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THE FCC'S ANTI-PAYOLA ENFORCEMENT: A POLICY AT WAR WITH ITSELF

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THE FCC'S ANTI-PAYOLA ENFORCEMENT: A POLICY AT WAR WITH ITSELF

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ABSTRACT

Is it sensible for the Federal Communications Commission to ban songwriters from advertising songs on radio through payola, when Geico and McDonald's can get more radio spins than Taylor Swift and your top five favorite singers combined without any of the hassles of anti-payola regulations? A robust line of scholarly work in economics, starting with the seminal work of Ronald Coase on the topic nearly three decades ago, has advocated for allowing the type of undisclosed pay-for-play transactions known as payola, generally considered to have benign effects on markets. In the last decade however, anti-payola enforcement has gained significant momentum mostly under the rationale that the practice effects upon audiences a type of deception that lowers audience welfare. Although recent work in economics appears to give weight to the deception concern, for the most part economic analysis and even legal scholars defending the practice have failed to address audience deception in their analyses. In this article I examine the merits of the "deception" rationale—the last and most entrenched line of defense supporting anti-payola enforcement—building on my work on multi-sided media markets. I argue that the flawed understanding of broadcasting, music and advertising markets has obscured the true workings of payola and led regulators to believe, incorrectly, that the practice lowers audience welfare. I show that in the absence of payola, song selection by broadcasters is not primarily focused on pursuing musical talent or maximizing audience utility—as implied by FCC officials—and hence that the banning of this beneficial practice simply forces radio stations to steer away from audience welfare by selecting songs that facilitate the sale of products to particular demographics but that are more weakly correlated with listening utility. I construct a simple payoff matrix to illustrate how profit maximizing stations, in the absence of payola transactions, are likely to further deviate from maximizing audience welfare, reduce program diversity and increase advertising levels suboptimally.

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DRAFT: JULY 31, 2010

1 INTRODUCTION

On July 26, 2010 the Federal Communications Commission (FCC) announced the latest in a series of highly publicized enforcement actions against broadcasters and record labels suspected of engaging in the type of undisclosed "pay-for-play" transactions known as payola.[1] This victory for the FCC continues to enlarge a growing but relatively unscrutinized network of agreements and consent decrees executed between the FCC, the office of the New York Attorney General and some of the largest broadcasters and record labels in the country.

These agreements, which presently bind more than a thousand radio stations, often require the targeted companies to make hefty voluntary contributions to the U.S. treasury (or State charities in the case of State Attorney General's settlements), appoint Compliance Officers and Regional Compliance Contacts, institute annual training programs for programming personnel and supervisors, and make voluntary commitments to air a minimum number of songs from local and independent artists.[2]

As costly as they might seem however, these settlements may actually be a bargain for these companies considering that in exchange for such *voluntary* commitments, the FCC and State enforcers will normally drop all charges against them, charges which could otherwise potentially cause broadcasters to lose their licenses and expose the individuals involved to fines or even prison.

Though widely celebrated, the solid streak of FCC victories suffers however from a rather fundamental problem: these victories—and the large fines they have brought with them—have been built upon enforcement practices that are premised on a flawed understanding of broadcasting and music licensing markets, and which penalize a practice that actually increases audience welfare. Far from the nefarious effects attributed to payola by the FCC and the popular press, the practice is not only beneficial to markets in its customary form, but if modernized and popularized it could actually leverage vast improvements in these markets raising the welfare not only of audiences, but of tax-payers and countless songwriters.

The economics of payola have, for the most part, been well understood at least since Ronald Coase's seminal work on the subject in 1979: because broadcasters can

[1] Federal Communications Commission, Payola and Sponsorship Identification, Univision Radio Inc. http://www.fcc.gov/eb/Orders/2010/DA-10-45A1.html.
[2] Federal Communications Commission ,Clear Channel Inc., http://www.fcc.gov/eb/Orders/2007/FCC-07-29A1.html

offer something of value to record labels and songwriters—exposure of their songs to audiences likely to purchase records, concert tickets or other similar products—it is only natural that labels and songwriters would be willing to pay for access to such service.[3] Given that available airtime is limited, it simply makes sense for some sort of pricing system to allocate such limited resource to those who value it the most. Scores of economists and lawyers have embraced variations of Coase's analysis for the last three decades.

