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## 2.1 Subsidies: Conceptual and Definitional Problems

If one first lays aside any definitional problems—the term *state aid* is used within the European Union, and the term *subsidies* the standard expression of the World Trade Organization, while the OECD prefers to use the word *support*—state aid, at a very fundamental level, commonly refers to a cash payment or financial assistance from a government or other public authority to a person or company. State aid for newspapers, more particularly, usually serves two main purposes: They should reduce a person’s or company’s cost of producing and bringing a commodity to market, and, secondly, by reducing the price of the commodity, should increase its consumption beyond what competitive market forces would provide for.

State aid for newspapers in the form of a financial subsidy thus works like a negative tax as they are given (and not taken) by government and, in the most general case, should encourage the production and consumption of a good. In most cases, subsidies are given out to producers in order to encourage supply but, occasionally, government can offer a cash or in-kind subsidy to the consumer which itself aims at boosting demand in a market.<sup>1</sup>

Subsidies are a notoriously difficult concept to grasp. They only seem to become more tangible when referring to their main purpose: “*Subsidies are provided to promote media industries, support political activities, spur cultural development, meet the needs of minority linguistic and ethnic groups, assist religious and*

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<sup>1</sup> Ross argued that to raise welfare of an individual at the lowest possible cost, cash grants are more efficient than subsidies to the consumption of specific commodities (Ross 1988). Equally, Peltzman (1973) looked into education subsidies and found that an in-kind subsidy, such as below-cost education provided by state universities, replaces more private consumption of the subsidized good than an equivalent money subsidy, such as a scholarship.

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other organizations sanctioned by states, and reward political allies” (Picard 2008, p. 4891).

Subsidies come in a variety of different forms, including direct subsidies such as cash grants and indirect measures such as tax reductions (notably, reduced VAT rates on subscription and single copy sales and advertising revenues) and tax breaks (e.g., for investments), etc. Ronald Steenblik, senior trade policy analyst in the *Trade and Agriculture Directorate* of the *Organisation for Economic Co-operation and Development* (OECD), stressed the importance of direct subsidies but noted that other, indirect subsidies would also play an important role as they would bring regulatory relief to suffering industries: “*Many subsidies are indeed provided in that form, as grants or, more generically, direct payments. Grants are the elephants in the subsidy zoo: they are large and highly visible. But there are numerous other subsidy beasts which are better camouflaged, stealthier, and keep closer to the ground*” (Steenblik 1990). Any of these kinds of financial transfers aim at (re) funding the operational activities of companies the market does not efficiently allocate for, and, importantly, governments and other stakeholders would have an interest in to be supported.

Newspapers, known as the *chroniclers of daily life*, come in different shapes and may differ according to frequency of publication, pitch of editorial content, geographic distribution area, format and layout, etc., and normally attract funding from internal and external sources: They collect revenues from two-sided markets of audiences and advertisers (Rochet and Tirole 2003; Roson 2005). Other funding sources may come from private equity, loan capital, or shareholder equity. Public subsidies, on their part, come as an additional source of funding. All of these financial resources may cover for any financial commitment needs, for example, to newsrooms (Lacy 1992), add to the organization’s survival based on its optimal utilization of both internal and external resources (Pfeffer and Salancik 1978), optimally balance these financial resources in order to relieve from financial distress (Modigliani and Miller 1958), or support the capital structure of the media firm in order to leverage any future investment needs (Myers 1984, 2000).<sup>2</sup>

In order to treat such complex issues systematically, subsidy definitions tend to make reference to one of the following characteristics of government intervention in order to confine the concept (Steenblik 2003):

- Subsidy types and instruments
- Rationale and design of a subsidy program or scheme
- Effects on the market, the business firm, journalism, the consumer/citizen, and/or the public at large

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<sup>2</sup>For an overview on financial issues of media management, see, Rizzuto (2006), Ozanich (2006), and Picard (2011).

### 2.1.1 Subsidy Types and Instruments

Indeed, state intervention to help the press can be classified according to whether they are:

- *General* (applying to all papers) or *specific* (intended to help weak papers or certain types of paper with a social, political, or cultural role)
- *Indirect* (e.g., tax concessions) or *direct* (e.g., grants and loans)
- Intended for *existing* (perhaps ailing) papers or designed to help *new entrants* into the market
- Aimed at *local* or *national* press markets
- Governed by *selective* or *mandated* allocation procedure mechanisms

General aid is given to assist a selected range of newspapers, but not for a single use.<sup>3</sup> This type of use can be seen in operational subsidies that provide revenue that a newspaper manager can use for any purpose (e.g., tax concessions to newspapers, reduced import duties on newsprint, or reduced postal tariffs).

General subsidies are likely to be allocated according to the “watering can principle,” that is, a procedure of subsidy distribution, with which neither the temporal sequence of the demand submission nor the subsidy urgency, but if necessary the height of the requested subsidies—if at all—is decisive. For the watering can principle it is characteristic that the subsidies without detailed examination of the actual need are distributed evenly over the entire target group, without considering the possible differences in market power and urgency of help of the individual cases.

Specific forms of financial assistance, by contrast, come as a special “capital injection” and include aid that can be used only for a specific purpose, such as grants received to retrain printing personnel in the use of digital prepress equipment. Further, specific subsidies may go to particular groups of beneficiaries, as opposed to the recipient population as a whole. These financial endowments may be paid out on a first-in, first-served basis whereby the requests of subsidy applicants are attended to in the order that they arrived, without other preferences such as, for example, the financial need.

The terms *direct* and *indirect* indicate how the intervention is provided. Direct aid is given directly to specific newspapers, such as a loan provided to purchase new printing presses. Most popular are direct cash payments made to newspapers by governments to help pay their operating expenses, most commonly referred to as *direct operating subsidies*. Direct cash injections also include subsidies for training and research grants, grants to encourage economic improvements in the industry, low-interest loans and loan guarantees, equity injections to avoid bankruptcy, and financial aid to political newspapers and other informational activities of political parties.<sup>4</sup>

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<sup>3</sup> The term *subsidy* may also refer to assistance granted by other institutions than government, such as individuals or private nongovernmental institutions, although this is more commonly described as charity.

<sup>4</sup> Picard (1982, pp. 4–5).

