up as a public corporation and with a governance structure designed to pursue the public interest. It was a structure not unlike that adopted for a broad range of public bodies: its board would decide for itself, within a broad discretionary context, how to interpret the public interest. It would be made up as it went along, in the classic British, pragmatic and empirical approach to administration, regulation and public provision. Governors would be the arbiters of what the corporation would produce. The first director general set out the vision of public service broadcasting – the Reithian approach – which has endured ever since, and proved remarkably adaptable to the changing marketplace.

As a structure, the BBC has certain advantages. It has a history and a corporate culture that define a set of professional ethics, which do not have to be directed. A common culture is often managerially efficient: it takes years to create, and can be quickly dissipated. The BBC has the further advantage that it is largely vertically integrated. In its early history, this was an essential feature of

11 There is a host of different kinds of government and regulatory failures, which can be divided for analytical ease into informational failures, public monopoly failures, and regulatory capture. All of these may pertain to the relationship between the government and the BBC, and none is obviously 'solved' by the existence of Governors.

broadcasting development, but as the market developed the same standards could be applied throughout the full vertical chain.

Such a culture can degenerate into the pursuit of the quiet life. A monopoly position tends to encourage cost inflation, and hence there is a need for effective regulation. This is currently largely provided by the BBC itself, through its Governors. These people are supposed to represent the public interest, and to protect the independence and impartiality of the BBC. Where direct state provision and/or regulation – or, indeed, voluntary provisions – might well have biased its output, the Governors have managed to keep the political process at arms' length, and withstood repeated challenges by politicians of both parties. It is a structure that has arguably performed this role quite well in comparison to many other public institutions and other models internationally.

Yet questions remain. How can we be sure that the BBC is cost-efficient, without the disciplines of competition? The answer is that we cannot, and there is a good argument for an element of external audit. In other core monopolies, this function is performed by independent regulators. These bodies use benchmark and comparative information to assess the efficient cost levels, and prices are set accordingly. While there have been repeated efficiency audits with the past reviews of the BBC, and many internal efficiency drives, there is no such arm's-length regulator, and a good case can be made for passing this efficiency function to Ofcom, with the remit to advise the Secretary of State on this aspect of setting future licence fees. In its Phase 2 report, Ofcom recognises this role, though the claim that efficiency gains might be sufficient to make significant inroads into the licence fee is more a conjecture that a carefully researched empirical proposition.

The question of 'independence' of the BBC in its choice of programmes and editing processes is more difficult, and it is far from clear that Ofcom has a role here. The political dimension of independence can be expressed in economic terms as how to separate the principal (the government) from the agent (the BBC). The recent Hutton Inquiry cast considerable light on the issues, but less on the appropriate structures. In practical terms, the question is: what stands between the government and the BBC? This role is currently fulfilled by the Charter and the Governors. Given the administrative approach of delegating discretion to them, it matters greatly *who they are*, *how they are chosen*, and *how they are held to account*.

If the regulatory task in respect of efficiency is delegated to Ofcom, as suggested above, the Governors' prime functions are to represent the interests of the citizens as listeners and viewers and to ensure that the output is consistent with these interests. It is a role similar to that of the board of the National Trust – representing the members who pay the membership fee, in this case the licence fee. But, unlike the National Trust, the licence fee payers do not elect their representatives, and hence the link is indirect via the political process. It is far from obvious that this is appropriate, and the aim of limiting government and regulatory failure suggests that alternative arrangements should at least be considered. The club good model discussed above provides the basis for one more radical model: creating a direct link to trustees, who could be subject to members' influence and even control. This would take the politics out of the process of selecting Governors, although the sheer size of the resulting BBC membership might limit their effective control.[12]

'Independence' is not a single dimension of conduct. A broadcaster has to *choose* what to broadcast and how to present issues, ideas and arguments. This is not some analytical or abstract activity: the choices made influence and reflect society as a whole. The BBC is required to be 'impartial', but what this means and what it is impartial about are deeply embedded within the political and social context. Referring back to the discussion on the role of citizenship and the extent to which market failure can capture most, or indeed all, of the public service broadcasting concept, independence is not simply a matter of reflecting consumer preferences. It is not simply what consumers would be willing or able to pay for. What sort of independence is produced depends critically on how the institution is designed, its history and the accountability of its programme makers. The club model has the merit of separating out the membership fee from individual programmes, leaving the trustees to make individual output decisions. But it creates a more direct bond with its members than does the BBC Governors' model.

