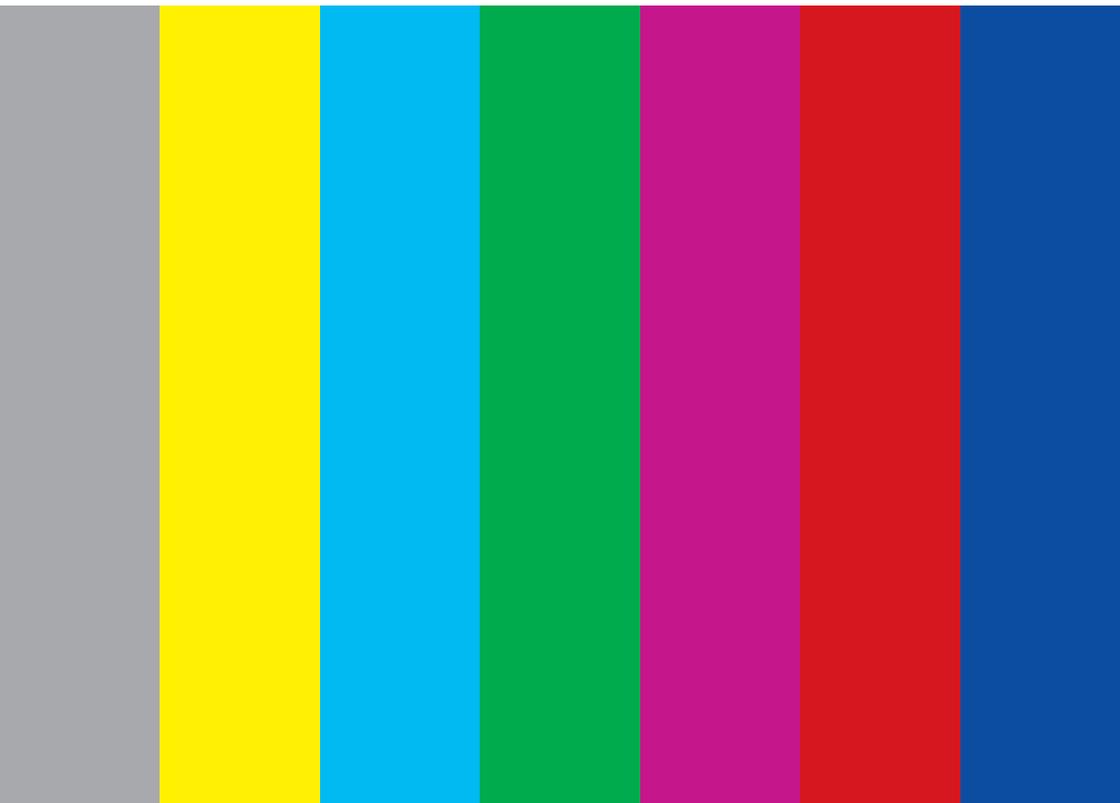




The BBC and Public Value

Gavyn Davies OBE

With commentary by Lord David Lipsey



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The BBC and Public Value

Gavyn Davies OBE

With commentary by Lord David Lipsey

Gavyn Davies's essay is based on a lecture he gave at the Said Business School, Oxford on 10 June 2004, and is published here with a contribution from Lord David Lipsey, Chair of the Social Market Foundation.

Social Market Foundation
November 2004

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Gavyn Davies OBE

Gavyn Davies was Chairman of the BBC from October 2001 until he resigned on 28 January 2004. In 1999 he chaired a UK Government inquiry into the Future Funding of the BBC.

He studied economics at St John's College, Cambridge and at Balliol College, Oxford. He was an economic adviser to the 10 Downing Street Policy Unit (1976 – 1979); an economist with Phillips and Drew (1979 – 1981); Chief UK Economist, Simon & Coates (1981 – 1986) and Chief UK Economist, Chief International Economist and Managing Director at Goldman Sachs (1986 – 2001). From 1992 to 1997 he was a member of HM Treasury's independent forecasting panel and has been Visiting Professor at the London School of Economics and an economic adviser to the House of Commons Treasury Select Committee.

Lord David Lipsey

David Lipsey (Lord Lipsey of Tooting Bec) took over the Chair of the SMF in November 2001. He is also Chair of the voting reform group, Make Votes Count and part-time chairman of the British Greyhound Racing Board and the Shadow Racing Trust. He is a director of ITV London, and a member of the council of the Advertising Standards Authority. He has previously served as a member of the Davies panel looking into the funding of the BBC; the Jenkins Commission on Electoral Reform and the Royal Commission on Long Term Care of the Elderly.

Prior to becoming a Peer in 1999, Lord Lipsey was Political Editor at The Economist and previously worked

for The Times, Sunday Correspondent, New Society and the Sunday Times. Before going into journalism, he was Special Adviser to Rt Hon. Anthony Crosland at the Foreign Office and a policy adviser, speech writer and later acting political secretary on the Prime Minister's staff at 10 Downing Street until 1979. He graduated with first class honours in Politics, Philosophy and Economics from Magdalen College, Oxford.

The BBC and Public Value

Gavyn Davies

Introduction

This essay asks what we can learn from economics to inform the debate on the renewal of the BBC's Charter in 2006, and in particular what economics can contribute to the basic question of why the BBC should exist at all. Many of the BBC's supporters will be resistant to approaching questions about its value from an economic standpoint, since they tend to prefer arguments couched in social or cultural terms. But there is much in the unappealing language of economics which can help justify the role of the BBC.

I am going to argue that economics is relevant to more than a calculation of the consumer value to the BBC.

Making an economic case for the BBC

There is a line of thought, widely held, that the core case for the BBC should rest not on money and markets, but on culture and citizenship. I agree. I have argued elsewhere that the concept of public value should lie at the heart of the BBC's charter bid¹. Some elements of public value – such as the price the consumer would pay to view a Premiership football match – can be readily measured in monetary terms in the marketplace. But other elements – such as the value placed by society as a whole on an informed electorate – cannot be so easily valued, or even sensibly valued at all.

This has led some observers to argue that economics is only relevant to a part of what the BBC should be expected to provide, and that the consumer value of the BBC is the rightful subject matter of the economist. The citizen value, on the other hand, lies outside the purview of the economist. Ofcom, among many others, is prone to this type of assertion.

¹ recent lecture at Hertford College, Oxford

There is nothing intrinsically wrong with this distinction, especially as it makes clear that there are a number of facets to the Corporation's value. However, as a professional economist, I am slightly offended by it, since it entirely forgets that economics is not simply about what can be measured in market exchanges, but is also about all those things which cannot be so measured, but which need to be considered when designing policy. Much of the subject matter of economics concerns the problems that arise when markets are missing, or when important relationships between individuals are not captured by monetary exchanges.

These causes of market failure form the core justification for public intervention in private activity, and always have done, from Adam Smith onwards. It can be frustrating for economists to listen to confident opinions being expressed by commentators who appear blissfully oblivious to the fact that two centuries of detailed economic thought has already been devoted to precisely the matters under discussion. It would be perverse to ignore these economic principles during the Charter debate.