**Table 2.1** Types of direct subsidies (selection)

General	Selective
Direct operating grants to all newspapers	
Support of cooperations: joint-delivery, printing, advertising acquisition	
Financial grants to all newspapers (equal amount to all)	Financial grants to all newspapers which are in the red
Print-specific subsidies for investment in general (e.g., into new printing technology, innovation subsidies)	Subsidies to newspapers for special investments
General press export subsidies to encourage sales and reading of newspapers abroad	Export subsidies through low-cost loans or tax relief for exporters
Soft loans to all newspapers to stimulate capital investment	Soft loans at below market interest rates based on specific selection criteria (e.g., economic indicators)

Source: the author

Preferably, direct cash subsidies are aligned to specific bright-line selection criteria for subsidization such as news media company size measured by printed circulation, competitive position in well-defined (i.e., geographic, product, or consumer) markets, frequency of publication, or disadvantaged financial position on the advertising market.

Direct selective subsidies may be granted to new market entrants in order to lower entry barriers, restore competition, and reinforce the market system (Gustafsson 1993).

Other forms of direct financial subsidies include support for cooperation in distribution and printing, government loans on preferential terms, and government insertions—if they are explicitly declared to be press subsidies by the authorities—grants for press research and education, and grants for press exports. The following Table 2.1 highlights some general and selective direct subsidies.

While cash grants are most visible transfer payments in the *subsidy panopticon*, other forms of state aid are, as mentioned above, better camouflaged, stealthier, and thus less subject to political or civil society observation and control. For example, tax concessions are common forms of indirect subsidies in many well-developed tax systems. Tax concessions are assistance programs that include tax exemptions (when a tax is not paid), tax credits (which reduce a tax otherwise due), tax deferrals (which delay the payment of a tax), and a host of other instruments.

Most European countries give tax concessions on VAT to the newspaper industry. These advantages may take the form of zero rating, exemption, or the use of a positive rate lower than the standard rate, applied either on newsprint, sales revenues, advertising revenues, purchases of printing equipment, or to any combination of these. VAT reductions are used across a wide number of nations and

represent a significant indirect subsidy of print (and/or online) journalism. However, research on its value and effects on newspaper markets is scarce.<sup>5</sup>

Besides adding complexity to tax systems, tax concessions are often criticized by economists as being less transparent than grants and more resistant to change. In addition, VAT is regressive and is being equally paid by all consumers whether they are rich or poor, young or old.

Another important advantage includes distribution support through reduced postal delivery rates and other transportation concessions. Reduced tariffs of newspapers delivered by postal services, in Sweden to be traced back to the last century, in France even to the French Revolution, and in the USA back to the Postal Act of 1792, are enjoyed by the press in most countries so as to alleviate general distribution costs of newspapers. As a general rule, newspapers with larger distribution, particularly supra-regional and national newspapers, benefit most from these nonselective reduced postal delivery tariffs. Other transportation concessions are rarer and take the form of reduced rates for the carriage of newspapers by rail or airline. Telecommunications support to newspapers is fairly popular and ranges from reductions on telephone charges to a reduction of subscription fees to news services. Furthermore, lower import duties are another form of indirect support and are on occasion levied on the import of newsprint. Grants to journalists, research and innovation subsidies, and cooperation grants for printing and distribution may also alleviate the cost pressures.

Further, news agencies may be promoted and subsidies to newsprint export may help reading abroad. On top of that, government advertising in the press represents another important yet much hidden form of indirect support to newspapers. To my knowledge, however, scholarly research on types and effects of this important issue is absent. The following Table 2.2 collects these indirect types of subsidies (general and selective).

While these types of indirect subsidies are more or less known, there are also more hidden, below-the-line subsidies and other shadowy practices of public support which are not only difficult to detect and in the absence of an official scheme act beyond legal governance and control. However, they may give rise to adverse effects of market distortion in many ways. While above-the-line subsidies act to distort specific submarkets deliberately in order to support needy beneficiaries, these other forms of support deliver grounds for suspicion of corruption, political lobbying seeking protection, and even practices of subsidy abuse. Because research has shown that a free press may be a powerful control on corruption (Ahrend 2002; Brunetti and Weder 2003; Lindstedt and Naurin 2005), state subsidies may come as subtle instruments that subvert this freedom in many ways. It is both political influence over media content which puts pressure on the

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<sup>5</sup>Timo Toivonen, researcher at Turku School of Economics in Finland, calculated the value of VAT reductions in three nations and found that VAT reductions for circulation sales in 2010 amounted for by 525 million euros in Germany, 250 million euros in Italy, and 748 million euros in the UK [Toivonen, as cited in Nielsen and Linnebank (2011), pp. 31–32].

**Table 2.2** Types of indirect subsidies (selection)

General	Selective
Reduced postal tariffs for newspaper delivery and delivery by train	Reduced postal tariffs for newspaper delivery and delivery by train based on specific criteria (e.g., low circulation)
Telecommunications support	
Subsidies for newsprint, partly combined with the incentive to prefer domestic newsprint in order to support the domestic industry	
Reduced import duties on newsprint	
General tax reliefs, e.g., reduced VAT rate on newsprint, sales revenues, advertising revenues	Reliefs up to a specific circulation or advertising revenue level
Tax exemption for reinvestments	
Special support to news agencies or measures taken to increase their number	
State control on advertising volume in other media, e.g., TV	
Reallocation of advertising revenue from other media (e.g., TV to print)	
Education and further promotional subsidies to journalists	
Subsidies to promote reading	Subsidies to promote reading of migrant inhabitants

Source: the author

day-to-day conditions in which a journalist works and economic influence to exert competitive pressures that distort reportage. Economic favoritism or reprisals by government for unwanted press coverage are further critical instances that endanger press freedom.

In referring to the administration of assistance, the terms selective and mandated are often employed. Selective intervention refers to advantages, subsidies, or other types of regulation in which an administrative body independent from government regulates as to who should be provided with funds and how the allocation procedure is to be organized in detail. Selective funding is awarded to subsidy applicants according to a series of qualitative selective criteria and generally involves a more rigorous selection process. Mandated intervention, by contrast, is regulation mandated by a state in order to organize the allocation procedure by an agency automatically and by transparent rules so that no discretion or even *agency capture* to provide or withhold the assistance should rest within a regulatory agency respectively. Such regulatory agencies are set up and the task of regulation deputed to it because government intervention has been mandated by a law that clearly defines which beneficiary should receive the assistance and under which circumstances. These regulatory agencies may be set up from outside an industry in order to remain independent and thus ring-fenced against state intervention, or use may be made of self-regulation by bodies representing firms in an industry. The advantage of self-regulatory organizations is that while industry practitioners can

be expected to be aware of its problems they may tend to identify the public interest with the interests of producers in the industry, rather than the interests of its customers, or the general public.

