Theory of economics in the film industry

Introduction

In this essay I shall examine the theory of economics within the film industry and how it contributes to the production and distribution of mainstream Hollywood films. For the purposes of this essay I shall be researching and commenting solely upon Hollywood productions.

My research will include an examination of different theories that investigate and explain how economics shape the way that film is stripped down to its bare essentials so that the business of making movies can begin in earnest. Throughout this essay I shall investigate the importance of budget, audience, genre, stars and guidance ratings in relation to the success of a movie. With the collation of this data I shall explore how these economic factors sculpt what is recognised as mainstream Hollywood cinema; investigating how important they are in shaping the strengths and limitations of what is exhibited onto cinema screens across the world.

Using this information I shall argue the pros and cons of how a rigidly structured industry can produce works of art, passion and brilliance whilst being presided over by a business-orientated mentality that should, in theory, stifle any creative development. In my conclusion I aim to explain how this is possible and what may lie ahead in the future.

Economics of Film

The way that economics work in film is complex. There are a great number or variables that need to be taken into consideration from the outset when preparing any kind of financial package to put a film project into production.

This ‘ green lighting’ analysis seems to have become an exact science over the years in Hollywood; it has had to be as the average budget to make and market an-MPAA accredited major film in 2005 was $96. 2 million (this includes $60 million in negative costs and $36. 2 million in marketing costs). [1] With the average budget totalling almost $100 million the stakes are high, and the pressure to recoup the costs and go on to make the film an official success are immense. Unlike low budget films where the emphasis is to produce the film for as little money as possible, Hollywood aims high and expects high returns. It is this importance of making money in Hollywood that has led to widespread criticism of its methodology of producing films. How can art be held at ransom to the demands of cash flow forecasts and daily target sales? In his book, *Hollywood Cinema,* Richard Maltby questioned this paradox: *“ For the vulgar Romantic in us all, Hollywood is not Art because it is commercial. For the vulgar Marxist in us all, Hollywood’s enslavement to the profit system means that all its products can do is blindly reproduce the dominant ideology of bourgeois capitalism.”* [2] In its simplest form it is possible to split Hollywood into two significant camps; the business of making movies and the production of film. Obviously this is an extreme simplification, but for the basis of this essay it can be used to identify how the images we see on the silver screen on a Friday night begin life as a list of figures and calculations on an economist’s laptop. The fact that Hollywood is a multi-billion dollar industry guarantees its survival. It deserves to be viewed upon as a completely different entity to any other artistic medium such as photography, painting or sculpture. The reality is that the audience actually sees an identical copy (a reproduction), but this does not take away anything from the original work. It is not like going to a museum and looking at a reproduction print of a work of art instead of the actual brushstrokes of the artist. As such there is no real loss in value because of this. Richard Maltby writes that: *“ The economics of Hollywood rely expressly upon this technical possibility, since any number of prints can be struck from an original master negative and exhibited simultaneously.”* [3]

There have been many different models that have been introduced to analyse the process of how economics work in Hollywood. The common denominator of these theories is that the most effective way of studying the medium of film is to study it on its own merits and not as a broad comparison to other media. This focused view of film in the field of economics has been labelled as ‘ micro-economic research’: *“ Given the interesting characteristics of movies as ideal examples of differentiated products and of the institutional arrangements governing their production and distribution, such increased data availability would make this an exceptionally attractive area for applied micro-economic research.”* [4] In the late 1970s, American economist Thomas Guback wrote his essay *‘ Are We Looking at the Right Things in Film?’* in which he argued that the study of cinema seemed to ignore the *‘ analysis of cinema as an economic institution and as a medium of communication’* [5] . Nearly thirty years on Guback’s concerns are still relevant in that a lot more attention is given to the understanding of a film’s economics. Another economist, Professor Robert Picard, explained the importance of audience consumption in 1989 when he stated that: *“ Media economics is concerned with how media operators meet the informational and entertainment wants and needs of audiences, advertisers and society with available resources. It deals with the factors* *influencing production of media goods and services and the allocation of those products for consumption."* [6] When Picard speaks of the wants and needs of the audience he is introducing a wide range of attributes that need to be addressed when contemplating how a film must be produced to subjectively please its audience, and therefore returning its costs. This concern is highlighted in the industrial organisation model created by Douglas Gomery. In it he describes how the analyst must focus on the objective description of the organisation (in this case the film production) and not the subjective response (how the audience reacts): *" The industrial organization model of structure, conduct, and performance provides a powerful and useful analytical framework for economic analysis. Using it, the analyst seeks to define the size and scope of the structure of an industry and then go on to examine its economic behaviour. Both of these steps require analyzing the status and operations of the industry, not as the analyst wishes it were. Evaluation of its performance is the final step, a careful weighing of ' what is' versus ' what ought to be'."* [7]

