

## CHAPTER SEVEN: ADVERTISEMENT

### 7.0. Chapter overview

Advertising is a mass paid communication, the ultimate purpose of which is to impart information, develop attitudes and induce action beneficial to the advertiser. It can take many forms: media advertisements, direct mail, leaflets, or sponsorship. The content of an advertisement can vary considerably. It can simply display the name of the product or it may compare the product with that of rivals. It may provide detailed information about the product's attributes, or may simply enhance its image.

Advertising is one of many forms of *promotional activity*. Instead of advertising, a firm might promote sales by employing more sales representatives, by altering the product's packaging, or by widening wholesale and retail margins. Advertising can be either a substitution or a complement to, other forms of promotional activity. This complicates the economic analysis of its effects since it is difficult to separate them from those of other promotional activities. Indeed, some economists refer to 'advertising' when they are really discussing promotional activity in general. They recognized the fact that different promotional activities overlap. Given that the effects of advertising and other promotional activity are similar, empirical work which considers only advertising will give misleading results.

### Chapter objectives

- ↳ **After completing this chapter you must be able to;**
  - Introduce the concept of advertising and concern for its economic analysis.
  - Discuss the types or objectives of advertisement
  - Explain reason for variation in the amount of advertising level for different goods/services
  - Understand the social cost and benefit of advertising

## 1.0. Introduction

Advertisements contain the only truth to be relied on in a news paper.



*Define Advertising? Give examples of Advertising.*

### *Definition of Advertisement*

According to **Thomas Jefferson** “advertising is a racket... its constructive contribution to humanity is exactly minus zero.”

According to **Scott Fitzgerald**, “Advertising has many purposes. An advertisement may inform consumers that a firm has a new product or the lowest price, or it may help to differentiate the firm’s product from that of its rivals. A firm uses advertisements to inform consumers of its product’s strengths but not its weakness. In this unit we will examine information and advertising, advertising and market structure; advertising and profitability and the social benefits of advertising.”

## 7.1 Information and Advertising

Advertising may convey hard facts, vague claims, or try to create a favorable impression of a product. Some advertisements list a store’s prices. If consumers learn that a firm has the lowest prices in town, the demand for its products increases. In contrast, other advertisements merely show a product being used in a pleasant setting. An attractive person consuming a soft drink near a water fall may convey to consumers the impression that this product is refreshing. By convincing consumers that its product has certain desirable traits, a firm can differentiate it from other products. As its product becomes differentiated, a firm may face a higher and less elastic demand curve, so that it can charge a higher price and earn greater profits. For example, one

heavily promoted brand of bleach sells at a much higher price than many other bleaches that are physically identical.

### **A. Promotions**

Advertising is only one of many ways to promote a product; firms also use price discounts and sales staffs. When it is hard to describe a product, a firm may include discount coupon in its advertisement or encourage consumers to try the product. Sales people act like living advertisements. In addition to advertising in news papers, on radio, and on television, firms may advertise indirectly by establishing a brand name or otherwise establishing a positive reputation.

For example, some agricultural firms now sell their fruits and vegetables under brand names. Unlike sellers of unbranded produce, these farmers are trying to develop a reputation for producing a particular quality of produce.

### **B. ‘Search’ versus ‘Experience’ Goods**

The informational content of advertising depends on whether consumers can determine the quality of a product prior to purchase. If a consumer can establish a product’s quality prior to purchase by inspection, the product has search qualities, Examples are furniture, closeting (determine style), and other products whose chief attributes can be determined by visual or facile inspection. If a customer must consume the product to determine its quality, it is said to have experience qualities. Examples are processed foods & soft ware programmers.