Principally, nonmarket or *government failure* is the case when the costs of intervention are greater than the benefits. This type of failure may occur when the costs of setting up, operating, and controlling the scheme exceed the benefits (Stiglitz 1989). *Regulatory capture*, a form of government failure, refers to collusion between firms and government agencies assigned to regulate them (Dal Bó 2006; Laffont and Tirole 1991; Zerbo and McCurdy 1999). Here, rent-seeking behavior is an important explanatory concept in economics. In public choice theory, rent-seeking is the attempt of people to obtain economic benefit for themselves through lobbying the government for privileges.<sup>6</sup> They typically do so by getting a subsidy for a good they produce or for belonging to a particular group of people, by getting a tariff on a good they produce, or by getting a special regulation that hampers their competitors. In fact, from a theoretical standpoint, the moral hazard of rent-seeking may considerably endanger any potential efficiency gains public subsidies are about to initiate in the first place (Buchanan et al. 1980; Congleton et al. 2008; Tullock 1967, 1987). There are various instances of government-beneficent relations which result in a negative net effect of rent-seeking. Then, total social wealth is reduced, because resources are spent wastefully and no new wealth is created. When applied to state aid for newspapers, if lobbying for a favorable regulatory environment is cheaper than building a more efficient production, a newspaper may opt for the latter, and money is thus spent on lobbying activities rather than on improved business practices. The main source of inefficiency caused by subsidies, besides their possible wasteful nature, is that they tamper with market signals. This means that when state aid targets specific firms they alter the self-regulating mechanism of the marketplace (a phenomenon that Adam Smith referred to as the *invisible hand of the market*) by which resources are allocated to the most efficient firm.

And, additionally, there is another possible adverse impact effect of state aid: the so-called *soft budget constraint* (Kornai et al. 2003; Kornai 1986). The “softening” of the budget constraint appears when the strict relationship between the expenditure and the earnings of a firm is relaxed because excess expenditure will typically be paid by a paternalistic state.

If the subsidy is soft it is negotiable, subject to bargaining, lobbying, etc. as a result of which it becomes a source of the inefficiency as it raises expectations among potential applicants that failing firms could be bailed out and subsidized. More generally, a firm’s incentives to become more efficient so as to cut costs, raise quality, or innovate are likely to be dampened if it expects that the resulting competitive advantage will be offset by the granting of aid to its lazier rivals. All in all, the power of government to effectively govern state aid is seen as

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<sup>6</sup>Gordon Tullock, who originated the idea in 1967, was first to point to the negative externalities through rent-seeking behavior (Tullock 1967).

significantly reduced as it is susceptible to capture by special interests through activities such as lobbying and favor seeking (Becker 1983; Peltzman 1976; Stigler 1971).

### 2.1.2 Subsidy Rationale and Design

When society's goal is to raise the welfare of an individual, household, organization, industry, or society at large, regulatory action may be taken by a government in order to affect or interfere with decisions made by individuals, groups, or organizations regarding social and economic matters.

Theoretically, when discussing the rationale of government intervention into the press, three main theoretical conjectures emerge:

- The *public interest theory of regulation*, which assumes that the “free play of market forces” of supply and demand would be the most efficient organizing principle of exchange and lead to a welfare-optimizing allocation of resources without government intervention (Hantke-Domas 2003; Pigou 1932; Posner 1974).
- The *paradigm of market failure*, a doctrine within economics which explains the notion that self-regulated markets reveal structural and behavioral instances that lead to their failure in working efficiently as a result of which corrective government action seems warranted (Bator 1958; Cowen 1988; Cowen and Crampton 2002).
- Traditions in the *political economy of the media* which look into the issue of government control over the media whereby government may seize the media and induce bias such that media misreport the news in favor of government interests. Subsidies to these favorable media may be the price to pay for such covert government control (Gehlbach and Sonin 2011; Prat and Strömberg 2011; Strömberg 2004).

In what follows, I shall track these trajectories in more detail. Special focus shall, however, be given to economic theories of market (and government) failure, notably through the lens of the “market failure” paradigm from a media economics point of view. Other theories are more briefly referred to as supporting theories. Public interest theory, for example, was first developed by Pigou (1932) and holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices. Certainly, effective governance plans for supporting a whole industry will first have to identify the big picture when aiming to resolve an ailing or otherwise to be supported industry, all the way from setting clear and realistic objectives to measuring subsidy-impacted industry performance and output. Naturally, effectively designing these schemes is a very difficult task. Originally, press support was indirectly distributed through the political parties to their supporting news media—mainly newspapers and other periodicals, but today subsidies are more direct in form and are tied to certain requirements. If support to newspapers is politically approved—and market imperfections are not, in itself, a sufficient condition for concluding that public



financial support is warranted—regulators face the obvious choice of tax-financed subsidy approaches, either through direct cash injections or indirect cash advantages, or antitrust policies as means of regulatory state action, or, most likely, a combination of these.

While it is notoriously difficult to strike this balance in an ever changing and highly dynamic media environment, policymakers may need to conciliate between the following motives—among others—behind public press policy and the subsidy rationale that emanates from them (Baldwin and Cave 1999; Baldwin et al. 2010; McChesney 2008; Seabright and von Hagen 2007):

- Curbing the market power of dominant firms (e.g., by handing over subsidies to “weaker” newspapers)
- Enabling market access for new entrants (e.g., of nonprofit or not-for-profit organizations)
- Relieving financial distress to keep companies alive
- Supporting market exit (e.g., of failing companies)
- Supporting a political purpose (which need not be in the public interest)
- Supporting a national/regional/local culture and its linguistic representations
- Enabling growth and innovation plans of a media company
- Improving journalistic quality for general public benefit
- Encouraging political discourse and the formation of public opinion
- Protecting vulnerable values and groups in society (e.g., linguistic plurality and ethnic diversity)
- Strengthening of the national industry and offering incentives for newspapers not to relocate
- Safeguarding political plausibility and civic support

### 2.1.3 The Subsidy Effects Debate

State aid for newspapers via financial subsidies is public monies intended to maintain and increase the revenues (incomes) of producers and whole industries during times of special difficulties, by guaranteeing supply of products offered by these companies. They may smooth or slow down the process of long-term structural decline of an industry. Yet, they may also aim at improving the competitiveness of market players in a healthy industry by supporting those products in a market which are said to confer properties of merit goods in the sense that their provision and use benefit society at large such that the provision of high-quality objective information, high culture, and education are promoted (Musgrave 2008). Further, state aid may target activities that would otherwise not take place, such as investments on innovation.