In order to justify the existence of the BBC in its present form, there are at least three large questions which need to be addressed. These are:

Are there market failures in the private broadcasting market which imply that the market does not function efficiently, and therefore justify government intervention?

Are there distributional failings in the free market system, implying that the market (though possibly efficient) is unable to allocate information and entertainment satisfactorily to all citizens?

If public intervention in the market is justified on either of these grounds, are there alternative forms of intervention or regulation which would be preferable to the BBC?

I focus primarily on the first of these questions, since this is where the most serious intellectual attacks on the BBC are now to be found. It is incontrovertible that a necessary condition for the BBC to exist is that there is a market failure in the private broadcasting market in Britain. Otherwise, why would we want to go to all the trouble of collecting a licence fee, and using it to create a massive public body like the BBC? If that were the case, it would be much simpler just to leave all this to the private sector, if we believed that the free market produces an optimal out-turn.

A market failure in Reithian television services²

It used to be widely accepted that there was a clear market failure in broadcasting. There was a severe shortage of spectrum, leading to a restricted choice of channels, and there was no way of charging people directly for channels or programmes individually. But now there is virtually no shortage of spectrum, and many homes have access to the encryption technology which implies that channels can be bought and sold like any other free market service. This has led many to conclude that the television market is now just like any other, and that the case for market failure has therefore dropped away.

It is my view that free markets are generally, indeed almost always, the first and best default option for the organisation of human activity. But that does not mean that they are always and everywhere optimal. Sometimes markets can fail. Is this the case in the broadcasting market? More precisely, is this the case for the service which BBC television seeks to provide? This needs to be seen as a package of channels, which are together intended to inform, educate and entertain the viewer. The BBC package is explicitly intended to reach the mass market, not the tiny niche which is reached by Public Service Broadcast (PBS) in America. I shall call this the market for Reithian services.

It is important to be clear what we mean by a market failure in the area of Reithian broadcasting. Market failure exists when there is an under-provision of Reithian broadcasting services under free market conditions, relative to the socially optimum level. As in any other field of micro-economics, the socially optimum level occurs when the marginal social benefit is exactly equal to the marginal social cost. If the marginal benefit is greater than the marginal cost, then more Reithian services should be produced, and vice versa.

Many of my former colleagues at the BBC were extremely reluctant to hinge any argument for the BBC's existence on the concept of market failure. Since this concept is so widely misunderstood and misrepresented, I could readily understand their reluctance. But as a rigorous economist, their reluctance made no sense at all. Without market failure, the government should not intervene in the commercial market-place, and the BBC should be privatised.

The confusion about this arises, I believe, because people

² Lord Reith of Stonehaven was General Manager/Managing Director, British Broadcasting Company 1922-1927, and then Director-General, British Broadcasting Corporation 1927-1938. He is credited with inculcating the BBC with the mission to educate, inform and entertain.

misunderstand what economists mean by market failure. The term is frequently over-interpreted. So it is vital to say explicitly what I do not mean when I use this particular term of art.

First, I do not mean that Reithian broadcasting will be entirely absent from a free market system. If the BBC did not exist, there would still be a great deal of Reithian television produced by ITV, Channel 4, the excellent Sky News and other commercial providers. But there may not be enough to attain the socially optimum level.

Second, I do not mean that the BBC should produce only those programmes which are absent in the market place, while focusing solely on unique, minority content. Since practically everything is produced to some degree by the free market, such a rule would soon leave the BBC producing absolutely nothing at all.

I therefore reject the fear that the market failure case automatically implies that the BBC will become an increasingly irrelevant provider of up-market niche channels. What it does imply is that the BBC should top-up the supply of mass market Reithian broadcasting which comes from the private sector.

Causes of market failure in Reithian broadcasting

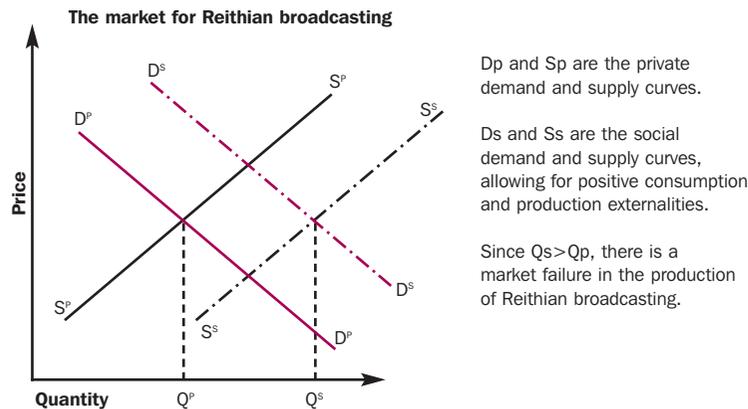
The subject of welfare economics has established that a free market will result in a socially optimal level of production of any good or service under certain conditions. These conditions include perfect competition, the absence of externalities, decreasing returns to scale, no missing markets, and no asymmetries of information. If these and a few other conditions hold, we would expect the free operation of supply and demand to result in an optimal or "efficient" level of output. Economists call this a Pareto-optimal situation, and it implies that no-one in the economy can be made better off without making someone else worse off. It represents the beautiful result of the free working of the price mechanism. For most goods and services, governments should get out of the way and watch the price mechanism do its magical work.

However, this is not always the case. Figure 1 shows a stylized version of how deviations from the assumptions of welfare economics might affect the market for Reithian services. In the

diagram, the private demand and supply curves intersect at Q_p , which is the amount of Reithian television which would be produced in a pure commercial market. However, let us now assume that some of the benefits of such television are not paid for directly by consumers, but are valued only by society as a whole. Such benefits might be the average level of information possessed by all citizens, or the general availability of cultural programmes.

Figure 1

Difference between free market and socially optimum level of output



If these items are generally valued, but not directly purchased by individual subscribers to TV channels, then the social demand curve for Reithian television will be to the right of the private demand curve, and the optimal quantity Q_s will exceed the amount produced in a free market. In such circumstances, the role of the BBC is to fill the gap between the amount of Reithian services that would be produced by the commercial sector, and the higher quantity which is implied by the social optimum.

There are in fact four main reasons why there is market failure in the UK broadcasting market. These represent clear deviations from the assumptions which are required in welfare economics to ensure that the free market produces a socially

3 Graham, A. and Davies, G. *Broadcasting, Society and Policy in the Multimedia Age* (University of Luton Press, 1997)

4 *The Future Funding of the BBC – Report of the Independent Review Panel* <http://www.culture.gov.uk/NR/rdonlyres/ejtmx662ood4hgxo2s2vx24awcsmhn5nqiiqc6nqcoiajcp1hlc5ir7s6vhlr6nvp3fzo2aixrsj jk6qbewh3k4eyg/reviewcobbc.pdf> (Department for Culture, Media and Sport, 1999)

optimum result. The reasons are:

- 1 Broadcasting remains a public good, which implies that it should be provided without making a charge at the point of use.
- 2 Broadcasting involves the creation of inter-personal relationships, called externalities, which are not fully reflected in market transactions.
- 3 Broadcasting involves increasing returns to scale, which tend to lead to the existence of private monopolies in a free market.
- 4 Broadcasting involves informational deficiencies which lead to sub-optimal levels of demand for quality products from consumers in the free market.