In recent work I expanded the economic understanding of this practice by suggesting that payola is a relatively small pricing anomaly resulting from the profoundly inadequate workings of a three-sided media market where the interdependent demands or songwriters, advertisers and audiences are (poorly) mediated by broadcasters.[4] As broadcasted music is licensed through blanket licenses—which do not allow for relative prices for songs but are nevertheless tolerated by the current consent decree managed by the U.S. Department of Justice—sticky song prices tend to gravitate towards market prices through the safety-valve that payola introduces in an otherwise malfunctioning pricing system. Even better than a payola market, I argued then, would be a *competitive* payola market, where *most* songs would accurately reflect market prices rather than just the few subject to payola payments. Payola, in this sense, is merely the tip of a large market that remains submersed for lack of better transactional platforms that, much like blanket licenses, could enable the efficient trading of songs in the *negative* domain of song prices.

The preceding arguments, however, are not enough to put an end to the payola debate as the practice of payola is subject to governmental and public condemnation for reasons that are not entirely captured by the analysis that has been offered so far. The last surviving but most entrenched critique leveraged against payola is harbored today in the understanding that payola effects upon audiences a type of deception which can only be prevented through government action.

2 THE PAYOLA DECEPTION: AN IMAGINARY MARKET FAILURE

So what exactly does this deception entail and how is current enforcement curbing it? When songwriters, record labels or independent promoters make direct payments to stations in exchange for playing a particular song, the practice is commonly called *pay-for-play* and it is legal if adequately disclosed. On the other hand, the same payments, if not properly disclosed under Federal Communications Commission[5]and state rules,[6] constitute a crime and are commonly referred to as payola.

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[3] *See* Ronald H. Coase, *Payola in Radio and Television Broadcasting*, 22(2) J. L. & ECON. 269 (1979).
[4] *See* Ivan Reidel, *The Price of Fame: The Antitrust Law and Economics of Broadcasting, Music and Advertising*, HARVARD JOHN M. OLIN FELLOW'S DISCUSSION PAPER SERIES NO. 35, http://www.law.harvard.edu/programs/olin_center/fellows_papers/35_Reidel.php.
[5] *See* Section 317 of the Communications Act of 1934, 47 U.S.C. § 317 and Section 508 Communications Act of 1934, 47 U.S.C. § 508.

Such sponsorship identification regulations should in theory apply to all types of advertising, but under the current regime, other advertisers such as fast food or insurance companies are not required to identify their messages. The reasoning behind this exemption seems intuitive: such sponsorship requirements are costly and consume limited airtime, and audiences can, for the most part, easily identify an ad for a Big Mac as a message paid by McDonald's but they can't know whether a song by Taylor Swift was selected by the station because it was paid by Swift's record company to promote the song.

The question this article attempts to answers however, is: Is this distinction a meaningful one? Would audiences be any less deceived about the artistic merits of particular song if they knew that such song is being sponsored by a songwriter rather than selected on the basis of targeting a particular demographic group which matches the desired customer profile of a particular advertiser such as McDonald's?

Current enforcement efforts appear to be based on the understanding that this distinction is indeed a meaningful one. The FCC presently acts upon the articulated belief that payola deceives listeners as to the quality of musical compositions, "denies consumers choice in what they hear," and "deprives musicians of the exposure they need to survive."[7] Under this perspective, it would seem that broadcasting outlets would be, but for payola, more focused on airing the work of talented songwriters based on the quality of their works rather than on the ability of these songs to increase the station profits. Indeed at least some modern economic commentary seems to be also embracing "deception" as a credible drawback of anti-payola regulations. Connelly and Kruger for example, recently suggested that "[p]ayola is analogous to a professor paying bribes to the editor of the *American Economic Review* to publish his paper…" noting that "AER readers expect the published articles to be the best and most relevant to the field, not the ones written by those with the biggest pockets or the most eager to get tenure."[8]

Unfortunately, in its effort to eradicate the *insidious*[9] payola, the FCC relies on an explicit understanding of background market conditions which is not only at odds with the premise that radio stations are profit maximizing enterprises but also at odds with the FCC's own commissioned reports assessing how it is exactly that radio stations select their programming.[10]

There is surely room for debate as to what the FCC means by "quality" of musical compositions, but let's assume for the time being that quality entails some measure of the utility elicited in audiences by exposure to particular songs, in other words, let's assume quality to mean "what audiences like the most," high quality

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[6] While for the reasons I will state below, *payola* does not constitute deception in any meaningful way, several state anti-deception laws have been used to prosecute the type of undisclosed payments commonly referred to as payola.