When considering competition effects of state support, public subsidies might come to adversely affect competition. Here, the UK’s economic government

regulator, the *Office of Fair Trading* (OFT), has developed a guidance on how to assess the competition effects of subsidies in general (OFT 2004, 2006). Accordingly, subsidies may:

- Change the behavior of the recipient to the detriment of social welfare. While full competition, through efficient markets, delivers lower prices, greater choice, and more popular products to consumers, subsidies have the potential to cause firms to produce at higher costs or sell their products at higher prices than it had actually cost to produce them.
- Impact on the recipient's costs (either fixed, variable, or total) and so will affect its decisions concerning what to produce, how much to produce, how to produce it, and what to charge for it. Such a change is likely to have an immediate effect on the competitive process, including the relative strengths of firms receiving and not receiving subsidies.
- Force efficient firms out of the market, or reduce their long-term investment or reduce employment, for example, in order to ensure their short-term survival.
- Reduce the future incentives of firms to act efficiently. If firms anticipate that poor performance might be compensated for by subsidies, they will have less strong incentives to be efficient. The dynamic profit incentive at the heart of the competitive process will be suppressed.
- Prolong the time an inefficient firm is able to stay in the market directly and distort a firm's incentives to innovate. For example, an R&D subsidy that benefits just one firm in a market may reduce the incentives of their competitors to invest in research and development (R&D).
- Drive competing firms to react by adjusting their behavior. In response, subsidy recipients may adjust their behavior again prompting second round and third round effects.
- Encourage firms to use time and resources in trying to obtain subsidies whereby such resources are unlikely to be directed in an efficient manner.

Hence, subsidy design can help determine whether the subsidy will have a material effect on competition. In particular, the magnitude, in both absolute and relative terms (i.e., in relation to the costs of the subsidized activity), and the structure of subsidy payments (i.e., periodical or one-off) all may have potential effects on recipients as well as the competitors' behavior.

In this context, Robert Picard's analytical framework of 1991 of analyzing competitive effects resulting from state press policies is still valid today. Picard followed Nobel Prize winner Ronald H. Coase (1974) in claiming that newspapers serve two different markets: the information/ideas market (i.e., the editorial content production and services side of the market) and the economic market for goods (i.e., the revenues-creating side of audiences and advertisers' markets) with one and the same product. As a result, public policy choices must sometimes be made in favor of the press as such that promote competition in one market while harming competition in the other. General policy goal is, as Picard put it, that "*creating and adjusting press policies should be that no negative effect from state activity occurs in either the economic or the information/idea market*" (Picard 1991, p. 3).

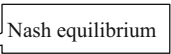
As for selected state press policies, aimed at reducing the production costs of newspapers, they can have different effects on the economic and journalistic competition of newspapers. What may have positive effects on the economic competition may have negative effects on the information/idea market, and vice versa, or have no effect at all respectively. If one follows Picard (1991) further, the “*selective production subsidies, that is cash payments made to specific papers to help cover their costs (...) and ownership regulation, that is legal efforts to limit the number of publications or the amount of circulation that may be owned or controlled by a single publisher*” (Picard 1991, pp. 6–7), best promote competition both in the economic and in the information/idea market. On the other side, nonselective tariff discounts on the postal delivery of newspapers, for example, promote the information/idea market, but harm economic competition because they consolidate the financial resources of high-circulation newspapers and thus lower the costs of doing business even further for the market leaders instead of singling out specifically the smaller newspapers for special aid. Picard leaves no doubt that only a balanced and coherent set of public press policies may best promote overall competition, so stressing the need to conform to the general economic policies of the nation in which they are proposed (Picard 1985).

#### 2.1.4 Subsidy Effects Through a Game Theory Lens

Now, let us consider the issue of subsidy effects on pricing competition between two newspapers competing for readers in a predefined market for news. Here, it is helpful to apply a noncooperative pricing game based on simple game theory logic (Carmichael 2005; Fuldenberg and Tirole 1991; Rasmusen 2007). Let me model a two-player, two-strategy choice, single-episode, noncooperative pricing game in a duopoly market for printed news. For this, I assume that:

- There are two market players: *Newspaper A* and *Newspaper B* which are perfect substitutes, i.e. consumers perceived them as being homogeneous goods.
- Newspaper A does not receive government subsidies while *Newspaper B* is granted specific financial aid.
- Newspaper B passes (some or all) of the subsidy on to the consumer, resulting in a lower end-cover sales price per copy.
- Consumers prefer to read the lower priced paper.
- Each of the players competes in the same market for, say, printed quality news (e.g. regional daily newspapers), and they offer a homogeneous (i.e. undifferentiated) product, and thus do not cooperate in any way.
- Both players compete by setting prices simultaneously are decision-makers and must choose between two pricing strategies: (*low price*) and (*high price*).
- One player’s performance is directly related to decisions made by another player, no unilateral decisions are made (i.e. A guesses what B will do by guessing what B will guess A will do, *ad infinitum*).

		<i>Newspaper B (Subsidized)</i>	
		<i>{high price}</i>	<i>{low price}</i>
<i>Newspaper A</i>	<i>{high price}</i>	60, 60	60, 0
	<i>{low price}</i>	0, 60	0, 0



**Matrix 2.1** Newspaper pricing game payoff matrix. Source: the author

- Both players tend to act non-co-operatively since it is the individual maximization, and not the joint maximization, of utility that determines their individual choice.
- Their plans result into behavioral actions and the dominant strategy chosen will be the one with the highest expected payoff (or utility).
- Both players know all the rules of the game and the preferences of the other player for each of the outcomes. Each player is fully informed about all prior choices when it is time to decide.

By using game theory design, we can now set up the payoff matrix with possible strategies and the respective payoffs in order to find a solution to this game. Some more data is needed for this. We assume that *Newspaper A* and *Newspaper B*'s production costs are 1.00 euros per copy (i.e., per unit cost) and their price is either 1 euro or 2 euros. Readers love to purchase the cheaper newspaper. In case of a same price they split among the paper equally. For a price 1 euro 1,100,000 newspapers are sold, for 2 euros only 60,000. Now the solution looks as follows (see, Matrix 2.1):

Overall, there is a big incentive to cooperate in this (Bertrand) duopoly model (Bertrand 1883).<sup>7</sup> First, if both newspapers colluded and charged the high price, they would share the market equally and at highest payoff each [60, 60].<sup>8</sup> This would be the best decision both newspapers could choose in this setup. However, if the government-subsidized newspaper (*Newspaper B*) went for the (*low price*) strategy, while *Newspaper A* remained unimpressed, it would sell more copies but accrue higher marginal costs as a result of which it would achieve zero payoff. While readers would prefer to read *Newspaper B*, *Newspaper A* would have to follow lowering its price to the level of *Newspaper B*. If both players decided for the (*low price*) strategy, we would arrive at the Nash equilibrium (Nash 1950). This

<sup>7</sup> This duopoly game model is inspired by the model of competition used in economics, named after the French mathematician Joseph Louis François Bertrand (1822–1900).