None of these assertions is remotely new. They have been widely discussed in the literature, including in previous work by myself and Andrew Graham³, and also in my government report on BBC funding in 1999.⁴ They, together with a departure from the list of the assumptions required for Pareto optimality listed earlier, effectively capture the causes of market failure. Sometimes, an eager new author will come up with a fresh twist on these old favourites (such as the invention of the importance of citizenship, which is simply a particular type of externality), but the novelty usually turns out to be more apparent than real.

Broadcasting: a public good in the digital age

It is important to revisit these causes of market failure because they have not disappeared simply because technology has gone digital, despite assumptions to the contrary. Indeed, they will be with us for a very long time.

The first issue for consideration is whether broadcasting is still a public good. Public goods or services have two characteristics. The first is that they are non-rivalrous, which means that consumption of the service by one individual does not preclude consumption of that same good by another individual. Street lighting is an obvious example. This implies that the marginal cost of supplying the good to successive individuals is effectively

zero, once the original costs of production have been incurred. Furthermore, it implies that the price charged for the service should also be zero, since any positive charge will prevent some consumers from enjoying a product which could be supplied to them for nothing. I do not see how this can be described as optimal by anyone who has studied welfare economics.

The second characteristic of public goods is that they are non-excludable, which means that consumption by one individual makes it impossible to exclude any other individual from having the opportunity to consume the same benefits. National defence is a prime example. The implication of non-excludability is that it is impossible to make a charge for the product, since no-one will choose to pay for a product that is freely available to all. Therefore no private market will develop for the product, and it has to be provided through the public sector.

Traditional analogue broadcasting fulfils both of these requirements completely. Once the analogue signal has been provided for a single user, there is no extra cost for providing it to everyone in the same locality, so the product is clearly non-rivalrous. Furthermore, once you have provided the signal for any household, you cannot exclude all other households, so it is also non-excludable. It is in fact almost the perfect textbook example of a public good. To the extent that analogue broadcasting still exists (and by far the majority of television sets in the UK are able to receive only analogue signals), then television remains an archetypal public good.

However, this is not so obviously true of digital broadcasting, which is presumably one reason why some commentators believe that the arrival of digital services undermines the case for treating broadcasting as a public good. Digital broadcasting can be made excludable, via encryption of the signal along with set-top boxes inside each home. This means that a free market in television services can develop, since people can be charged for their use of individual channels and maybe even individual programmes. However, this will not become feasible until analogue switch over, and even then most TV sets may not be equipped with the necessary boxes, since many Freeview boxes are being sold without a charging facility.

More importantly, digital broadcasting will still be non-rivalrous, just like its analogue predecessor. This will never

change. The marginal cost of providing a satellite digital signal to all homes is effectively zero, once the satellite has been launched. So broadcasting will remain forever a public good, in the sense that the marginal cost of provision to additional users is negligible. This is a sufficient condition to suggest that a charge at the point of use would be inefficient, for the reasons explained above.

Figure 2

Broadcasting compared with other public goods

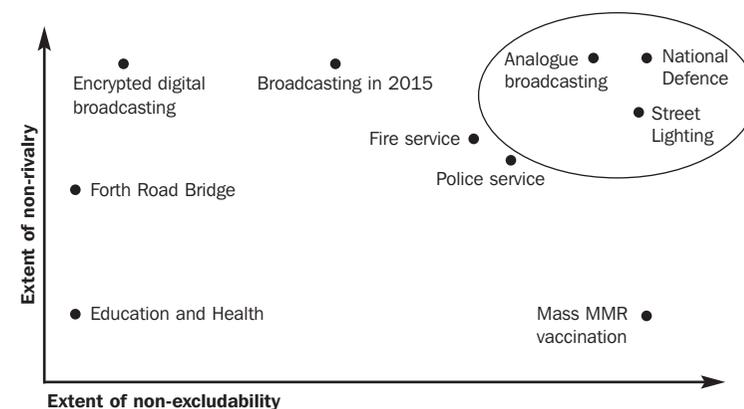


Figure 2 compares broadcasting with other public services, based on the extent to which the relevant services exhibit the characteristics of non-rivalry and non-excludability. The further upwards and to the right you move in the chart, the greater the extent that the requirements of a public good are met. Analogue broadcasting is almost a pure public good, alongside national defence and street lighting. Encrypted digital broadcasting is at the top left, with the likely state of the actual broadcasting market in 2015 somewhere around the middle top. This would still leave broadcasting at the end of the next charter period exhibiting far more of the characteristics of a public good than many other services provided by the public sector – including health, education, vaccinations, the Forth road bridge, and the fire and police services. Based on this graph, it is not clear why so many commentators wish to

shift the BBC outside the public sector, while leaving these other services firmly inside it.

In summary, then, broadcasting will always remain non-rivalrous, so the optimal subscription charge at the point of use should be zero. Any attempt to exclude some users by levying a subscription may result in under-consumption and could be sub-optimal. Furthermore the technology required to put such a charging mechanism in place would be a waste of resources.

Figure 3
The optimal output of a public good

How do we know what is the output level of a public good?

Derive a 'market demand curve' or social marginal benefit curve by vertically adding individual demand curves, shown alongside as D^A and D^B

Optimal output occurs where the resulting curve intersects the social marginal cost, or 'market supply curve', shown alongside as S

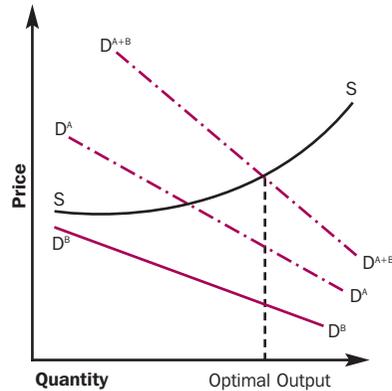
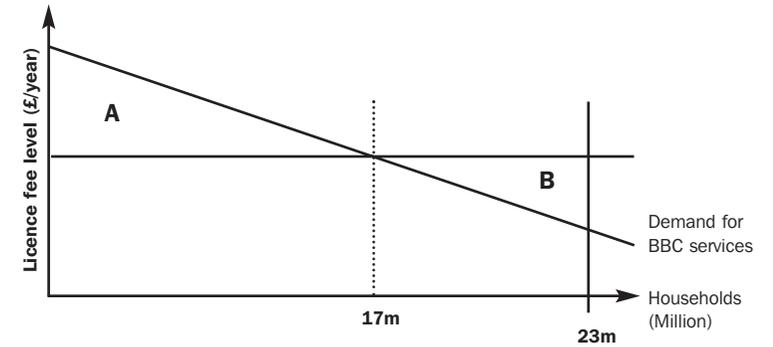


Figure 3 shows that the demand curve for a public good is derived by adding vertically the individual demand curves for every member of society. Obviously this is impossible in practice, but it is possible to derive a national demand curve for BBC services by asking samples of the population how much they would be willing to pay for the entire package of BBC services, if they were available on subscription. [Just before I left the BBC in January, we were in the process of doing this, with the research being carried out by Human Capital.]⁵ Figure 4 shows the results of a preliminary study, which was a pilot.