What these theorists introduce to the equation is that there are many problems that need to be addressed before embarking on the goal of putting a film into production. This uncertainty is readdressed by Arthur de Vany in his book, *Hollywood Economics.* In it de Vany explains the uniqueness of each individual project and how its life as a commercial product in the theatrical market is hazardous. He introduces the idea that films exist in a battling arena, a box-office tournament, fighting against one another for the public's attention: *" Motion pictures live and die in the box-office tournament as they are challenged during their run by a randomly evolving cast of new* *competitors. The challengers come from films previously released and from newly released films. The contending films are ranked by filmgoers and those with high rank survive and are carried over to the next week. Low ranked films fail and are replaced by new contenders."* [8] This colourful analogy of films as knights in shining armour jousting for the acceptance of the audience is a perfect example of how weaker films (financially rather than artistically in most Hollywood films) are often tossed aside by bigger and stronger productions. He continues to say that: *" The leading products command a disproportionate share of the market and they have longer runs. Even then, a film's rank in the tournament is ephemeral and its life unpredictable."* [9] Using de Vany's theory it becomes apparent that certain actions by the parties responsible for production prove vitally important to the success of the project. These actions are described by Albert Moran in his study of film policy: *" Policy is a series of practice engaged in by an agency – whether government, private, or commercial – to achieve a particular set of outcomes."* [10] These outcomes, in this particular case the target being that of a successful movie release, rely on many attributes and the policy exists in a *" complex field affected by factors such as constitutional and legislative arrangements, general economic conditions, the prevailing culture, social awareness, and technological capacities, as well as such human agencies as politicians, business entrepreneurs, white- and blue-collar labour, bureaucrats, and cultural and social workers."* [11]

It is easy to be bogged down by so many different economic models and theories when analysing how the Hollywood system works. With so many factors influencing the results the process becomes a minefield of potential disasters waiting to happen. How can anyone truly predict what is going to be a successful film? Writer Harold Vogel highlights this quandary when he points out that: *“ Of any 10 major theatrical films produced, on the average 6 or 7 are unprofitable, and 1 will break even.”* [12] If we were to surmise that this list of ten films were produced by the same studio in one year then the models as used by Picard, Gomery, et al really do not ease the pressure faced by the film executives. The cold, hard facts point at only a 20-30% success rate in their annual production slate recouping their costs. It is all very well studying the market, assessing the competition and second-guessing the audiences’ preferences, but the fact is that 60-70% of the studio’s product will lose money. If we reintroduce the MPAA’s statistic that the average major release in 2005 cost around $100 million, it would mean that the studio understands that only two movies from their annual releases must do enough business at the box office to recoup their own costs as well as the costs of the $700 million from the other eight films. According to the MPAA in the full calendar year of 2005, only eight films grossed over $200 million, twelve films grossed $100 – $199 million and 36 films grossed $50 – $99 million. [13] Economic models can only interpret the market to a certain point; blind faith takes over after that. Vogel breaks away from the other theorists by boldly stating that: *“ There are no formulas for success in Hollywood. We find that much conventional Hollywood wisdom is not valid. By making strategic choices in booking screens, budgeting and hiring producers, directors and actors with marquee value, a studio can position a movie to improve its chances of success. But, after a movie opens, the audience decides its fate. The exchange of information among a large number of individuals interacting personally unleashes a dynamic that is* *complex and unpredictable."* [14] Vogel's theory on the exchange of information from the public audience unleashing a complex and unpredictable dynamic typifies the world in which the Hollywood film is now being made. It is now, more than ever, that the success of a film in the box office is paramount to how Hollywood works. He describes the essence of the movie business as this: *" The mean of box-office revenue is dominated by a few ' blockbuster' movies and the probability distribution of box-office outcomes has infinite variance! The distribution of box-office revenues is a member of the class of probability distributions known as Lèvy stable distributions. These distributions are the limiting distributions of sums of random variables and are appropriate for modelling the box-office revenues that motion pictures earn during their theatrical runs… Movie projects are, in reality, probability distributions and a proper assessment of their prospects requires one to do a risk analysis of the probabilities of extreme outcomes."* [15] What I believe Vogel is saying is that the importance of ticket sales from the box office shapes the type of movie that the studio will produce. A blockbuster film that boasts a line up of A-list stars will fare significantly better than a film that has no stars attached; the fact that the blockbuster might be an artistically inferior film has no real relation to its success. In turn, the ' bigger' the picture the more people go to see it. The more people go to see it, the longer it runs at the cinemas. The longer it runs at the cinemas, the more revenue the studio gets back. This means that a studio is more likely to release a major film, perhaps one of its 20% profit-movies, with big stars attached; this acts as insurance that it should, theoretically, be widely accepted by the audience. Vogel adds that: *" The complex dynamics of personal interaction between viewers and potential viewers overwhelm* *the initial conditions. The difficulties of predicting outcomes for individual movies is more sensible than the current practice of ‘ greenlighting’ individual movie projects.”* [16] Therefore the studios can have a clearer idea of how the movie is going to fare if there is a star attached. This is a Hollywood trait that has been successful since the 1920s and the Hollywood Star System.