<sup>8</sup> If *Newspaper B* chooses a low price its payoffs is calculated as follows:  $(1 \times 100,000 \text{ euros}) - (1 \times 100,000 \text{ euros}) = 0$ . In this competitive pricing scenario, *Newspaper A* would have to expect the same zero profit payoff in this equilibrium.

equilibrium is the solution of this noncooperative pricing game. There, each newspaper is assumed to know the equilibrium strategy of the other, and no player has anything to gain by changing only its own strategy unilaterally. Still, this Bertrand–Nash equilibrium is only a weak one. This means that the other game’s equilibrium where both players play the (*high price*) strategy may well be sustained as an equilibrium of a repeated game. If both firms agreed to deviate from the competitive price they would make a profit, and only the readers would lose.

What does this solution imply for public subsidy governance? Clearly, in the duopoly model scenario shown above, government subsidies which aim at lowering prices drive both competitors to reduce their prices at the cost of their individual payoff. If government-subsidized Newspaper B offered a competitive price below the equilibrium pre-subsidy price, Newspaper A would be better off entering into a price war in order to not lose readers to the rival. Yet, at the Bertrand equilibrium zero profits are made. A government subsidy to one market player would, following this model’s logic, lead to Pareto-efficient market result where price equals marginal costs. In order to achieve this result, governments are thus advised to offer *selective* subsidies to homogeneous newspapers on the basis of specific criteria (e.g., market position). However, there is still the danger that the subsidized newspaper would not lower its end-cover price but instead invested into cost-reduction policies in order to drive down costs.

If we applied game theory to real-life situations we would probably come to a different conclusion: Newspapers are rarely identical goods because readers add to their meaning in very specific ways. They consume and interpret news content fairly individualistically and develop preferences for rather specific bundles of information (Lacy 1993, 2004). In this second scenario, let me thus argue that each player’s level of product differentiation is not decided in isolation but with respect to the strategy of its opponent. Publishers, it is assumed, will be best able to produce high-quality news when they are most insulated from competitive market pressures. Increases and decreases in competitive pressure, the argument goes, are commonly associated with increases and decreases in the quality of news (Picard 2004; Waterman 1991; Zaller 1999). When tackling product differentiation print news managers may differentiate their products according to periodicity or feature frequency, revenue model, geographic focus, editorial orientation, news style, visual complexity, content organization, or newsprint quality, or most commonly a combination of them (Reddaway 1963; Picard and Brody 1997).

Hence, I assume the following game settings for this new scenario. Applying the PAPI framework reveals the following results:

1. *Players*: Two newspaper firms, the entrant (B) and the incumbent (A).
2. *Actions*: In the first stage, the players simultaneously decide on either offering a high-quality newspaper {*high quality*} or a {*low quality*} one, indicated by a high sales cover price or a low one, respectively. In order to invoke an analogy from Hotelling’s geographic location model, both newspapers simultaneously choose locations  $x_i$  along an interval [0, 1], with 0 and 1 corresponding to maximum distance levels. We model that both firms compete on the quality

**Matrix 2.2** Newspaper quality game payoff matrix. The *arrows* indicate how a player can increase its payoff

		Newspaper A	
		<i>{high quality}</i>	<i>{low quality}</i>
Newspaper B	<i>{high quality}</i>	$-50, -50$ <i>b<sub>1</sub></i>	$200, 100$ <i>b<sub>2</sub></i>
	<i>{low quality}</i>	$100, 200$	$-50, -50$

characteristic as an alias for their geographic location. Readers are supposed to be uniformly distributed along the interval and have no preference for any newspaper. As the game is simultaneous, each player can choose to go for the high-end *{high quality}* or the low-end product market *{low quality}*. If we look at B, it has two options: Either it decides for a high-end *{high quality}* strategy and attacks the incumbent with an editorial quality which is close but not identical to it, or it bargains on a position at the long side of the market in order to avoid the incumbent’s response.

3. *Payoffs*: Suppose market profits are 300 at the monopolist quality. Market profits under duopoly competition are split by 1/3 to 2/3, depending on who triggers which differentiation strategy. If both players decide for a uniform strategy, total market profit will drop drastically and a market loss of  $-100$  will be incurred, which is assumed to be split evenly.<sup>9</sup> Suppose Newspaper B decides to offer *{low quality}* and differentiates maximally, the incumbent’s best response would be to offer *{high quality}*. Similarly, the game is played back-to-front when A started off.
4. *Information*: The simultaneous game is one of imperfect information. This means that if a player does not know exactly what actions the other player takes.

Graphically, the solution to this game can be shown by the following Matrix 2.2.

As shown in Matrix 2.2 above, newspaper B has got the following options: it could offset Newspaper A’s market-leader advantage by offering a low product quality which would, all else equal, be indicated by a low price. If A was to remain delivering a high-quality paper, B’s plan was to steal readers and corresponding market share from A (move *b<sub>1</sub>*). This could, in theory, end up in a retaliatory measure by the market leader as a result of which both newspapers would end up in a loss (as shown by the payoff in the *{low quality, low quality}* profile).

Equally, in order to maximize expected payoff, B could be positioning itself in the high-end segment of the market and, if A offered a low quality product, was

<sup>9</sup>Of course, this is a stark simplification as, under such conditions, numerous external factors influencing demand, such as population and tastes, and the quality of the newspaper from the point of view of the reader are assumed away.

better off by delivering a horizontally (e.g., distinct political orientation) and/or vertically (e.g., more accurate news) differentiated substitute product, which, when indicated by a higher sales price, would achieve a higher payoff (move  $b_2$ ).

As shown in the following Matrix 2.1, the Nash equilibrium solution is back-to-back pairing at the median of the reader distribution, a result christened as the principle of minimum differentiation. This is where both newspapers face the “dilemma of opposites” of producing a “cheap” newspaper at a high level of quality. Naturally, the challenger may want to gain market share and profit and commit to a low-cost, low price differentiation strategy, where its payoff of 100 is positive, while the market leader would still be able to reap a profit of 200. It is up to both players to resolve this dilemma. Once they fail to do so and imitate each other’s quality, their profit situation will turn negative ( $-50/-50$ ). Obviously, the market trick is to be perceived as both identical and different at the same time.