Advertising provides direct information about the characteristics of products with search qualities; advertisements for search products often include photographs. In some cases a consumer cannot directly observe a physical attribute, but it can be concisely described. For example, food and drink advertisements may claim that their products are low in calories. In contrast, for experience goods, the most important information may be conveyed simply by the presence of the advertising, some advertisement do little more than mention the name of the firm to enhance the firm’s reputation. Such advertisers hope that consumers infer the quality of reputability of a firm by the frequency of its advertising and the expense involved. Fly-by-night firms may be less likely to advertise in expensive publications or on national television.

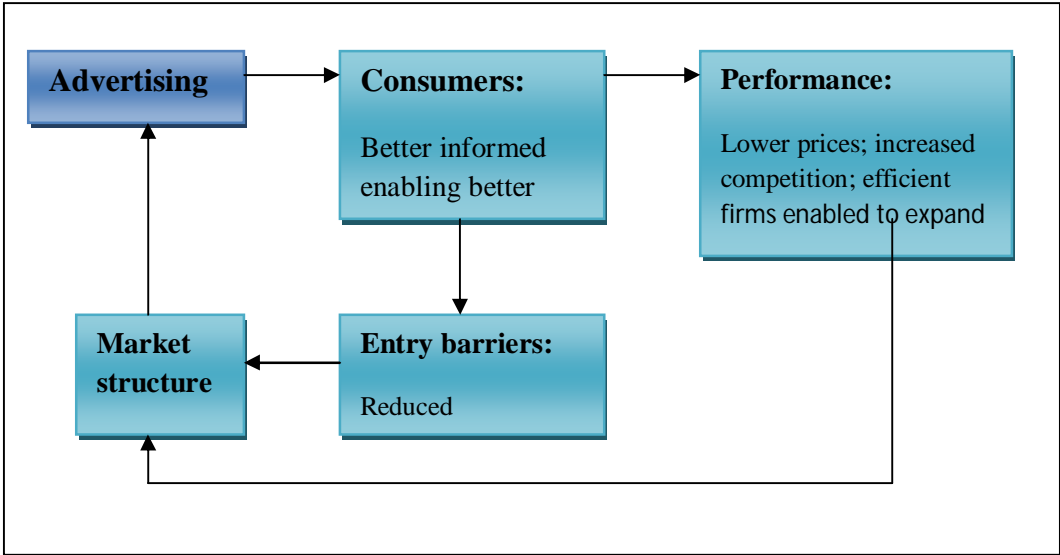
Some firms claim that all their products are excellent. Their advertisements contend that if you have experienced and liked one of their products, you will like all of them. Such advertisements

may do little more than show the company’s name; they do not describe the properties of each of its product. Alternatively, a firm may try to convince consumers that its product is different and superior to other, similarly brands-that is, it attempts to differentiate its product from competing brands.

**C. Informational versus Persuasive Advertising**

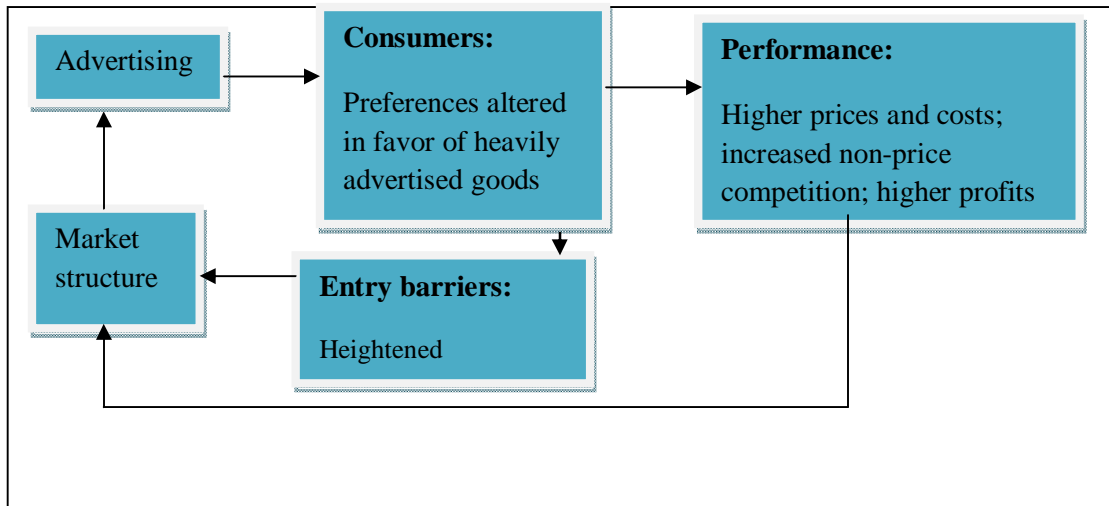
Some economists distinguish between informational advertising, which describes a product’s objective characteristics, and persuasive advertising, which is designed to shift consumer’s tastes. For example, informational advertising may cite the price of a product, compare the advertising store’s price of its rival’s prices, describe the features of the product, or list its uses.