There is an alternative and more radical regulatory model than that discussed above, based on the approach towards telecoms and other network utility services.[13] The BBC could be vertically unbundled and subject to a full economic regulatory regime (rather than just an efficiency audit), driven by Ofcom. This approach has many attractions, inducing consistency between the broadcasters, providing a basis for promoting competition, and, in using an existing regulatory body, keeping the costs of regulation down. It is also implicit in the Ofcom Phase 2 report.

12 Although its governance has been subject to criticism, the National Trust manages to enfranchise over 3 million members.

13 See Laffont & Tirole (1999) for a comprehensive survey of the telecommunications issues, and in particular the discussion of universal service in Chapter 6.

There are, however, problems with the utility model. First, unbundling would need to be an industry policy, not BBC-specific. It makes little sense to break up the BBC without also breaking up the other players, notably BSkyB. To do one, but not the other, would reinforce the market power of BSkyB and hence the overall level of competition is unlikely to be improved, and may actually fall. But since nobody is actually proposing to tackle BSkyB in this way, the unbundling of the BBC on its own is unlikely to be desirable.

Bringing the BBC under the full wing of Ofcom has several advantages. Ofcom has expertise in respect of competition and competition policy, and in the broadcasting market. If the purpose of Ofcom is to bring consistency to regulation across broadcasting and communications, then having a domain over the whole market might be a sensible step. Again, however, there are practical problems. The BBC would not need Governors and Ofcom to play the regulatory role: the Governors, as currently constituted, would be redundant, and the BBC would have a normal corporate board instead, even if it remained not-for-profit. As with unbundling, halfway houses may be more imperfect than the *status quo*.

5. Financing public service broadcasting and the licence fee

The licence fee as a method of finance was devised in a world where the BBC was the monopoly provider. It was therefore a fee for access to a service, and for pragmatic reasons was tied to the ownership of radios and televisions. There are good economic reasons for thinking that this was very efficient: it was a classic club membership fee, which recovered the costs of the networks from the users without significantly distorting marginal decisions. Given that the marginal cost was zero, as discussed above, it provided the right incentives to viewers. In the monopoly world, then, the licence fee was optimal.

This early justification was undermined by the arrival of competitors. By tying the licence fee to radio and television ownership, in principle viewers might be paying for a service they did not want, although, in practice, everyone watched the two main channels. While audience share has fallen, it can be assumed that almost all watch at least some BBC output or tune in to one or more BBC radio stations. Whether the proceeds of the licence fee should accrue to one supplier, however, is a more open question.

Two other forms of finance have been suggested on numerous occasions: advertising and subscription. The main economic issues in relation to advertising as the principal source of finance have been well researched. Advertising has the advantage of avoiding direct payment by viewers, and therefore does not distort the incentives to watch programmes. The marginal cost is therefore zero. It therefore allows the public good characteristics to be met. However, this does not mean that it is costless – the costs will be passed through to the consumers of the products. Advertising is itself a market with considerable failures, as noted above. It is a sunk cost, and there are scale economies. If the objective of the BBC were to maximise advertising revenues, it would shape its outputs to maximise the benefits to the advertisers rather than the viewers. It would encourage convergence on mass-audience programmes and hence undermine public service broadcasting.

Advertising can also create disutility: viewers do not choose to watch adverts and, for some programmes – particularly live events – the disutility can be quite large. Finally, advertising will have a consequence for competition in the market. If the BBC were to switch to this form of finance, the ITV companies would lose advertising revenues, and hence the quality of their programming would decline. There may even be a reduction in the number of mass-market channels.

Direct charges, in the form of subscriptions, for programmes or channels split up a market, and have their own transaction costs associated with the exclusion mechanisms. A charge-per-programme creates an important negative externality: each person paying the charge contributes to the fixed cost. Hence, as the number of viewers reduces, the price per programme rises to meet the total costs. As a result, the gap between marginal and average cost increases, reducing the access. This effect is likely to be especially important in the case of minority public service broadcasting.