⁵ *Measuring the Value of the BBC*, report by the BBC and Human Capital, October 2004

Figure 4
Consumer surplus created by the BBC



On rough estimates, about 17m households value BBC services at more than the current licence fee. These are gainers from the existence of the BBC.

About 6 million value the BBC at less than the current licence fee. These are the losers.

The net consumer surplus created is A minus B, estimated to be well over £2bn/year, or 1/4% of GDP.

Source: BBC Pilot Study, Jan 2004

About 17 million households, or more than three-quarters of the population in the UK, value the BBC at or above the £121 per year which they are charged in the licence fee. About one third of the population would be willing to pay double the licence fee, and more than one quarter would be willing to pay treble the licence fee. Thus the vast majority of the population are gainers from the existence of the BBC, with many gaining by a very large amount.

However, around 6 million households say that they value the BBC at less than the current licence fee. Whether they would in practice refuse to pay £121 per year if they actually tried to live without the BBC is not clear, but that is certainly what they say today. Of these 6 million, it is quite likely that a large number actually refuse to pay the licence fee, and are not caught in any given year. This might lower the total by about 1.5 million, leaving about 4.5 million households who actually pay the licence fee while attaching a lower value to the BBC's

services than the cost of the licence fee. These are the losers from the current compulsory system of funding the BBC, though most of them do not lose by very much, since even they generally assign a positive value to BBC services.

It is right for the BBC to worry about these people, and to tailor some of their services towards addressing the problem. It does not seem to me impossible to eliminate this problem entirely by shifting BBC priorities somewhat towards those who are currently underserved, many of whom will probably be in the ethnic minorities, will be on lower incomes, and will be located outside the south east of England. Greg Dyke was very aware of this problem, and was addressing it very effectively. However, more needs to be done during the new charter. A disaffected minority is dangerous for the BBC and for the licence fee system. It has never been a feature of the BBC in the past, and it should remain a priority to eliminate the problem in the future.

The problem, however, must be seen in context. Those who gain from the existence of the BBC vastly outweigh those who lose, both in raw numbers and in monetary terms. By my estimation, the amount gained exceeds the amount lost by well over £2 billion a year, equivalent to 0.25% of GDP. This amount of consumer surplus would be instantly lost if the BBC were closed down.

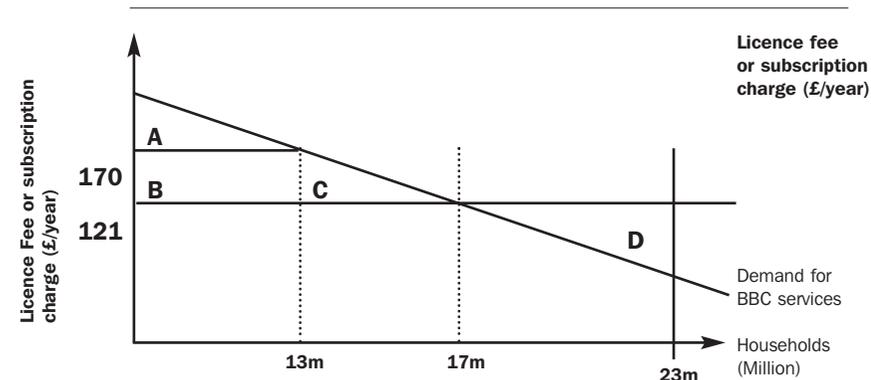
This may be what explains the extraordinary and enduring popularity of the BBC as a public service in the UK. These figures also provide a strong and enduring economic case for the BBC.

The impact of privatisation on the BBC

Those who deny that broadcasting is a public good usually argue that channels and programmes should be financed in the market just like any other service. In the old days, the recommended method for privately financing the BBC was usually advertising revenue, but since the Peacock Report in the late 1980s, the fatal flaws in this option have been widely recognised. Instead, those who believe in privatising the BBC's revenue stream usually recommend that the BBC should become a subscription service. If this were to happen, the BBC might choose to charge a licence fee which maximised its overall revenue (Figure 5).

Figure 5

The impact of a subscription model on consumer surplus



Under the subscription model, the BBC would probably charge a revenue maximising subscription charge of (say) £170/year

About 6 million consumers would benefit, by an amount equivalent to A. The rest would lose an amount equivalent to C+B.

Assuming $B+C > D$, the total amount of consumer surplus would fall under a subscription model compared to the licence fee system

Source: BBC Pilot Study, January 2004

I estimate that this might be around £170 per year, at which point about 13 million households would choose to pay the new charge, and about 10 million would choose to lose the services of the BBC. Clearly, the ability of the BBC to provide universal services for the whole nation would be lost overnight – a sacrifice which I for one would not be prepared to make.

Some people would, however, probably welcome such a shift in policy. These would be the 6 million households who currently value the BBC at less than the licence fee. Everyone else would lose part of their consumer surplus if there were a shift to a subscription system. About four million would lose all of their consumer surplus because they would no longer subscribe to the BBC at all, while about 13 million would subscribe, but would see their consumer surplus declining because they would now be paying about £170 per year for the BBC instead of the current £121 per year.

Overall, there would be a large drop of about £0.5 billion in national welfare if the BBC shifted from a licence fee system

to a subscription system. This could only be justified if one placed a very high weight indeed on the welfare of those 6 million households who would welcome such a change, and placed rather a low weight on the welfare of everyone else. Rather than conducting intellectual distortions to do this, I would prefer to eliminate the problem of the 6 million by addressing the underserved directly, as discussed earlier.

So the existence of the BBC adds enormously to the total welfare of the country, compared either to a situation in which the BBC were closed down, or to a situation in which the BBC were privatised and allowed to behave like any other commercial company, financing itself through subscription revenues. Many people dislike the licence fee system on political grounds, and many others seem to have persuaded themselves that changes in technology should lead inexorably to the BBC becoming a subscription based service. These people should face up directly to the large welfare losses which would immediately be incurred if their ideas came to fruition. They need to address the question of how the nation would be compensated for these losses.

The optimal scale of the BBC

If we accept that the BBC continues to produce a public good which adds to national welfare, this still leaves an important question about the optimum scale of the BBC itself. One way of looking at this is to define the core television service of the BBC to be BBC1, and then ask whether the marginal benefit derived from extra services exceeds the marginal cost of providing them. If so, then perhaps the BBC is too big. It is easy to measure the marginal costs of extra television services, and these are shown on a per household and per head basis in figure 6.