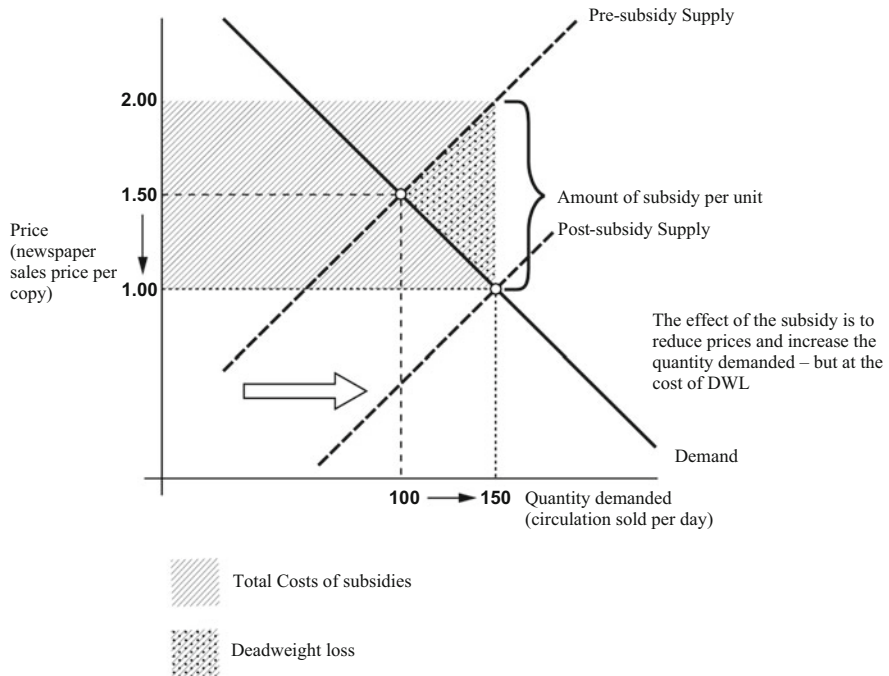
Again, what does this solution mean for subsidy governance? The situation is quite dilemmatic. When subsidies are given out to the market challenger in order to improve its content quality with a view to improving its market position against the leader, the only opportunity of the weaker paper is to offer a price inferior to that of the market leader in order to remain profitable. But as consumers may miss information other than the price as quality indicator and may thus be confused about on the small rivals’ actual quality offered (Zeithaml 1988), the subsidized *Newspaper B* is forced to master this price-quality gap by offering a *relatively* lower price at a *distinctively* better quality. In order for the subsidy to have a positive market effect, the beneficiary will need to know more about the price elasticity of demand for its product in order to find out how relative price changes would affect demand. Alternatively, it could only cheat, for example, as part of a marketing and branding campaign, and pretend to offer a high-quality product while, in fact, it would offer a lower-quality newspaper, banking in on cost-reducing measures in order to improve its payoff.<sup>10</sup>

### 2.1.5 Identifying Indicators for Measurement

A further exiting issue refers to identifying indicators for measuring the effects of newspapers to be subsidized (Jung 2003). This, again, is not a pedestrian question. Technically, in order to be eligible for state funding, quality criteria, for example, must be identified which can be measured over time without any bigger data acquisition problem. But while the direct measurement of product-related quality criteria such as objectivity (accuracy, truth, separation of news and opinion, etc.) or timeliness is a high-effort and time-consuming exercise, indirect indicators for quality may prove less demanding but are yet more intuitive.

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<sup>10</sup> On the upside, incomplete information about vertical quality signaled via price would soften price competition (Daugherty and Reinganum 2008).



**Fig. 2.1** The effect of a newspaper subsidy and deadweight loss. Source: the author

Hence, the usage of the following quality indicators seems advisable:

- Number of editors compared to the volume of editorial pages
- Level of education and job experience of full-time editors and free lancers
- Level of editorial budget in relation to the total budget
- Number of subscribed news agencies and in-house correspondents
- Prizes and awards granted to journalists
- Expert evaluations to set up minimum quality standards as benchmark

Another index is newspaper readership or reach as benchmark against which the effects of subsidies to newspapers can be measured. Arguably, newspaper demand is higher to lower priced newspapers so nations that give higher subsidies to their newspapers experience higher demand, all other things being equal, than nations that give small subsidies. Let us state an example: In Denmark, public press subsidies amount to 54 million euros a year. With its 5.5 million inhabitants, the state thus subsidizes a Dane with 9.8 euros per head. Austria, in comparison, would only show a subsidy per head (Fig. 2.1).

Another difficulty that must be dealt with when balancing the positive and negative impact of subsidy measures is that the analysis of market failure to warrant intervention is mainly a prospective one. As such, the objective of ex ante regulation would be first to identify which market failure needed correction. Alternatively



or in addition, ex post assessment mechanisms may also be put in place in order to limit the negative impact of state aid and subsidies (OECD 2010).

Finally, this combination of instruments of state subsidies to the press and the principles of intervention applied has various effects on the business operations of newspapers themselves. When subsidies relax cost pressures on printing and distribution of physical copies, for example, their effects are relative to the cost structure of the respective beneficiary. In France, for example, a report (the so-called *Cardoso plan*) on reforming public government support to the press found out that—by comparison—the left daily *Libération* would benefit from a mere 0.09 euros from direct aid per copy on its sales cover price, while *France Soir*, a French daily newspaper that prospered during the 1950s and 1960s but went online only on December 14, 2011, would receive a share of 0.52 euros per copy out of the public hand, still failing to survive its printed editions. Obviously, different cost structures can reduce the efficacy of subsidies to zero (Truffly 2011).

To my knowledge, little theoretical reasoning has been applied to study the impacts of government subsidies on the editorial work of journalism within a media economics or communication studies research domain. However, one may import organizational theories as conceptual frameworks in order to explain issues of *internal market failure* as diagnosis tool for firm inefficiency (Vining 2003). This may validly widen the canvas of media economics research towards the effects of subsidies as tools of intra-organizational incentives for journalists to achieve higher firm efficiency and improved organizational performance. Alas, the literature has yet to treat such questions more systematically.

### 2.1.6 State Aid as Antidote to Market Failure?

From the neoclassical economics perspective, government intervention in private markets is justified to enforce property rights, correct market failures, reign in the market power of monopolies, or address inequity by redistributing resources. Standard examples of interventions motivated by market failures include the use of taxes and subsidies to correct externalities, to organize the provision of public goods, or to redistribute resources in order to improve welfare.