If you were to ask an average cinema goer what the most important ingredient of a Hollywood blockbuster was the answer, more often than not, would be that of an A-list star in the leading role. This is not a modern phenomenon in Hollywood. The star system was first professionally handled with the introduction of United Artists, a talent management company formed by D. W. Griffith, Charlie Chaplin, Douglas Fairbanks, William S. Hart and Mary Pickford in 1919. Nearly ninety years later the importance of the agent in Hollywood can determine the success of an entire studio; it is their client that attracts a vast number of the public to the cinemas. If it wasn’t for the love affair that the viewing public has for celebrity then Hollywood would be a different place, yet the power of Hollywood as the market leader in film is unassailable; even from competitive new film nations such as India’s Bollywood productions. The ‘ Big Six’ (Warner Bros., Paramount, Twentieth Century Fox, Sony, Disney, and Universal) and the Hollywood stars still ‘ front’ the production. As Douglas Gomery writes: *“ The Big Six studios retained a growing appetite for hot new talents. By the late-1990s newcomers Gwyneth Paltrow and Ben Affleck, as well as proven box-office winners like Jim Carrey and Tom Cruise, could command $20 million a picture.”* [17] He argues that the current climate of Hollywood movie production is more akin to the Golden Age of the 1930s and 1940s. He believes that nothing much has changed in this time as the Big Six still have a dominant control over production and distribution: *"…the end of the 20th century was the era when the Big Six in Hollywood achieved its greatest power and profitability."* [18] Another believer in the power that stars have over a film's performance at the box office is S. Abraham Ravid who was analysed the impact of well-known and well-loved acting talent on individual productions: *" Profitability studies have been closely related to the study of stars. Stars have always been a puzzling phenomenon. Some stars seem to have vastly superior talents, whereas many others do not seem very different in looks or any other observable characteristics from many other talented performers. Yet, they receive vastly more attention, money, and recognition than anybody else."* [19]

Another important factor in understanding the economics of Hollywood is by analysing the demographics involved in worldwide releases. According to the figures from the MPAA, in 2005 the total domestic box office receipts in the United States remained near $9 billion and global box office receipts came in at over $23 billion. Admissions in US cinemas decreased 8. 7% in 2005 to 1. 4 billion. [20] The importance of understanding how the audience reacts to certain types of films is paramount in determining what projects are most likely to recoup their production budgets. One way of assessing this information is by identifying what genre of film is most successful at the box office. I shall examine the importance of genre in Hollywood later in the essay, but for the time being I shall focus on the importance of the film's appointed rating. In the UK the British Board of Film Classification (BBFC) uses a scale of ratings to *‘ give the public information that empowers them to make appropriate viewing decisions for themselves and those in their care.’* [21] In the United States the classification system is similar yet it is not fully enforceable as it is here in the UK. The MPAA ratings range from G (General Audiences; similar to our U), PG (Parental Guidance), PG-13 (Parents Strongly Cautioned; similar to our 15), R (Restricted; similar to our 18) and NC-17 (Over 18 Only). Using the statistics supplied by the MPAA it is apparent that, *‘ consistent with past years, PG-13 films comprised the majority of top grossers for the industry, with PG and PG-13 films accounting for 85% of 2005’s top 20 films’* [22] In closer inspection the top 20 grossing films were made up of 5% G-rated, 25% PG-rated, 60% PG-13-rated and 10% R-rated. It is also interesting to note that since 1968, nine of the top ten grossing films have been PG and PG-13-rated (the other is R-rated); this is even though only 33% of films released since 1968 are PG or PG-13-rated compared to 58% of R-rated movies. [23] In his studies, Arthur de Vany examined a ten year period of Hollywood production and found some interesting facts: *“ From 1985 to 1996, inclusive, Hollywood made 1, 057 R-rated movies; just 60 G-rated movies were made during that same period… R-rated movies accounted for 52 percent of the 1, 689 movies that did not feature a star and they accounted for 57 percent of the movies that did feature a star. The 100 stars of the ‘ A-list’ appear in, produce or direct more often in R-rated movies than in any other rating.”* [24] Using the same research data it is interesting to note that less than three per cent of low budget R-rated movies included a star compared with ten per cent of medium budget and 45 per cent of high budget productions: *“ Success rates* *are a more representative measure of revenue earning power than is the number of high grossing films. The success rate for R-rated movies is just 6 percent, whereas 13 percent of G- and PG-rated movies are hits and 10 percent of PG-13 movies are hits. The box-office success rates for all non-R-rated movies (G, PG and PG13) are twice the rate for R-rated movies."* [25]