Advertising helps the competitive process: by supplementing other sources of information, it facilitates entrepreneurial action by economic agents. Taking the view of advertising as information, rather different conclusions emerge as to the effects of advertising on market structures and prices (summarized in figure 6:3)



Persuasive advertising may explicitly or implicitly make claims such as “smoke these cigarettes to look more mature and sexier.” Some companies may try to change consumers’ perceptions of their product using persuasive advertising, when they could not truthfully change their informative advertising. For example, the share of coke grew by about a tenth in 1992 over 1991 when it altered its image.

The traditional view - advanced, among others, by Bain (1968) and Comanor and Wilson (1974) –is that advertising works by persuasion, and results in increases in both market power and prices (the process is summarized in the following figure)



The advertising as persuasion view implicitly assumes that advertising distorts consumers' preferences. This may cause consumers to make wrong choices, selecting advertised goods instead of those which would give them greater satisfaction or buying a product in the mistaken belief that it is better than its rivals. By altering consumers' preferences to favor the advertised product, demand for the 'product becomes less sensitive to price changes. Advertising also has the effect of reducing the cross elasticity of demand between the advertised product and its close substitutes. This makes consumers less responsive if rival firms reduce prices or increase their promotional activity.

#### **D. Advertising and Profitability**

All advertising is designed to increase the demand for a firm's product whether facts are used or not. An increase in informative or persuasive advertising expenditures from  $\alpha$  to  $\alpha'$  causes an out ward shift of the demand curve facing a firm. The firm chooses its output, given its advertising expenditures, by setting its marginal revenue with respect to quantity, equal to its marginal cost, MC.

A profit maximizing firm sets its advertising expenditures so that the last birr spent on advertising increases its profits, excluding advertising costs, by exactly one birr. That is, the firm maximizes its profits by setting the marginal cost of advertising equal to the marginal benefit.

For example, seldom and Doroodian (1989) find that advertising increases the demand for cigarettes and that health warnings (essentially negative advertisements) reduce consumption. Firms, however, react to health warnings by increasing advertising. The lower the cost, the more advertising in a society.

Usually, firms with market power incur promotional expense to cause their demand curves to shift out or become more inelastic, so they can sell more at higher prices. However, it is possible for firms to advertise and still face very elastic demand curves. For example, such a firm may act as a price taker but needs to inform customers where it is located. That is, advertising need not be inconsistent with price taking behavior. Moreover, competing firms may jointly advertise to increase demand for a homogeneous product.

## 7.2. The Social Benefits and Costs of Advertising



*What are the benefits and costs of Advertising?*

Product differentiation often has a positive social impact. Good locations are good for the economy because they minimize the costs of obtaining goods and services and therefore increase consumer welfare. Similarly, given a choice between good and bad service, many consumers willingly pay a premium to receive good service. The most controversial aspect of product differentiation is advertising aimed at creating subjective differences between products.

