

7. Payola ¹

Payola is the “undisclosed” inducement to bring about inclusion of material in broadcasts — undisclosed to the listening audience. The practice was criminalized in 1960 in the Communications Act of that year. The criminalization followed a series of Congressional hearings that culminated in the disclosure that the owner of a department store had paid \$10,000 to the producers of the infamous TV game show “\$64,000 Question” in order that his employee could be a contestant. The department store owner had assumed, correctly so, that the contestants would be asked about where they worked. The Congressional hearing focused in part on the issue of whether it was fraud against the sponsors. In spite of the public outrage, the focus of the Act was much more directed at DJ’s who took money from record companies in order to play their songs. This issue had failed in the Congressional hearings of the year before to generate any interest. One senator likened it to tipping a head waiter, which, of course, it is. Senator Smathers who called the hearings tried to stir up interest by railing against the new trend to rock and roll (Elvis), but it didn’t seem to play large.

Note that the difference between payola and commercial bribery is that commercial bribery is the action of an employee, without the consent of the employer, that harms the employer. Commercial bribery is an act of opportunism. Payola may also be an act of opportunism, again, between the station owner and the DJ if it can be shown that the interests of the station owner and the DJ are not perfectly aligned.

The practice of payola was widely publicized in the 30s when sheet music publishers were want to give gifts to bands to play their songs. The incentive was to increase sheet music sales and performance royalties. However, the practice is much older dating back at least to the mid 1800s where the Novello music publishing company of London had family members sing the songs that they sold sheet music for. Sometimes performers were offered a percentage of a song’s sheet music royalties.

Evidence of the attempt by publishers to try to cartelize dates to the 1890s. Between 1912 and 1916 *Variety* magazine reported widespread use of “plugging” by Vaudeville performers. Al Jolson is reported to have made more songs hits than any other performer of his generation. The term “plugging” originated during this period.² Reports, too, were common that performers reneged on their promises to the pluggers, after receipt of the inducements.

In 1916, a prominent 5¢ & 10¢ store owner attempted to cartelize publishers and sanction those who plugged. Didn’t work, but the manager of *Variety* was able to form the Music Publisher Protective Association. This assoc formed to stop plugging. It was able to get all the big publishers to join, but was unable to stop the plugging practice.

¹ Ronald Coase, “Payola in Radio and Television Broadcasting,” *Journal of Law & Economics*, October 1979, 269-328. Payola is derived from the word “pay” and the suffix of the trademark name of a player piano, Pianola, popular around 1900.

² The use of the term in this sense seems to derive from it meaning to work hard at some chore. This meaning dates to 1865 in reference to sculling on the river at Oxford.

The MPPA continued its quest. In 1933, the National Recovery Act formalized Trade Practice Rules that outlawed plugging. This law was ruled unconstitutional, however. In 1935, the Trade Practices Board of the FTC considered the same rules. While there was some support in the FTC, the fact that ASCAP was facing an antitrust suit turned the FTC cold.

In 1939, the Song Pluggers Union was formed. It tried to stop the practice of payola by imposing fines on publishers who paid. But by 1944, pluggers were making payments out of their own pockets.

Some economic history is interesting. From 1948-55, four music publishers controlled 78 % of the market based on *Billboard's* top 10 hits; they were Capitol, Columbia, Decca, and RCA-Victor. In '56, their control was 66%; '57, 40%; '58, 36%, '59, 34%. Elvis Presley and rock & roll, rhythm & blues. Also competition between ASCAP (big band and crooners) and BMI (rock, country, and R&B); '48 — '55, ASCAP had 68% of top ten. By late '50s it had fallen to 20-30%.

There is no evidence that there was a problem of opportunism between pluggers and the record companies. The argument is that DJs are somehow stealing from their employers when they take inducements in exchange for playing the songs of the recording studio. Interestingly, it appears that the owners of the radio stations were fully aware of the practice and no evidence was presented that radio station owners were opposed to it. Indeed, the lobbying force and bulk of the testimony came from the recording studios.

It seems reasonable that record studios would pay inducements to get their new, unproven songs on the air. They would do this as one of many forms of promotional activities. Others include billboard, poster, and print advertisements, as well as press conferences with their star artists.