[7] *See* Federal Communications Commission (FCC) Order in the Matter of Citadel Broadcasting Corp. 22 F.C.C.R. 7045, 7057 (2007) (hereinafter Citadel Broadcasting Corp.).

[8] Marie Connolly & Allan B. Krueger, *Rockonomics: The Economics of Popular Music*, 48, http://www.irs.princeton.edu/pubs/pdfs/499.pdf

[9] *See* Citadel Broadcasting Corp *supra* note 7.

[10] *See* Federal Communications Commission, *When Being No. 1 Is Not Enough*, http://www.fcc.gov/Bureaus/Mass_Media/Informal/ad-study/

songs eliciting more utility than lower quality songs. Is payola really likely to result in programming that reduces the utility of audiences? Given that advertising is the other remaining major source of funding, the question could also be rephrased as: Is programming supported exclusively by advertisers likely to result in higher audience welfare than programming supported partially or entirely by payola?

The purpose of payola payments is undoubtedly to stimulate the sales of a bundle of products produced by songwriters such as concerts, CDs, song downloads, dolls, perfumes, clothing lines and the like. But the idea that but for payola the songs selected by radio stations would be based on the artistic merit or quality of the songs betrays a radical misunderstanding of how these markets work and how profit-maximizing radio stations operate. Radio stations are not in the business of raising the utility of audiences but in the business of maximizing profits, and as economic research[11] and the recent study chartered by the FCC suggest,[12] the songs that audiences like the most are not necessarily the songs that reach the most profitable demographics. If radio stations cannot extract profits from payola payments from songwriters or record labels, they need to do so from (other) advertisers, which in turn are interested in reaching not the largest, not the happiest, but the most profitable audiences (i.e. the specific demographic that is likely to spend the most on the products offered by radio advertisers).

As not all songs are created equal, some may reach audience members likely to purchase CDs or concert tickets, and some may reach audiences likely to consume burgers or car insurance instead. However, because FCC anti-payola regulations diminish the profitability of advertising CDs, concerts or other products in the bundle of products offered by songwriters and labels, the ads of all other products such as burgers or car insurance are implicitly being subsidized by making "song" advertising more expensive, even if such subsidy reduces audience welfare. Is this a good idea?

3 A NUMERICAL EXAMPLE OF WELFARE EFFECTS

Consider the following numerical example: Imagine that there are two listeners Tom who likes "Country Music," especially Taylor Swift and Ben who likes "Adult Contemporary" in particular Barbra Streisand. According to Arbitron, listeners of Country Music generally eat fast food more often than listeners of Adult Contemporary.[13] So for ease let us assume that McDonald's, the only restaurant in HypertensionVille, is also the sole advertiser on local radio.

Assume further that there is only one radio station in HyptertensionVille, and that the station will play one song and one advertisement. There are only two songwriters, Taylor Swift, and Barbra Streisand each with one song. Both songwriters sell their songs on iTunes. Given this setup, it is not difficult to identify cases where a radio station will select a profit maximizing programming that simultaneously

[11] Philip M. Napoli, *Audience Valuation and Minority Media: An Analysis of the Determinants of the Value of Radio Audiences*, 46 J. BROAD. & ELEC. MEDIA, 169 (2002).
[12] *See* Federal Communications Commission, *supra* note 10.
[13] *See* Arbitron, *Radio Today*: *How America Listens to Radio Today,* 22 & 26 (2009 Edition), http://www.arbitron.com/downloads/RadioToday_2009.pdf.

decreases audience welfare and total welfare (defined as the sum of payoffs of all players):

The matrix below shows payoffs for all players subject to the following assumptions:

(a) There are 2 composers: Barbra Streisand and Taylor Swift.
(b) There are 2 radio listeners: Ben and Tom.
(c) There is 1 radio advertiser: "McDonald's."
(d) There is 1 radio station that plays only 1 song and 1 ad.
(e) The radio station pays $5 to the composer of the song it chooses to play (note that a blanket license results in the same outcome, given that the radio pays a flat fee and only the composer that gets played gets paid).
(f) There are 2 songs available: "Evergreen" by Streisand and "Fearless" by Swift.
(g) Both songs have already been produced.
(h) The song "Evergreen" cost $3 to produce.
(i) The song "Fearless" cost $4 to produce.
(j) Ben values "Evergreen" in $10 and "Fearless" in $5.
(k) Tom values "Evergreen" in $6 and "Fearless" in $10.
(l) Both Streisand and Swift also sell their songs on iTunes.
(m) Streisand will increase her download sales by $20 and receive $5 from the radio if "Evergreen" gets played. Swift will increase her download sales in $1 and receive $5 from the radio station if her song gets played.
(n) McDonald's will increase its burger sales by $10 if "Fearless" gets played and will not sell any more burgers if "Evergreen" gets played.
(o) No composer is allowed to pay the radio station anything, and they can't change the price of their songs.

Under these rules the payoff and social welfare matrix looks as follows:

TABLE 1

PLAYER	PAYOFF WHEN "FEARLESS" GET PLAYED	DETAILED "FEARLESS" CALCULATION	PAYOFF WHEN "EVERGREEN" GETS PLAYED	DETAILED "EVERGREEN" CALCULATION
RADIO	$5	$10 (what McDonald's is willing to pay) minus $5 (cost of song to radio station) = **$5**	-$5	$0 (what McDonald's is willing to pay) minus $5 (cost of song to radio station) = **-$5**
MCDONALD'S	$0	(a wash between cost of ads and sales) = $0	$0	(didn't pay for ads and didn't sell more) = $0
TAYLOR SWIFT	$2	$5 (revenue from radio) plus $1 (revenue from download sales) minus $4 (cost of song production) = $2	$-4	$0 (revenue from radio) plus $0 (download sales) minus $4 (cost of song production) = -$4
BARBRA STREISAND	-$3	$-3 (the cost of song without offsetting profit)	$22	$-3 (the cost of song) plus $25 (revenue from radio and download sales) = $22
TOM	$10		$6	
BEN	$5		$10	

PLAYER	PAYOFF WHEN "FEARLESS" GET PLAYED	DETAILED "FEARLESS" CALCULATION	PAYOFF WHEN "EVERGREEN" GETS PLAYED	DETAILED "EVERGREEN" CALCULATION
TOTAL PAYOFFS (SOCIAL WELFARE)	$19		$29	

In the preceding example while total welfare (defined as the total sum of payoffs by all players) and aggregate audience welfare is maximized by playing "Evergreen" the radio station will instead play "Fearless" which increases its payoff. Extending this setup dynamically would mean that diminished rewards from the radio station would in turn decrease the creative incentives of the songwriter excluded from radio programming, in this case Streisand, and less songs will be created by Streisand—even if they are of higher quality (elicit more utility) as assumed to be in the example. Insofar as the same dynamics prevail in real broadcasting markets, we should expect the quality of songs to go down from the attainable social optimum and expect increased entry of songwriters writing songs that attract the demographic that increase sales for the top radio advertisers.

The result here is driven by the fact that Streisand's profits are an externality to the radio station because Streisand can neither charge less for her song, nor make a direct payment to the stations for playing her song. The fact that these profits are an externality to broadcasters also means that stations have worse information about the listening preferences of their audiences. If on the other hand, all else being equal, we allowed transactions between Streisand and the radio station (and hence competition through pay-for-play or payola with the advertiser), Streisand would be willing to pay up to $25 to the radio station and the radio station would choose "Evergreen" instead of "Fearless" (Swift and McDonald's would only be willing to pay up to a combined $16).

This example accurately replicates a few of the troublesome features of present in these markets. The prevalence of blanket licenses issued by Performing Rights Organizations such as ASCAP or BMI makes it difficult for individual songwriters to lower the price of their songs even if increased airplay would benefit them. In such uniform pricing system, labels and songwriters naturally stand to gain from making direct payments to radio stations (in a sense, discounts over the price of the blanket license). Advertising CDs, or concerts or song downloads through pay-for-play however—given the disclosure requirement presently imposed, compliance mechanisms currently in place and stigma imposed by the FCC's official discourse—is surely a more costly and less effective enterprise than advertising any other type of products, which also require the selection of a particular type of song targeting a particular demographic, regardless of whether audience welfare is maximized or not.