Mainstream Hollywood

To summarise all the information I have analysed above, it would seem that the best possible way for a Hollywood executive to decide whether to green light a project would be to make sure that the film was directed by a known director, starred two A-list actors and had a PG-13 rating. Also to be taken into consideration would be adaptations of popular books or remakes of previous films. True to form, Hollywood's Big Six released the following last year: *Star Wars III: Revenge of the Sith* (Fox); *Harry Potter* (Warner Bros.); *The Chronicles of Narnia* (Buena Vista); *War of the Worlds* (Paramount); *King Kong* (Universal); and *Hitch* (Sony). It is no coincidence that these six films from the Big Six represent six of the top eleven grossing films, with a combined gross box office total of almost $1. 6 billion. [26] However, as previously mentioned it is the R-rated movie that is the most popular release in Hollywood. This is mainly due the subject matter of the story that classifies it as such. This subject matter is defined by genre. Film is a medium that can be divided, and subdivided, into different categories. These categories allow the filmmaker to choose what style the script will be filmed with. The resulting production will then attract an audience that appreciates that specific type of film. These categories and sub-categories are referred to as genres and sub-genres. The idea of genre caters mainly for the mass-produced studio films, most notably those of Hollywood. In his book *‘ Genre and Hollywood’,* author Steve Neale iterates this by stating that: *“ The definition and discussion of genre and genres in the cinema has tended to focus on mainstream, commercial films in general and Hollywood films in particular”.* [27] This is supported by another writer of genre, Barry Keith Grant, when he identifies that *“…genre movies are those commercial feature films which, through repetition and variation, tell familiar stories with familiar characters in familiar situations”.* [28] The most popular genres such as action, comedy, gangster and war films are almost always classified as an R-rating; this is why such a large percentage of Hollywood production falls into this category.

So why is it that Hollywood still gambles on making films that, according to models, theories and past experience will not go on to make the studios rich? At the start of this essay I simplified the Hollywood process by splitting it between the business and the art. The business of Hollywood is to make money by getting audiences to watch their product, however, it is not as simple as that (thankfully). Even though it may seem that Hollywood is run by men in suits, there is still a lot of power held by the artists. These artists are in turn respected by the business men because they make them money. This money is made by investing in their ideas and vision. This vision is what eventually makes it onto the big screen. There are hugely identifiable strengths weaknesses in the Hollywood system; this is best demonstrated using the first film from the list I have just mentioned. *Star Wars III: Revenge of the Sith* grossed $380 million and is a blockbuster science-fiction film.