Many types of externalities clearly exist in broadcasting. These are linkages between the welfare of individuals which are never traded in exchange for money

Figure 6

Comparison of marginal costs and marginal benefits for BBC services

	Does marginal benefit for willingness to pay exceed the following marginal costs?	
	Per Household (£ per year)	Per Head (£ per year)
BBC2	15.58	6.67
BBC3	3.39	1.45
BBC4	1.75	0.75
News24	1.78	0.76

For comparison, the cheapest Sky package (no sport) costs £150 per annum, while the full package costs £582 per annum.

Essentially, it is worth providing BBC2 if the average individual is willing to value the service at just under £7 per year – not per week or per month. The values that need to be placed on BBC3, BBC4 and News24 are on average less than £1 per year for each citizen. I would make the confident assertion that an average individual would place at least that amount of value on these services, noting that the cheapest Sky package, excluding sport, costs about £150 per annum. If this is indeed the case, then I would argue that the recent expansion of BBC television into the digital world has already added further to national welfare.

Other causes of market failure

Many types of externalities clearly exist in broadcasting. These are linkages between the welfare of individuals which are never traded in exchange for money. For example, if an individual feels better off because other people are better informed or educated, this effect will never be captured in free market prices, and programmes which contribute to information and education will be under-provided in a commercial system. These effects are well known, as are the negative externalities

which are triggered when some citizens choose to access pornographic or violent programming. Less familiar are the externalities which are created when television is the catalyst for communities of interest to develop.

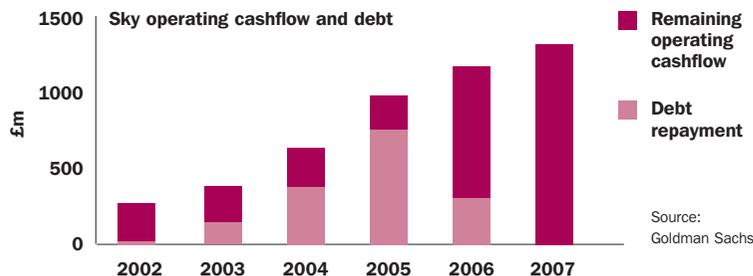
These allow individuals to derive greater enjoyment from their enthusiasms because they are shared with many other people. As Martin Brookes has recently pointed out in an important paper⁶, these externalities apply just as much to football and Eastenders as they do to opera and politics. They offer a clear economic justification for the BBC to be involved in popular programming.

A third form of market failure is that broadcasting tends to be an industry in which there are high fixed costs (for example, the cost of launching a satellite), and much lower variable costs. There are therefore substantial economies of scale and scope which result in marginal costs declining as the scale of the firm increases. The minimum efficient scale of a broadcaster will tend to be large, leading to a lack of competition and eventually to monopoly. Monopoly producers will over-charge for their products, and the quantity produced will be much less than the social optimum.

Those who think this is all rather far-fetched should consider the recent history of the television market in the UK. BSkyB, after knocking out BSB, grew its revenue from nothing to £3 billion in just over a decade. It is now larger than the BBC. ITV has struggled against this competition, and forces to consolidate ITV further, and then sell to a foreign buyer, are strong. According to some forecasts, Sky's free cash flow will rise several fold in the next few years, reaching well over £1 billion in 2007.

Figure 7

Sky will deliver over £1bn of free cash flow by 2007

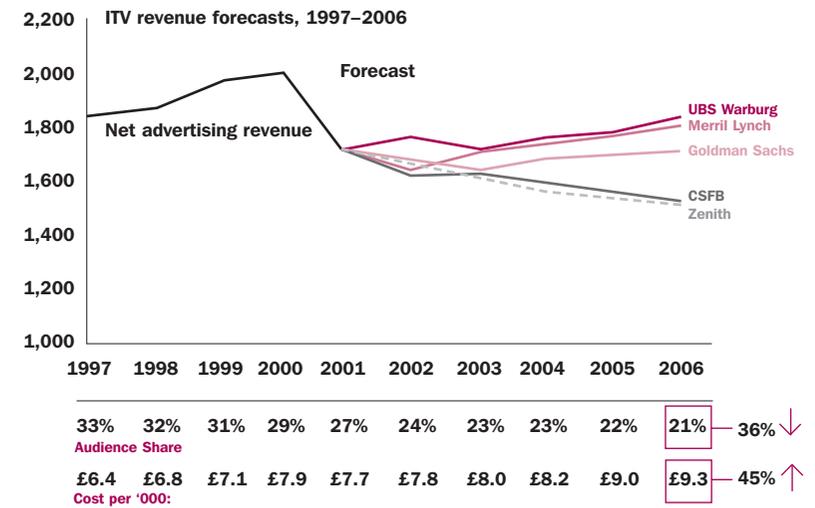


6 Brookes, M. *Watching Alone: Social Capital and Public Service Broadcasting* http://www.bbc.co.uk/info/policies/pdf/watching_alone.pdf (BBC/Work Foundation, 2004)

Sky is becoming a colossus compared to ITV, which now exhibits a business model which is clearly under threat. (Figure 8.) It would be surprising if ITV's advertising revenue rose at all during the current decade, since ITV's audience share has fallen by about one third over ten years. The only way in which ITV has been able to stabilise its revenue in the face of these plummeting audiences has been to increase its advertising rates substantially. But it is increasingly questionable whether advertisers will be willing to pay premium rates for access to a declining minority audience. This squeeze may pose an ever-greater threat to the ability of ITV to afford the kind of public service programming which it has been able to make in the past. Ofcom will no doubt fight strongly against these trends, but I have only limited faith in the ability of outside regulators to hold back the powerful forces of the market.

Figure 8

ITV's prospects look less certain than ever and relies on continued cost inflation

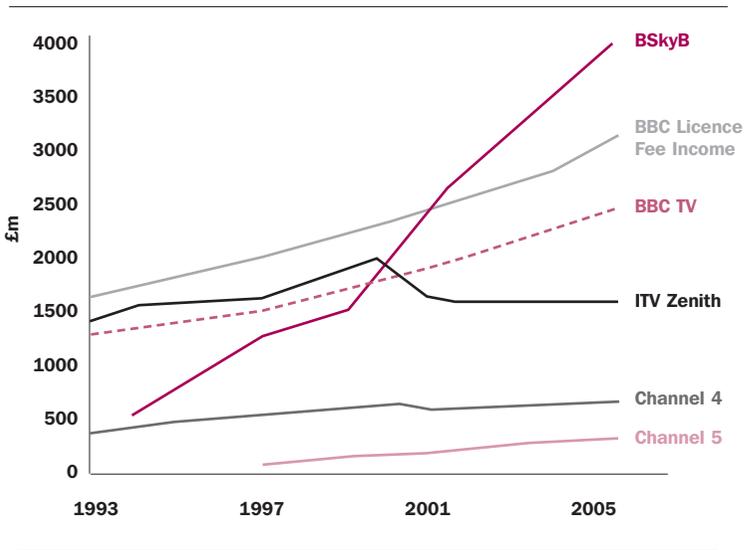


Sources: Zenith Media; CSFB; Merrill Lynch, Goldman Sachs, UBS Warburg, Corporate Strategy