If there is a fundamental standard of music quality, which there appears to be because record studios spend resources to hire the best artists, then the records that will ultimately be found to be the best will be the ones that will spend the most on promotional activities. In general, this means that if the DJ plays the songs with the highest payola, the DJ is acting in a way that maximizes the listening audience and thereby maximizes the profits of the radio station. The incentives of the DJ and the station are perfectly aligned.

However, it may be the case that while the best records will spend the most on promotion, the promotional expenses may not go to payola. For instance, it may be that in September, 1956, when Elvis Presley's recording of *Love Me Tender* was released it did not need to be plugged because everyone knew that it was going to be a hit. Hence, if the DJ plays only those records with the highest payola, it may not maximize the listening audience.

Even so, just because the DJ accepts payola, it does not mean that payola alone will influence the choice of the program. Other promotional activities influence the DJ just like they do the public. We could model the DJ objective function as maximizing station salary, payola income, plus celebrity fees, and in a simple model it might appear that there is a conflict between the station owner and DJ. However, a more commodious characterization of the DJs behavior should recognize that life time income is maximized by maximizing popularity. In particular, more

payola income will come to DJs with more popularity. Popularity is driven by the confidence that listeners have in the recommendations of the DJ.

Payola is not unique to the record industry. It is just like tipping in restaurants as pointed out by one of the senators during the hearings. Indeed restaurant production is worth considering. Why do we tip in restaurants and is there ever a conflict of interest between the restaurateur and the waiter?

Restaurant tipping seems to be associated with food service where the waiter adds importantly to the quality of the dining experience. Generally, it is associated with meals where the delivery of the product is spread over an extended period of time. It is also most often associated with meals where there is uncertainty as to the quality of individual items and the waiter is asked to provide information. In this case, there may be a conflict of interests between the waiter and the restaurant owner, at least in the short run. The restaurateur may wish the waiter to plug one menu item because it has a higher profit margin, while the waiter counsels diners to other meals that are more likely appealing and thereby increase the tip. While there is a potential conflict of interest between the owner and worker, this conflict favors the customer and maximizes consumer surplus. Hence, it survives in the long run.

Other examples of plugging include promotional inducements given/paid to employees in grocery stores, quicky marts, and furniture stores. Indeed, all entertainment expenses are forms of plugging. When a gas distributor takes the energy procurer of a large company on a hunting trip, we have plugging. Most everyone agrees that there are bounds of propriety in these matters. When the inducements get too large, and when they are kept secret from the employer, it becomes a case of opportunism between the employer and employee. This is one reason why such plugging often takes the form of logo clothes and merchandise or sponsored trips. Trips and logo merchandise are much harder to conceal and hence there is less risk of a charge of opportunism.³

³ My brother-in-law who was national sales manager for A&W Brands before it was taken over by Cadbury was forced to fire one of his salesmen for paying inducements to several bottling company executives. The facts of the case were that the A&W fellow would take these people on trips to Las Vegas and give them fairly large amounts of cash. The owner of the bottling company somehow found out and forced A&W to fire the salesman.

Agent	Action	Principal	Discussion of Possible Incentive Misalignments
d/j	payola	Station Owner	Play the wrong songs. — Possibly, but not likely. The d/js inside pay is linked to his popularity. Incentives are probably aligned. Popularity of the station is carefully measured overall, so d/j is monitored.
Maitre d'	tips for tables	Restaurant Owner	Seat people who won't consume/pay—Seems unlikely. People who are willing to pay for a table are likely to be the big spenders. Incentives are aligned Give away food. — Difficult because it requires the coordination of the waitress and that cook. Easy to monitor.
Waitress	tips for service	Restaurant Owner	Give bad service. — Won't do this. Incentives are aligned. Give away food. — Can be monitored.
Bartender	tips for service	Bar Owner	Give away drinks. — This is a serious problem.
Stock Boys	side payments	Store Mgr	Coke distributor pays the stock boys directly for their help. Payment usually in form of goods like jackets and caps, so not secret from store Manager.
Furniture Salesman	side payments	Store owner/mgr	Mattress companies pay salesmen directly, often in the form of trips. Probably best viewed as efficient compensation to encourage sales people to learn nuances of mattress business.
College Prof	\$ from bk pub.	College Students/ University	This is a suspicious practice. It is like the prof (or department for dept-wide textbook adoptions) is forcing the student to pay tuition to the prof.
Reporter/ Columnist	side payments	Readers / News Paper Owners	In 2005 it was reported that the Afr-Am conservative columnist Armstrong Williams took money (\$250K) from the U.S. Dept of Ed to promote the No Child Left Behind legislation.
Doctor	payments for "learning" about drugs	Patient	Prescribe drugs that are not in the best interest of the patient. Potentially a problem. However, the drug companies usually do not make the payments on a quid pro quo basis. Requires long term dealing relation. Reputation works between doctor and patients in same way, so incentives aligned except for the problem of long term complications.