The differential treatment between songwriters and other kinds of advertisers results in a variety of harms that in addition to songwriters also affect audiences and broadcasters. Advertising costs, artificially increased for songwriters, prevent them from effectively using radio and television for publicizing their works. Simultaneously, as common advertisers find it cheaper to advertise on radio than what the normal functioning of markets would allow for, listeners are forced to endure more advertising rather than enjoying more songs. As ads replace songs, and fewer songs are aired, diversity is necessarily reduced by the coalescing effect of blanket licenses and anti-payola regulations. Finally, replacing songs sponsored through payola with regular ads also reduces market efficiency as payola is more efficient than most other types of advertising because it inexpensively conveys information as to both product consumption *and* listening utility (and how intense this utility is as measured in willingness to pay for downloads, for example) which benefits broadcasters and audiences in ways that traditional advertising does not.

4 CONCLUDING REMARKS

It would seem that anti-payola regulations undermine precisely the objectives the FCC intended to accomplish with them: diversity is diminished (in a way which is consistent with the findings of recent empirical research suggesting that anti-payola regulations have in fact reduced variety in radio),[14] songwriters are displaced by advertisers, audiences more annoyed by ads and broadcasters less profitable.

Unfortunately, sustained FCC and occasional Federal Trade Commission[15] enforcement practices and rhetoric against payola as well as private discourse reflecting the views of large record companies have done much to shape public disgust and taint the practice as repugnant. Recently two of the leading authors writing on the music industry, Krasilovsky and Shemel stated:

> The obvious incentive for engaging in payola is to increase the sales of records and the performances and other uses of a song by creating the public illusion of their spontaneous and genuine promotion. Payola is a crutch on which a promotion person with a second-rate product or insufficient contacts or ability may be tempted to lean. And when a record company representative or musician doesn't ante up the expected payment to a disc jockey or other station employee used

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[14] *See* Adam Rennhoff, *The Competitive Effects of "Consideration Payments": Lessons from Radio Payola*, DEP'T ECON. & FIN. WORKING PAPER SERIES (2009), http://frank.mtsu.edu/~berc/working/rennhoff_payola.pdf.

[15] *See* In the Matter of Triumph Records, Inc. et al., Consent Order, etc., In Regard to the Alleged Violation of the Federal Trade Commission Act Docket 7964, Complaint June 1960-Decision, 1065 (1960),http://www.ftc.gov/os/decisions/docs/Vol%2057/ftcd-vol57(JULY-DECEMBER1960)PAGES1060-1175.pdf.

> to getting payola, they may bottle up and keep a record
> from the public ear, no matter how good it is.[16]

On July 26, 2010 FCC chairman Genachowski stated "Payola — the idea of pay-for-play—misleads the listening public…[t]his agreement with Univision underscores the FCC's focus on consumer protection and our commitment to ensuring that broadcasters play it straight with the public."[17]

Regrettably, it seems that the FCC through its extensive use of the "quality" and "deception" rhetoric, is actually reinforcing unrealistic optimism on the part of listeners. Repeatedly assured by the FCC that quality or artistic merit are preserved by their enforcement activities, listeners are more likely to believe that stations select songs based on quality and not marketing power or the ability to influence valuable ad-susceptible demographics.

In the context of the preceding analysis, these observations seem unwarranted and dangerously misguided. In particular, they represent an obstacle to serious and welfare enhancing reforms in these markets. Mark Twain is often credited for coining the phrase "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so." It would seem that the claim that payola lowers audience welfare just ain't so.

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[16] *See* M. WILLIAM KRASILOVSKY ET AL., THIS BUSINESS OF MUSIC: THE DEFINITIVE GUIDE TO THE MUSIC INDUSTRY 142 (10th ed. 2007).

[17] Federal Communications Commission, *Univision Radio Pays $1 Million to Resolve "Pay-for-Play" Investigations*, http://www.fcc.gov/eb/News_Releases/DOC-300325A1.html