Market failure can be defined by multiple institutional weaknesses to coordinate economic activities efficiently and equitably. Markets may fail when competition cannot unfold or is organized deficiently.<sup>11</sup> Market failure describes situations where economic efficiency is *greatly* constrained (i.e., market imperfection or partial market failure) or is not being provided by the market *at all* (i.e., *pure market failure*) (Murschetz 2008). Market failure can be defined by multiple

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<sup>11</sup> In economic theory, the first fundamental theorem of welfare economics describes an idealized system of equilibrium conditions to efficiently coordinate economic activity (Pareto 1971/1927). Markets that do not achieve this Pareto optimality are said to result in market failure.

institutional weaknesses to coordinate economic activities efficiently and equitably. It may reside in:

- Product and cost characteristics of media goods, (e.g., lack of property rights, public and merit goods, high first-copy costs, high costs of production, distribution, and marketing),
- Forces towards imperfect competition which may themselves have supply or demand-side origins, such as market power achieved through monopolistic or oligopolistic market structure (Robinson 1933; Chamberlin 1962/1933; Rosse 1967) or a low-price elasticity of consumer demand for newspapers (Blair and Romano 1993),
- Constraints embedded in the organizational structures of markets which become manifest in high barriers to entry by means of economies of scale and brand loyalty (Bain 1956; Baumol et al. 1981; Demsetz 1982; Heinrich 1984; Stigler 1968; von Weizsäcker 1980),
- The existence of externalities; Pigou 1932/1920 and transaction costs (Coase 1960; Williamson 1979)
- Media customer-side specifics (e.g., asymmetric information; Akerlof 1970, intransitive preferences; Tversky 1969, irrational behavior; Kahneman 2003).

Additionally, dominant firms may raise market entry barriers or try to control successive value stages under their single roofs through means of ownership concentration and vertical integration. This gives rise to costs to the economy and society at large (Bator 1958; Cowen 1988; Cowen and Crampton 2002).<sup>12</sup>

From a publishers' point of view this means that if firms are not rewarded for making the right decisions, or are rewarded for making the wrong decisions, then resources are used inefficiently. This gives rise to costs to the economy and society.

Subsidies are possible regulatory tools that may correct market failure and work as one-way financial transfer payments that are payments of income which are not redeemed by any current factor services from the beneficiary. Although a number of other industries have been quiet victims of cyclical and structural industry changes, newspapers are a special case. Since the industry exhibits increasing returns to scale, high fixed and sunk costs, and significant economies of scope, setting prices equal to marginal cost will generally not recoup sufficient revenue to cover the fixed costs. And the standard economic recommendation to set prices at marginal cost will fail to cover total costs, thus requiring a subsidy, albeit not necessarily from the public purse (Ludwig 2000). However, with the news industry struggling to find new revenue streams that can reshape their broken business model, the industry's future seems to be predominantly defined by experiments in news media monetization

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<sup>12</sup> Arthur Cecil Pigou has been called the father of the market failure paradigm. Indeed, he argued that "*in any industry, where there is reason to believe that the free play of self-interest will cause an amount of resources to be invested different from the amount that is required in the best interests of the national dividend, there is a prima facie case for public intervention*" (1932, p. 331). He suggested that taxes could be used when external diseconomies are present and that the existence of external economies would warrant the use of subsidies.

by the industry players themselves. As such, pricing and output decisions are accompanied by strategies of product and business model innovation.

In any case, government cash subsidies are linked to prices in that they act as deficiency payments for producers to deliberately regulate for the differences between a sales price of a good or service and the actual price received for it in the market.

Economic theory shows the effect of a subsidy on the sales price and quantity demanded. Following the law of supply and demand, subsidies are external benefits that lower the cost of production and shift the supply curve ( $S_1$ -curve, pre-subsidy) vertically downwards by the amount of subsidy provided ( $S_2$ -curve, post-subsidy). The vertical shift to the right is equal to the subsidy being given by unit. Consequently, a subsidy may lead to an increase in producer revenue as the post-subsidy price is lower than the pre-subsidy equilibrium price and more units of quantity are sold at each price. The following Fig. 2.1 illustrates the potential effects of a newspaper subsidy on the equilibrium market price and quantity demanded.

In our example, we can see that with no subsidy newspaper publishers produce 100 copies per day (in 1,000) at a sales cover price of 1.50 euros a copy. A government subsidy of 1.00 (in euros) per copy would shift the supply curve rightward from the pre-subsidy supply curve  $S_1$  to post-subsidy supply curve  $S_2$ . The equilibrium quantity increases to 150 (in 1,000) copies sold a day, the price falls to 1.00 euros per copy, and the price plus the subsidy received by publishers rises to 2.00 euros per copy. The entire subsidy does not fully get passed on to the consumer as the publisher will keep some of it. This creates deadweight loss (DWL) from a subsidy, a measure of the welfare that is lost when the equilibrium in a market is not market-made but government-supported. Consequently, the magnitude of this loss is dependent on the size of the government subsidy. In other words, the higher the subsidy given, the larger the DWL, and the bigger the market failure or inefficiency caused by the subsidy. Graphically, DWL is represented by the shaded triangle in Fig. 2.1. In other words, government has to trade-off between a welfare loss to society of that money—in the new equilibrium, marginal social cost (on the supply curve) exceeds marginal social benefit (on the demand curve, which results in inefficient overproduction)—and the benefit the subsidy provides to readers (as the subsidy has reduced the sales cover price per copy).

Of course, the impact of subsidies on readers will depend on the *price elasticity of demand*. Price elasticity of demand (PED) shows the relationship between price and quantity demanded and provides a precise calculation of the effect of a change in price on quantity demanded.<sup>13</sup> There are several reasons why consumers may respond elastically or in-elastically to a price change, including:

<sup>13</sup> A PED is easily calculated. For example, if the price of a daily newspaper increases from 1.00 euros to 1.20 euros and the daily sales fall from 500,000 to 250,000, the PED will be  $-50\% \div 20\% = (-) 2.5$ . The negative sign indicates that P and Q are inversely related, which we would expect for most price/demand relationships. This is significant because the newspaper supplier can calculate or estimate how revenue will be affected by the change in price. In this case, revenue at 1.00 euros is 500,000 euros (1 euros  $\times$  500,000) but falls to 300,000 euros after the price rise (1.20 euros  $\times$  250,000).