In my opinion, these trends will increase the importance of the BBC as a provider of mass public service broadcasting, and as a

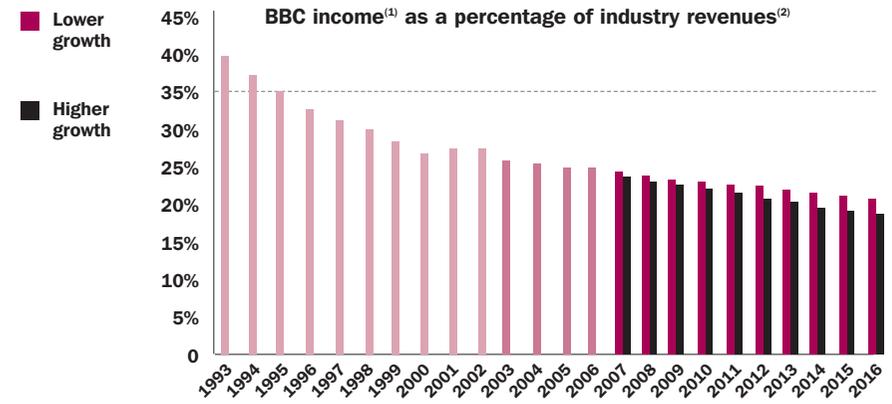
bulwark against the possible future dominance of Sky. But even the BBC will find this a hard task. (Figure 9.) Many observers have suggested that the BBC has been over-funded in recent years, and it is true that its revenue has grown relative to ITV. But the growth of Sky has out-stripped everyone, including the BBC. While this is an eloquent testimony to the strength of Sky's consumer offering, Britain needs to ask itself whether it wants Sky to be so much bigger than anyone else, including the BBC, in a few years time.

Figure 9
BBC income vs its competitors



Far from expanding relative to its competition, the BBC's share of broadcasting revenue has continued to shrink in the past decade. (Figure 10.) And if the licence fee rises only in line with the Retail Price Index (RPI) in the next charter period, this relative decline in the size of the BBC will accelerate. Its share of industry revenue will fall to under 20% by 2015, leaving it struggling to play its traditional role as the standard setter in British broadcasting.

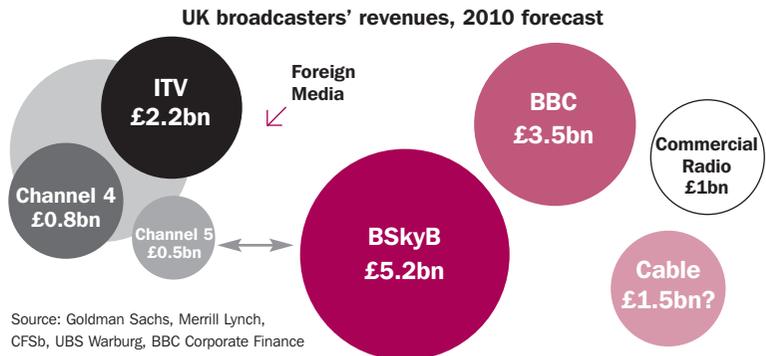
Figure 10
An RPI settlement will result in the BBC's share of industry revenues falling to c.20% by the close of the next charter period



(1) Net licence fee and commercial contribution only
(2) TV & Radio advertising and TV subscription + BBC Income
Source: Zenith, UBS Warburg, Financial & Commercial Strategy

The trend in the broadcasting market is towards fewer, bigger players, with Sky in particular being likely to exert increasing market power. Market failure on this score is increasing, not diminishing. And the BBC is shrinking in its relative size, making it harder for it to redress this market failure. Yet, in the face of all this evidence, the BBC's competitors and some politicians routinely castigate the BBC for being of frightening scale.

Figure 11
2010: Fewer, bigger, more powerful players



Source: Goldman Sachs, Merrill Lynch, CFSb, UBS Warburg, BBC Corporate Finance

I doubt if the BBC itself will have the temerity to fly in the face of this misguided tide of opinion by asking the government for a licence fee settlement in excess of inflation, for fear of being laughed out of court. But the truth is that no other public service in Britain – not the health service, not the schools, not the army and definitely not the police – would ever contemplate accepting a decade-long settlement in which its income is frozen in real terms. Such a miserly outcome should not be seen as a “good” settlement for the BBC, our consistently most successful public service throughout its eighty-year life.

The last source of market failure is informational deficiency. This is extremely familiar territory. Some goods and services need to be experienced by consumers before they can be fully appreciated. Education is normally thought to be such an “experience” good. Free market provision results in under-consumption, and therefore too little formation of human capital. This is close to the case for Reithian television, a complex set of services the benefits of which become clear only after considerable sampling and experience. The free market will not encourage such experience, which needs to be nurtured through marketing, scheduling and programme making skills. And this is hard to achieve through the attentions of a regulator like Ofcom, since it is so hard to define precisely in a contract. Hence the need for an institution like the BBC, which does all of this because it is built into its DNA.

So it seems to me clear that there are many sources of market failure for the BBC to address, and it is also clear that different genres have different degrees of market failure attached to them. (Figure 12.)

no other public service in Britain – not the health service, not the schools, not the army and definitely not the police – would ever contemplate accepting a decade-long settlement in which its income is frozen in real terms

Figure 12

Summary of market failures in television and radio

Type of television service	Public good		Externalities create ‘Public Value’ or ‘Social Capital?’	Economics of scale in production?*	Information asymmetries?
	Non-rival?	Non-excludable?			
Pornographic/violent content	Yes	No – always encrypted	Strongly negative	Yes	No
Imported mass entertainment	Yes	Often encrypted	Mildly positive	Yes	Unlikely
Mainstream popular entertainment	Yes	Yes	Positive	Strongly positive	Possible
Informative/educative content	Yes	Yes	Strongly positive	Strongly positive	Strong

**Potentially leading to monopoly at high concentration*

Few market failures are apparent, you will be pleased to hear, in the fields of pornographic or violent conduct, and rather few in the area of imported mass entertainment. It would not be the end of the world if the BBC were absent from these genres. On the other hand, mainstream popular entertainment, produced at home, does exhibit several key elements of market failure, and there are therefore good reasons for a strong BBC presence in this genre. And of course, the most serious market failures are in the fields of news, information and education, so this is where the BBC’s presence should be most pronounced. Given this pecking order of market failure, it is of considerable comfort that countless surveys of audience opinion show that the public believes that that the BBC’s strengths relative to its competition correspond precisely to what this theory says is appropriate.

Distributional failures

This is also reassuring from the point of view of so-called distributional failures. (Figure 13.)