The key issue in all of these cases is mapping the contractual arrangements and then discerning whether or not there is a misalignment of incentives, which produces the potential for opportunistic behavior. Some points from class discussion:

Every case except the doctor involves a triangle of agents. Furniture salespeople, stock boys, d/j's, college prof's, bartenders, waitresses, and maitre d's all work for a principal while accepting payments from someone else. In the restaurant case, the payments come from consumers. In these cases the incentives should be aligned, unless the agent is stealing from the principal in order to maximize side payments from customers.

For prof's, d/j's, stock boys, and furniture salespeople, the side payment comes from another input supplier. Here there could be an incentive misalignment. In the furniture and grocery cases, the side payments are usually visually obvious. Apparently this is to openly inform the principal of what is going on. Also, it is reasonable to believe that the incentives are largely aligned anyway. The furniture salesperson who does a good job of fitting people with the right mattress

will encourage future business from the satisfied customers. (The converse may make the case more clearly.) Finally, there is reason to believe that the side payments are important. Especially in the mattress business, product knowledge is important and it makes sense for the mattress vendors to monitor the process of learning by the salespeople. The same argument could be made about d/j's, and indeed, it is probably more obvious there that the d/j and not the station owner is the one who needs to learn about new music since the d/j specializes in that part of the production process.

The case of college prof's taking inducements from text book companies is the most disquieting. An argument akin to the bartender example can be made. In the case where the bartender is giving away free drinks for extra tips, a claim can be made that the bar owner knows what is happening and simply reduces the bartender's salary as a consequence.⁴ Similarly, if the university president recognizes that faculty receive kick-backs from book publishers, the faculty salaries (or research allowance) are appropriately reduced.

However, it is very likely that the side payment scheme is inefficient. Essentially, it is a process whereby the faculty member sets a higher tuition for the student than the schedule determined by the university administration. The prof uses a high priced book, from which the prof gets a kick-back from the sales price. This raises the full cost of education for the student. The tuition differential is likely based on economies of scale in book publishing and not elasticity of demand by students. For instance, the kick-backs are most likely in courses that enroll a lot of students and where a common textbook is used. Pre-calculus math is a likely example. The question is whether it is likely that the university maximizes value by charging these students a differentially higher tuition?

Consider the case of doctors taking side payments for prescribing drugs. While this is the example that seems to most affront our sensibilities, the contracting problem in this case is not largely different from the payola example. The doctor is selling healing services to the patient. The patient pays the doctor for advice in treating illness. Part of the advice is the recommendation about the use of drugs in the healing process. The full cost of healing for the patient is the payment made directly to the doctor and the cost of drugs prescribed by the doctor. The doctor is residual claimant to the satisfaction of the patient receiving the best treatment at the lowest cost. There is no incentive misalignment here in general. However, the doctor-patient example differs from the d/j-station owner case in that there is no way to monitor the long-run effects of the doctor's decision about drug applications. The doctor has no way to know about the long run effects anymore than the drug company or the FDA, so it is not clear that his judgment on the efficacy of the drug can be biased on this margin by taking money. However, there is the risk that money will make him less willing to ask pointed questions about long-run side effects. In the d/j case, the station owner is continually monitoring the size of the audience.

The case of reporters taking side payments to put stories in newspapers has several dimensions. To the extent that a reporter works for a newspaper and does not disclose the side payment, there may be a problem of opportunistic behavior. I think that we quickly label cases where the stories contain falsehoods and the side payment is hidden as opportunistic behavior. In the cases where

⁴ Arguably, this devolves to an efficient tax avoidance scheme.

the side payment is not hidden from the publisher, the publisher is conspiring with the reporter to deceive the public. This does not appear to be a survival trait among newspapers.

