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The Economic Analysis of Advertising

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The Economic Analysis of Advertising
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"What makes the advertising issue fascinating...is that it is fundamentally an issue in how to establish truth in economics." (Phillip Nelson, 1974a)

1. Introduction

By its very nature, advertising is a prominent feature of economic life. Advertising reaches consumers through their TV sets, radios, newspapers, magazines, mailboxes, computers and more. Not surprisingly, the associated advertising expenditures can be huge. For example, *Advertising Age* (2005) reports that, in 2003 in the U.S., General Motors spent \$3.43 billion to advertise its cars and trucks; Procter and Gamble devoted \$3.32 billion to the advertisement of its detergents and cosmetics; and Pfizer incurred a \$2.84 billion dollar advertising expense for its drugs. Advertising is big business indeed.

From the current perspective, it is thus surprising to learn that the major economists of the 19th century and before paid little attention to advertising. The economic analysis of advertising is almost entirely a 20th-century project. Why didn't 19th-century economists analyze advertising? Two reasons stand out.

First, 19th-century economic research is devoted largely to the development of the theory of perfect competition, and this theory does not immediately suggest a

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role for advertising. As Pigou (1924, pp. 173-4) remarks, "Under simple competition there is no purpose in this advertisement, because, *ex hypothesi*, the market will take, at the market price, as much as any one small seller wants to sell." Of course, whether a firm is competitive (i.e., price-taking) or not, it might advertise if it were thereby able to shift its demand curve upward so that a higher price could be obtained. But here a more basic problem arises: under the conventional assumptions that consumers have fixed preferences over products and perfect information with regard to prices and qualities, there is no reason for consumers to respond to advertising, and so the posited demand shift is unjustified.[1]

Second, while advertising has long been used by merchants, its transition to "big business" is more modern. In the late 19th and early 20th centuries, following significant advances in transportation (railroads) and communication (telegraph) networks, manufacturers were motivated to pursue innovations in the machinery of production and distribution, so that economies of scale could be reaped. These economies, however, could be achieved only if demand were appropriately stimulated. The turn-of-the-century technological innovations that are associated with mass production and distribution thus gave significant encouragement to large-scale brand advertising and mass marketing activities.[2]

At the beginning of the 20th century, advertising was thus a ripe topic for economic research. The economic analysis of advertising begins with Marshall (1890, 1919), who offers some insightful distinctions, and then gathers momentum with Chamberlin's (1933) integration of selling costs into economic theory. Over the second half of the century, the economic analysis of advertising has advanced at a furious pace. Now, following the close of the 20th century, a substantial literature has emerged. My purpose here is to survey this literature.

In so doing, I hope to accomplish two objectives. A first objective is to organize the literature in a manner that clarifies *what* is known.[3] Of course, it is impossible

[1] As Braithwaite (1928, p. 28) explains: "Under conditions of perfect competition producers would gain nothing by spending money on advertisement, for those conditions assume two things - (1) that the demand curve is fixed and cannot be altered directly by producers, and (2) that since producers can sell all that they can produce at the market price, none of them could produce (at a given moment) more at that price than they are already doing."

[2] The emergence of large-scale advertising is also attributable to income growth, printing and literacy advances, and urbanization. See also Borden (1942), Chandler (1990), Harris and Seldon (1962), Pope (1983), Simon (1970) and Wood (1958).

[3] Surprisingly, there does not appear to exist another contemporary and comprehensive survey of the economic analysis of advertising. Various portions on the literature are treated in other work. For example, Ekelund and Saurman (1988) offer an interesting discussion of early views

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