Figure 13**Distribution concerns about provision**

Type of television service	Distributional concerns?
Pornographic/violent content	No
Mainstream popular entertainment	No
Informative/educative content	yes – this is a 'merit good' implying concerns about under-provision to low income groups

This table shows concerns about whether the service will be provided in acceptable quantities to all income groups under a free market

These are not strictly in the same camp as the market inefficiencies which we have just been discussing, but they are nevertheless important further reasons for public intervention in commercial activity. If society is dissatisfied with the distributional consequences of the free market, it can legitimately decide to redistribute income and wealth, even though the required policies (taxation and public expenditure) may result in a breach of overall economic efficiency. A fairer distribution of resources, even in a less efficient economy, can sometimes be deemed to be a better overall outcome for society.

If redistribution is deemed desirable, this can be done via direct provision of specific goods and services. For example, most societies opt for a minimum compulsory provision of education services. This direct provision usually occurs when goods are deemed to be so-called “merit goods”. These goods are believed to be desirable in themselves, even if this overrides market preferences. Reithian broadcasting, which promotes learning, the growth of human capital and good citizenship, can be argued to be a merit good which should be subject to a minimum national provision. Once again, distributional concerns are much more powerful in the traditional BBC genres than they are in genres usually more associated with the commercial sector.

Conclusions

1. Market failure is a necessary condition for the BBC to exist in its present form. It is not a sufficient condition, but those who hope to justify the existence of the BBC without placing market failure at the centre of their case are facing an uphill intellectual struggle.

2. Despite widespread assertions that market failure in the broadcasting market is being eliminated by technical change, the free market in the new charter period would continue to result in an under-provision of Reithian broadcasting services, relative to the social optimum. Broadcasting will remain a public good in the digital world.

3. The BBC is one way of addressing this persistent market failure, thus ensuring that an under-provision of Reithian broadcasting does not occur. It is not the only way, but it is the way that Britain has chosen, and it is probably the best way.

4. The BBC, funded by a licence fee of £121 per year, creates well over £2 billion of consumer surplus, or national welfare, each year. In order to maintain its ability to contribute this amount to national welfare, the BBC should not be allowed to shrink in relative terms. This is exactly what would happen, notably relative to Sky, with a real terms freeze for the licence fee in the new charter.

5. A subscription-based BBC would exclude 10 million households from receiving the BBC, and would generate much less consumer welfare than the current licence fee system. There would be some net gainers from a switch to subscription, but they would be in a minority, and the nation as a whole would lose. Nevertheless, the needs of the minority – probably concentrated among the minority ethnic groups, the lower income groups, and those outside the south east of England – are important and should be addressed by re-orienting parts of the BBC's output to take account of their particular requirements. This does not imply dumbing down.

6. While the BBC is not the only way of addressing market failure, alternative models for government intervention and

regulation are at best unproven. Ofcom will be severely stretched to prevent the commercial sector from moving towards greater monopoly along with less public service broadcasting. It should focus its attention on this massive task, rather than seeking to extend its power over the BBC.

7. Market failure is in some ways much more obvious in broadcasting than it is in health and education, which are not public goods. (Figure 14.) Other public services like law and order and the road system also exhibit fewer of the characteristics of market failure than Reithian broadcasting. People should remember this before calling on the BBC to be privatised.

Figure 14
Market and distributional failures in the UK public sector

Public sector activity	Public good		Positive externalities	Increasing returns	Information asymmetries	Distributional concerns
	Non-rival	Non-excludable				
Health	No	No	Yes	No	Yes	Yes
Education	No	No	Yes	No	Yes	Yes
Defence	Yes	Yes	No	Yes	Yes	No
Law & Order	Partly	Partly	Yes	No	No	No
Roads	Partly	No	Slight	No	No	No
Reithian Broadcasting	Yes	Yes	Yes	Yes	Yes	Yes

8. Those who argue that changes in technology have eliminated the case for the BBC are wrong.

The BBC and Public Value

Commentary by Lord David Lipsey

Gavyn Davies and I are both fans of the BBC. However, he is the sort of fan who would travel 300 miles on a wet Saturday and I am the home-only sort. So, when I sat under his chairmanship on the Davies Committee on the BBC’s future financing, he wanted more extra resources for the Corporation than I did. I was more wary of its governance than he was. We both signed up for increased private participation in BBC Resources and Worldwide, which remains unfinished business, though the case remains strong.

As a fan of the BBC – as well as an unashamed fan of Mr Davies – I welcome his piece. It has two huge, and related, merits. First, it is the most rigorous argument yet in favour of the public good case for the BBC: that is to say, the argument that concrete benefits flow from the existence of the corporation, whose output is free at the point of use.

This is an important plus. It is easy for arguments about the BBC to degenerate into a debate between liberal fluffies, arguing its merits in cultural terms, and hard-headed economists, who tend by temperament to eschew non-market mechanisms. Mr Davies avoids that trap by constructing a strong economic case for the BBC in general and for licence fee-funded provision in particular. This he rests essentially on the consumer surplus argument; namely, that the BBC provides for most people services that they value more highly than the price they pay through the licence fee. Because once programmes have been

made, it costs virtually nothing to provide them to extra households, the zero price for use intrinsic in the licence fee system means that this consumer surplus is maximised.

The second and related virtue of Mr Davies's piece is that it does not stop at spelling out the argument in words. It attempts to quantify this advantage. It does so by using data on what people say they would be prepared to pay in order to enjoy the BBC's services compared with what they actually have to pay. This is not a perfect technique for estimation since survey data on what people are hypothetically prepared to pay does not necessarily reveal what their actual behaviour would be, faced with real decisions and real prices. But it provides at least a guide for estimation and debate.

It is thus vital that everyone involved in the debate over BBC charter renewal reads and absorbs Mr Davies's argument, which is why the SMF is publishing it. Post-Davies, it will no longer be possible to dismiss the economic case for the present funding of the BBC, or to claim, without ado, that services provided in response to individual viewers and listeners' effective demand must be economically optimal. Mr Murdoch and his apologists will have to look to their economic laurels.

To that extent then I am a fan of the Davies thesis. But my fanaticism stops short of his.

My first doubt concerns his conclusion on consumer surplus and the welfare economics that underlies it. I tremble to cross swords with the great man on economics, for he is a professional practitioner and I merely an enthusiastic amateur. But the argument he constructs is one that has been around for some time. Indeed in the 1950s it was widely used in support of a case for restricting the market and providing more goods free of charge subsidised by the taxpayer. It was argued that consumer surplus exists whenever a good has a very low or zero marginal cost of production; and whenever it is non-exclusive (when one person using a good does not reduce its value to other consumers). Its full value can only be captured if the price charged for use of that good is zero.

The trouble is that, though the marginal cost of the good may be zero, the total cost is not zero. In the 1950s debate, the opponents of the new welfare economics pointed out that, if that cost was not met by charging the consumer, it had to be

met by taxation. Once the incidence of taxation was taken into account, both its disincentive effects and its distorting effects, it was no longer obvious that a price of zero was optimal.

That argument has moved on but it retains its relevance today. Indeed arguably it applies more strongly than ever. For a characteristic of the modern economy, public and private, is that goods whose marginal cost is at or near zero are extremely common. To take some random examples, it applies to air travel (once the plane is flying, an extra passenger costs nearly nothing to transport), to newspapers, to computer software, to books, and many other goods.