The trickier problem is illustrated by the case of Armstrong Williams, a conservative African-American columnist who was revealed to have taken money from the U.S. Dept of Ed to promote the No Child Left Behind legislation, which was passed into law in the first term of the second Bush administration. The amount of money was substantial, \$250K. W'ms disclosed the payment to some of his colleagues, but not generally to all of the editors that ran his columns. When it was made widely public that he had been paid, his column was discontinued by some newspapers (e.g., G'ville News). The question is, To what extent did W'ms write things that he would not otherwise have written because of the payment? This is not any different from experts being paid to give testimony at trial, though there the truth content is monitored by the laws against perjury. But what about experts taking consulting money to do research for a proprietary entity? This is routine. In these cases as well as that of W'ms, professional reputation bonds the opinions of the experts. Is it reasonable to believe that W'ms said things about the NCLB act that he did not believe before he took the money? Seems unlikely. I wouldn't and don't when I am asked to give opinions. What the money did for W'ms (and for experts in general) is directed his time and effort to this topic v. other topics. But, ultimately he has to sell his spiel to the public. If he spends too much time on NCLB and loses his audience, then he loses reputation. So I think that this case is exactly like the d/j payola story except that W'ms failed to disclose up front to the newspapers that he worked for that he was being paid. Maybe that is a sin, even a mortal one.

More Payola

We must understand what the difference is between the dj taking money to play records and the doctor taking money to prescribe drugs. Another example is the wedding planner.

Are listeners defrauded when djs take money from record companies? (Assume that there is no agency cost between the dj and the radio station owner.) Listeners don't know who paid the dj and who didn't. The presumption is that everyone paid, some more than others, but which. The same is true for drugs and doctors, and caterers and wedding planners.

On the surface there is no difference. Ostensibly, none of these service providers is taking money to do anything, only to consider doing something. Arguably, reputation binds each provider to do right by their client.

When the wedding planner takes money from a band to promote them at weddings, she is not promising that they will definitely play, but rather that she will try to find the right event for them. If one never comes along, the band will be annoyed and will not give her any more money. But arguably the wedding planner will not risk her reputation by booking a band for a ceremony where they will not be appreciated.

Similarly, djs won't play songs that are bad. They won't play songs a lot that are only fair. They won't play songs all the time even if they are good. The reason is reputation.

Doctors won't prescribe drugs that are bad because it hurts their reputation.

The question becomes, does reputation bind in the same way for these different service providers? If not, why not?

Weddings, drugs, and songs differ in the time dimension of consumption. Women usually only have one big wedding. It is not possible to predict perfectly what it will be like before the event, but it is pretty clear after the event whether it was a success, what worked and what didn't, etc. With drugs, consumers go to the doctor with a complaint or just to receive advice. They are not fully informed about their health. Indeed they are less informed than the post-wedding bride. Treatments are prescribed and these go on over time. Patients at least know whether they are alive and feel good. Consumers listen to music on the radio. They don't necessarily know whether they will like a certain music and they may not like it the first time they hear it, but fairly quickly they are fully informed. They either like it or not.

Of the three, doctors stand out—in the following dimension. Doctors have the potential to cheat the consumer over time by saying, “If it were not for me, you would be dead. So even though you feel like you are about to die, it would be worse if not for me.” None of the other service providers can make this claim.

Because the doctor is directly in the position to act opportunistically, regardless of the drug company, the doctor cannot give the *appearance of impropriety* in dealing with drug companies. In other words, the appearance of impropriety will damage the doctor's reputation more than the wedding planner or the dj.

Apply argument to newspaper columnists (and newspeople) v. scientific experts.

Recognize that the app. of impro. is a tar brush that can be used politically to outlaw practices that are not necessarily inefficient.

What about direct consumer advertising of prescription drugs?

In the payola problem, does it matter that the airwaves were/are free? Would XM Radio be different?

What has happened in the record industry since 1960? Industrial organization.

Why is it no common for maitre d's to take tips?

Real estate agents almost always are under contract for the seller. This potentially creates an agency cost between the agent and buyer. Why doesn't the buyer hire her own agent?