- The number and “closeness” of substitutes which means that a unique and desirable product is likely to exhibit an inelastic demand with respect to price.
- The degree of necessity of the good (i.e., newspapers are no necessity like bread and will thus be demanded elastically with respect to price).
- Whether the good is habit forming whereby consumers are relatively insensitive to changes in the price of habitually demanded products (e.g., subscribed newspaper).
- The proportion of consumer income which is spent on the good (which means that the PED for a daily newspaper is likely to be much lower than that for a new car).
- Whether consumers are loyal to the brand (brand loyalty reduces sensitivity to price changes and reduces PED).
- The life cycle of a product e.g., when new products are launched, there are often very few competitors and PED is relatively inelastic. As other firms launch similar products, the wider choice increases PED. Finally, as a product begins to decline in its life cycle, consumers can become very responsive to price; hence discounting is extremely common.

What does this imply for government subsidies? In effect, this would mean that a subsidy-driven decrease in the sales price of a newspaper will lead to a proportionate change in the quantity sold. Importantly, when newspapers show a low PED, the subsidy effect in increasing newspaper circulation and readership will not be too strong as the quantity demanded is relatively inelastic. This must be considered as a strong point against stimulating competition through subsidies in specific segments of a news market, particularly when print readers face a lack of substitute news sources (e.g., online news).

When government identifies newspaper reading as an activity that carries *positive consumption externalities*, i.e., readers receive pleasure, get educated, and take part in public affairs etc., all for no extra costs to them, government may want to internalize these externalities by subsidizing the publishing activities that have this positive externality.

Still, the state may interfere in order to offset *information deficits* of newspaper readers who cannot evaluate the differences in the quality of information in order to provide all citizens with the same quality of information and opinion. With publishers tending to trade inferior information as quality and readers only aware of average qualities, an asymmetry in available information for quality newspapers may develop, with the effects of finally ceasing trade and driving quality newspapers out of the market.<sup>14</sup> In these circumstances, the state can act to even out the *quality uncertainty* in the market by reducing the incentive for either the publisher to oversupply low-quality or the reader to under-demand high-quality

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<sup>14</sup> If, on the information readily available to them, readers can discriminate between prices but are not able to discover quality and thus will not rationally price trade-off against quality, publishers with high-quality newspapers will be driven out of the market, and there will be a general lowering of standards (Akerlof 1970).

newspapers. Building intervention on the differences in quality of information is, however, difficult because the regulator itself may find it difficult to access information other than prices whereby quality can be conveyed in economic systems.<sup>15</sup>

In real terms, however, subsidies to newspapers are controversial in themselves. Robert Picard, media economist and director of research at the *Reuters institute for the Study of Journalism* at the University of Oxford, argued that the ability of public subsidies to solve current pressures in print media is limited (Picard 2006). Picard's *subsidy-failure hypothesis* is built on the following propositions:

- Subsidies do not avoid the fundamental economic problem of market failure in the print media industries.
- The number of newspapers has continued to decline as the state aid pays for variable costs rather than fixed costs, the latter of which weigh heavy on publishers' business operations.
- Public intervention into press markets is generally bad as "free markets" work more efficiently. Intervention leads to net welfare losses to society.
- Subsidies to newspapers for which there is a lack of audience interest are futile. These subsidies are a waste of taxpayers' money, i.e., cost to taxpayers exceeds benefit to consumers and producers.
- Although subsidies help newspapers to survive by means of a financial prop they do little to help newspapers adapt to future changes needed to get them suited to the needs of the market. The lifeboat of subsidies can thus be leaky at best.
- Selective subsidies are considered to be politically unacceptable as far as they require consent across opposing political forces backed up by a solid and impartial method of selecting companies and channeling the money to the papers.
- Subsidies cannot create long-term sustainability but instead create dependence on the annual handout of subsidies.

Arguably, another bigger problem seems to be that when print media publishers receive subsidies they may not necessarily be "passed through" to the end consumer, i.e., have a lowering effect on the sales price of the newspaper. Although this assumption may not always hold, and pass-through may be a matter of degree, it is conceivable that at least part of a subsidy is put to entirely different uses. And, worse yet, when the industry is experiencing an economic crisis and legacy newspapers have to see a painful and ongoing decline in advertising revenues, publishers are forced to react strategically by driving up their cover prices and thus sales revenues. This move, in turn, will effectively thwart the potential price-lowering effect of a subsidy.

Overall, when coming back to the big issue whether public subsidy payments can ban the specter of market failure or give in to agency capture and government failure is highly contested. Naturally, discussions about market failure reflect

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<sup>15</sup> Such means are, for example *signaling*, whereby information is distributed by sellers to buyers by way of quality monitoring systems, whereas "screening" refers to the buyers acquiring information by the help of consumer protection groups. The aim is identical: removing the asymmetry in information.

disputes among scholars of different schools of economic thought, notably between doctrinaire positions of the “free market school” versus the market-interventionist axis of scholarly reasoning. As it stands, the academic debate about the paradigm of market failure is complex and rather confusing. It originates from the paradigm’s hybrid intellectual architecture and results in competing scholarly discourses. Here, two dominant schools fight for scholarly hegemony: On the one hand, the *Harvard–MIT* axis of scholarly reasoning in economic theory argues that in case of market failure government is to intervene in the economy to correct for those and to restore the conditions for welfare optimization (Samuelson 1954; Musgrave 1959; Musgrave and Peacock 1958).<sup>16</sup> Counterarguments on that way of thinking come from the neoclassical *Chicago school* of economic thought (Reder 1982; Stigler 1988).<sup>17</sup> Their fundamental tenet is that competition within a perfect market will lead to efficiency, which is the desirable normative goal of the legal system. According to the Chicago analysis, intervention within the market is justified only when there is a market failure. For them, such failure exists when there are no multiple players on both sides of the market (the problem of monopoly), when these players do not have symmetric and full information relevant to their market activities, when any of the players bypass the market through involuntary actions, or when the traded commodity is a public good. The general orientation of the *Chicago school of economics*, however, is that these circumstances are rare and that in the real world there is too much central intervention. Media markets would thus have strong tendencies towards failure. Now, these are opposing schools of thought. But is their explanatory power still strong enough today?

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<sup>16</sup> Paul Samuelson (1954) and Richard A. Musgrave (1959) and others consolidated the market failure paradigm in the 1950s. However, this paradigm was contested since its inception.

<sup>17</sup> The term was coined in the 1950s to refer to economists teaching in the Economics Department at the University of Chicago, such as Frank Knight, Ronald Coase, and Milton Friedman.

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