All these have some elements of public good about them. Travel broadens the mind. Newspapers (sometimes) educate. Computer software expands capabilities. And so on. But no-one serious argues that all should be provided free. The reason is that if we did so, someone would have to pay their costs, and that someone would be the taxpayer. As taxpayers seem reluctant to pay much more in taxes than they do now, that creates a problem.

Moreover if all these goods were free, demand for them would rise sharply; and though the short run marginal cost may be zero, the long-run cost certainly isn't. Resources would be diverted into the production of goods which have a low marginal cost and away from other goods in a way that would leave a very unbalanced economy indeed. It is therefore necessary for society to make a choice among the various goods that could qualify as public goods as to which it will provide largely free, at the taxpayers' expense, and which not. Generally it decides to provide some irreducible collective services (such as defence and policing) and some public services which it does not want to be generally rationed by price (health and education).

Mr Davies argues that the goods provided by the BBC qualify highly under the criteria for being public goods: for they have very low marginal cost and are non-exclusive. However, there is another criterion which seems to me more important than either of these: namely, the degree to which a public good contributes to the wider public interest. How important is it?

Most people, though not everyone, would agree that

defence is very important, and so too policing. Most would agree that health and education are vital. Can the same be said of broadcasting? It's nice to have a good mix of programmes. Some educate; a lot may entertain; and certainly people spend many hours in front of their boxes. If you take public opinion as your guide, it has opted heavily for broadcasting.

But ask yourself this. Suppose someone proposed a society exactly like ours, save it provided no education. Would this be an attractive notion? It would not. And suppose someone proposed a society exactly like ours, save it had no broadcasting. Would that be an attractive notion? If you think the answer is an obvious "no" sit down, watch the latest Big Brother, and ask yourself again.

Not all programmes – not most programmes - are Big Brother – and I would not seriously argue for the abolition of broadcasting either in theory or in practice. I just think its moral value should be put into perspective when considering whether it, among all goods, should be free at the point of consumption.

The broadcasting provided by the BBC is a public good. It does generate consumer surplus. But that is not necessarily a sufficient case for it to remain free at the point of use, though it is a strong pointer in that direction. It certainly does not mean that every time someone inside the Corporation thinks of some new channel or service it would like to provide, that the money should instantly be made available. If anything, in the last few years and given the above-inflation rises in the licence fee awarded by the government, it is more plausible that the BBC's income has erred on the side of generosity than the reverse.

We have also to consider the source of the BBC's income. It comes from the licence fee. Now the licence fee is, from the consumer's view, the equivalent of a tax. Since nearly everyone has a television, nearly everyone is obliged to pay it. And a particularly vicious, unfair, regressive and onerous tax it is too. It bears horribly hard on the poor: someone on the minimum wage spends roughly a week's net earnings to pay it. It is enforced through the criminal courts. It has been rising each year faster than prices. To cap it all, the poor, on whom it bears hardest, are excluded from some of the services for which it pays: for example, BBC3, BBC4 and the on-line services since

gaining access to digital services incurs additional costs. That is why the Davies panel recommended that these new services should be paid for by a supplementary digital licence fee, a recommendation which the government, in a funk, rejected.

These poor people are not enjoying a consumer surplus, but a deficit. Mr Davies, who shares a concern for the poor, recognises this. But he puts forward a strange solution. What should happen, he thinks, is that the BBC should provide more services aimed at them until they do enjoy such a service. He does not specify what these are. Is it that these people only think they are getting bad value because there is a paucity of grand opera on BBC1? Or is it likely they crave more football? More programmes for ethnic minorities? If they get enough of what they at present lack, he implies, then they too will think the licence fee value for money.

But these people are not necessarily griping at the services they get. They are griping at the compulsory charge they have to pay, including for services they can't get. The Davies remedy would mean more BBC spending, which would mean a higher licence fee, which would arguably mean that they were even more affronted by its demands.

None of this is to argue that the licence fee should go. It is the best means for financing public broadcasting, and, bad tax though it is, it may remain for a while the least bad option. Maintaining it will not be easy, as the option of choosing not to receive BBC services becomes open to more people; but maintaining it may still be justified.

However if it is to be retained for its advantages it behoves government and the BBC to show the utmost restraint in setting its level. Mr Davies seems sad that the BBC is unlikely to demand increases in the licence fee above inflation in the next Charter period. To me, this shows wise, though doubtless painful, restraint.

There is another factor here too to which Mr Davies was very alert when he chaired the BBC, and which needs to be taken into account in assessing the public good argument. Economists generally think that monopolies tend to be inefficient. Insofar as services cost more because financed by the licence fee, giving the BBC few incentives to efficiency, consumer surplus is directly eroded.

It is impossible for an outsider to judge whether the BBC in general is efficient or not. Perhaps now the National Audit Office has a tentative foot in the door in examining its costs we shall find out, one of the many good reasons which convinced parliament that it should. But it is hard wholly to discount the travellers' tales of people who have worked in broadcasting in the public and the private sector who report examples of extravagance by the BBC. Certainly, it does not seem to find it too hard to achieve economies under pressure, though even with such economies and an expanding budget, it faces a deficit this year.

For this reason, I have some sympathy with the notion which has been floated in the OFCOM review of public service broadcasting which would remove the BBC's monopoly of state-funded public service broadcasting. Among other reasons, programmes which had a particular public service objective paid for by the licence fee but not by the BBC, would provide needed benchmarking of BBC costs. At the very least, this is an argument the BBC needs to address and answer. I believe too there is a strong case for increasing the quota for programmes for the BBC made by independents, both in radio and television, and the governors might even take steps to ensure that it meets those quotas rather than producing plausible excuses for its failure to do so.

I am a fan of the BBC. Given the government's reluctance to go for a digital licence fee, I think a continuation of the licence fee at least for one more charter period is probably justified, not least for the public good reasons Mr Davies cites. I don't go for the fashionable idea of extending the charter for a mere five years, which seems a recipe for non-stop uncertainty (including the possibility of a change to a very much less sympathetic government.) I don't think it should be ghettoised into making posh programmes for posh people; though I do welcome the recent move away from the rampant populism of Greg Dyke. I do favour a full-service broadcasting BBC.

I am however reluctant to see big increases in a poll tax that bears heavily on the poor in order to finance an excessively ambitious BBC. Mr Davies's arguments lend strength to a development of the status quo. They should not be taken as making the case for a new BBC imperialism.

The introduction of digital broadcasting has not eliminated market failure in the provision of Reithian public service broadcasting – the main economic justification for a BBC funded by the licence fee. The BBC should therefore be retained in its current form when its Charter is renewed in 2006. This is the argument made by Gavyn Davies in this reprise of his important speech to the Saïd Business School, Oxford, in June 2004. David Lipsey provides a valuable commentary challenging Mr Davies's arguments on key points.

This is the most extensive and thoroughly argued case for the maintenance of the BBC on economic, rather than social or cultural grounds and is essential reading for anyone involved or interested in the debate about the renewal of the BBC's Charter.

£10.00

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