### 7.2.1 The Social Benefits Advertising

We begin by distinguish between informational and persuasive advertising. Informational advertising provides consumers with truthful information about price, location, or quality. Most news paper, magazine, and direct mail advertising is informational. News papers in particular are full of advertisements emphasizing price. Grocery stores contend that they are the “low price

leader”. Department stores announce major sales. Automobile dealers advertise rebates and low cost credit. These are examples of pro competitive informational advertising.

Empirical evidence suggests that advertising about price, referred to as price advertising, results in lower prices. Two separate Studies found that eyeglass prices were significantly lower in markets that permitted optometrists to advertise than in markets that prohibited advertising. Proffer found that local news paper advertising has a presumptive effect by reducing the profits of convenience goods advertised in news papers.

Product differentiation puts pressure on manufacturers to produce high quality products. Even the simple act of placing a trade mark on a product provides some guarantee that the manufacturer believes in the quality of the product and will stand behind it. In the absence of trade mark identification consumers would not know who produced a product and there would be less incentive for producers to maintain quality. Advertising may help manufactures take advantages of economics of scale in production and distribution. Advertising provides a social benefit by subsidizing the mass media. Most of the revenues received by new papers, magazines, radio, and television are from advertising.

Finally, advertising is an entertaining art form, and some of it is quite good. The best, or worst, advertising often becomes part of modern culture.

### 7.2.2 The Social Costs Advertising

Few economists argue that informational advertising creates serious economic waste. Persuasive advertising is designed to create a subjective positive reaction to a product. Much of the advertising on television is persuasive. Persuasive advertising may provide valuable information about the quality of experience goods. Experience goods are those whose qualities can be identified only through trial after buying the good. Common examples include consume non durable convenience goods such as beer, tooth paste, soap, cereal and consumer durable goods including household appliances such as refrigerators and washing machines. Experience goods are distinguished from search goods, whose qualities can be judged before purchase through pre purchase testing. Search goods include fresh fruits and vegetables, which can be squeezed and smelled to test for freshness; fresh meats, which can be viewed; shoes, which can be tried on; and sofas and chairs, which can be sat on.

Consider two producers of toothpaste. Both toothpastes contain fluoride and have the American dental association seal of approval, but the high-quality toothpaste tastes wonderful, and the low-quality toothpaste tastes horrible. The costs of production are equal for both products. Toothpaste is an experience good, so consumers cannot determine quality taste unless they buy the toothpaste.

**Which firm has a greater incentive to advertise?**

The horrible-tasting toothpaste producer can induce consumers to buy its product once, but few will buy a second time. The wonderful-tasting toothpaste producer, however, can depend on many repeat purchases. The producer of the high-quality toothpaste has a much greater incentives to advertise because advertising will result not only initial purchase but in repeat purchases. The low-quality toothpaste manufacturer has little incentive to advertise because advertising will result in initial purchases but few repeat purchases. Large advertising expenditures by the high –quality toothpaste manufacturer signal consumers that it produces a high –quality product, because only high-quality producers would advertise extensively. The low quality producer would realize that consumers will not buy its toothpaste a second time regardless of their advertising expenditures, and therefore, the low-quality manufacturer would not waste resources on useless advertising.

Although the social benefits of persuasive advertising may be hard to identify, the private benefits are obvious. Persuasive advertising may increase market power and economic profits. The social costs of persuasive advertising, therefore, may be substantial.

Essentially negative advertisements reduce consumption. Firms, however, react to health warnings by increasing advertenting. The lower the cost, the more advertising in a society. Usually, firms with market power incur promotional expense to cause their demand curves to shift out or become more inelastic, so they can sell more at higher prices. However, it is possible for firms to advertise and still face very elastic demand curves. For example, such a firm may act as a price-taker, but needs to inform customers where it is located. That is, advertising need not be inconsistent with price-taking behavior. Moreover, competing firms may jointly advertise to increase demand for a homogenous product.