When the original *Star Wars* was released in 1977 there was nothing to compare it to, it created a new style of filmmaking that was light years away from the B-movie science-fiction films previously. Admittedly, the hype of the film and its predecessors certainly helped its success at the box office but it is still a movie that exemplifies the Hollywood experience; pure escapism. It can be labelled as ‘ painting by numbers’ in so much that it has a popular director (George Lucas), a couple of A-list stars (Ewan McGregor, Samuel L. Jackson) and a PG-13 rating. However, these attributes are just that; minor factors that make up the whole. Twenty years ago when Hollywood was in its darkest hour, such a major project would probably never have been given the infamous green light. The early 1980’s saw a dramatic drop in box office receipts. The beginning of the decade saw a 9% drop in tickets sold nationwide in American cinemas when only 1. 02 billion were sold. This figure got worse in 1986 when just over 1. 01 billion tickets were sold [29] (compared to over 4. 5 billion ticket sales in 1930). The home video market had certainly dented theatrical sales but Hollywood would always recoup somehow. The immediate problem was the cost of keeping cinemas open; a similar situation to the post Depression period of the 1930’s. Another financial reshuffle was in order. The Big Six were now part of conglomerates. *Gulf & Western* (Paramount’s parent company) also owned *Madison Square Gardens, Desilu, Simon and Schuster,* and *Paramount Pictures Television* . Yet, only 11% of Gulf & Western’s revenues were derived from entertainment industry holdings and just 4% from Paramount Pictures in 1981. That same year, United Artists was bringing only 12% of the revenues in for *Transamerica* , Universal represented 22% of *MCA* ‘ s income, and Warner Bros. accounted for 24% of Warner Communications revenue. [30]

However, by 1989, the entertainment division of Gulf & Western, led by Paramount Pictures, accounted for over 50% of Gulf & Western's yearly income during a year in which Paramount had only fourteen releases and a 13. 8% share of the market thanks to the success of *Indiana Jones and the Last Crusade* ($197 million domestic box office), [31] demonstrating again just how important a single film had become by the end of the 1980's. These blockbusters were to save Hollywood and allow it to grow stronger, and in 2002 ticket sales were over the 1. 52 billion mark which was the highest figure for over twenty years, and the blockbuster continues to support the film industry to this day. Without the blockbuster there would not be the same number of people visiting the cinema. Without these audiences cinemas would close. Without the cinemas there would not be the same number of films released; and only the blockbuster would survive. In typical Hollywood irony it is the blockbuster that is keeping world cinema and low budget cinema alive.

Conclusion

Hollywood is more than just a location on the map. Hollywood is a business, a factory, a production line, a pool of talent, a byword for escapism and a place where dreams come true. Over one hundred years ago when Edwin S. Porter's 1903 movie *The Great Train Robbery* introduced complex narrative structure in its editing techniques, and a decade later D. W. Griffith's 1915 feature *The Birth of a Nation* grossed $10 million at the box office, it was evident that Hollywood had firmly grasped the concept of making movies. One hundred years later it is still producing films that make enough money to keep the business running.

In conclusion to my research I have found that Hollywood operates on the basis that economics contribute considerably to the end product of the films produced. Without an in depth knowledge of how the market works the system would come crashing down. It would seem that this dependence on economic structure and theory would stagnate the film industry; only allowing the studios to release films that were targeted to a specific audience with restricted themes that would guarantee a return on profits. However, the statistics do not back this theory up. Hollywood does release blockbuster films that are almost generic in the way that they play, but the vast majority of films released are not going to return the costs involved. This is where the artistic side of Hollywood shines through. The fact that Hollywood is run as a business does not stop it producing the occasional work of art. There are not many businesses or industries that operate on the basis that around 70% of its product will make a financial loss. This is where the strengths and weaknesses of mainstream Hollywood are most visible. The 20% of film releases that go on to make a profit are all around us; advertising, marketing, merchandising, et al. Sometimes it is hard to get away from the Hollywood publicity machine that pumps its information out to the public, but this is the only way that it can get a return on its investments. It is the blockbuster that keeps the industry running, and as such we have to be prepared that for every *Harry Potter* there is a *Brokeback Mountain* and a *Capote.*

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Footnotes

[1] Statistic taken from the *US Theatrical Market 2005 Statistics* Motion Picture Association (p14)

[2] Maltby, Richard (2003) *Hollywood Cinema* Blackwell Publishing (p45)

[3] Maltby, Richard (2003) *Hollywood Cinema* Blackwell Publishing (p45)

[4] Smith, Sharon P. & Smith, Kerry V. (1986) *Successful Movies: A Preliminary Empirical Analysis* Applied Economics (issue 18: 5) (p506)

[5] Wasko, Janet (2003) *How Hollywood Works* Sage Publications (p6)

[6] Picard, Robert (1989) *Media Economics: Concepts and Issues* Sage Publications (p7)

[7] Gomery, Douglas (1989) *Media Economics: Terms of Analysis* Critical Studies in Mass Communication (Volume 6, Number 1) (p58)

[8] de Vany, Arthur S. (2003) *Hollywood Economics: How Extrem*