A per-channel charge is more likely to encourage diversity, since it spreads the average cost of all the programmes over the subscribers. As such, it is rather like the licence fee, except that it excludes between channels. To the extent that all customers might want to benefit from the lower average costs created by the fact that the licence fee covers all viewers, as opposed to a higher licence fee if some defect, the economic balance of costs and benefits in this regard is complex. What needs to be compared is the benefits to consumers who would be in the margin between the two levels of licence fee: the ‘everyone’ level and the ‘channel’ level. Since these are likely to be people constrained off through lack of income, consideration of social issues may tip the balance to the all-channels licence fee approach.

6. Conclusions: a case for pragmatic, not revolutionary reforms

This essay has considered two main aspects of the debate on the future of the BBC: the case for public service broadcasting, and the case for the licence fee.

In the process it has considered some of the arguments for the *status quo*: leaving the BBC roughly as it is, and the licence fee as a universal all-channels charge.

The case for public broadcasting should be based on values which go beyond mere economic efficiency – indeed, the citizen argument differs from the economic in that the former treats everyone equally, while the latter treats people according to their income constraints. An economically efficient broadcasting market, which pays proper regard to the market failures, will not be the most desirable if citizens-based arguments count.

Nevertheless, market failures cannot be ignored, and the pervasiveness of public goods and market power transcends the coming of the digital age. Ofcom's assertion that digital technology will change the nature of the public service broadcasting debate is probably correct only at the margin: in the digital age, the public good characteristics do not go away, nor will market power. Indeed, there are some good reasons to believe that the public good characteristics could make per-programme payments highly disadvantageous to marginal low-income viewers, and may actually reduce choice because the average cost of minority programmes will rise as the number of viewers fall. Without the BBC in roughly its current form, the market may actually concentrate further.

These considerations lead to the following conclusions: that there is a strong case for intervening to encourage the provision of public service broadcasting; that the licence fee remains an appropriate method of finance; and that the BBC should continue to play the central role in correcting for the market failures. Although the Phase 1 report points against this, in Phase 2 Ofcom broadly accepts these conclusions. It is more likely to deliver the citizen benefits than other alternatives, since, by including everyone in the contributions to the average costs, the gap between average and marginal costs will be minimised.

However, there may still be some marginal citizens excluded at the current level of the licence fee, and here there are two solutions: direct social security to provide the income, or some form of special category with lower charges. The latter route has many advantages, although it has to be carefully crafted to achieve the trade-off between maximising the number of contributors to the average costs, and not deterring people at the margin.

None of these considerations, however, implies that the BBC's current organisational structure and the domain of its programming and activities are optimal. There are also good general reasons to believe that it lacks incentives to be cost-efficient. Ofcom, in Phase 2, suggests a number of remedies, though none is convincing. The proposed PSP competitor and the greater reliance on independents are, at best, marginal, and, in the case of the PSP, may actually be ineffective in the context of the BBC's substantial website public services. More worrying still is Ofcom's suggestion that the BBC should be constrained to a narrow version of public service broadcasting, and hence retreat from the film and sports markets, thereby reducing choice and increasing BSkyB's market power.

That leaves the crucial requirement of effective governance and regulation. The question of who decides what the public interest is – and hence what best meets the public service broadcasting requirements – is wrapped up in the governance structure, and it is far from clear that the current internalisation of this problem is necessarily optimal. Although much of this essay – and the wider debate – has been about market failure, the issues around government and regulatory failure are of considerable importance, and once many of the former have been resolved, the Charter Review will need to look closely at the latter.

Bringing the economics of market failure – particularly public goods, the method of finance and the governance – together into a coherent framework can be achieved by thinking of the BBC as, in essence, a club. A club internalises the public good aspects efficiently by maximising access through minimising marginal costs, and the licence fee can be regarded as an (imperfect) form of club fee. In the BBC's case, what is missing from this framework is a direct link between the licence fee payers (the club members) and the BBC. It has been argued in this essay that there is merit in thinking about the role of Governors as close to that of trustees – what might be called the 'National Trust model' – and exploring greater accountability to, and control by, its members.

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