EE481: Industrial Economics

Advertising and Disclosure (Chapter 14)

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What we study

- Please read Chapter 14 of "Modern Industrial Organization" by Carlton and Perloff.
- Industrial economists study firms' behavior
- We study why and how firms adopt advertising strategies as they do.
- We do not teach you how to advertise.
- But with the knowledge, you can certainly apply it as you like.

"Search" vs. "Experience" Goods

- Search goods = characteristics and quality observed before using
  - No problem with imperfect information
- Experience goods = characteristics and quality **not observed** before using
  - Asymmetric information problem -> market for lemons
  - Advertising is one of the solutions to signal quality
- clips

Informational vs. Persuasive Advertising

- Informational advertising - only describes a product

- Persuasive advertising - shifts customers taste

Profit-Maximizing Advertising (1)

Advertising can shift out the demand curve. Thus, increase profit.

Profit-Maximizing Advertising (2)

In some cases, advertising increases a lot of willingness of some customers and totally turn off some customers.

Effects of advertising on welfare (1)

Positive Effects

- Helps buyers find the right sellers (informative advertising).
- If advertising is on “lower price”, the overall market price would decrease.
- Helps solve the “Market for Lemons” problem.
  - enables firms to get to sell their high-quality products.

Effects of advertising on welfare (2)

Negative Effects

- Could create barries to entry
  - spurious product differentiation because of persuasive ads.
- Could be excessive

Effects of advertising on welfare (3)

Why could advertising be excessive?

- Before reaching the equilibrium, firms keep on $\uparrow$advertising expense as long as the marginal gain > 0.
- At the equilibrium, firms advertise under the marginal gain from advertising $= 0$
- At this point, marginal consumer surplus < 0
  - Because advertising by firms keep on extracting CS until marginal gain from advertising $= 0$. So, on the process to the equilibrium, CS is decreasing.
- Thus, marginal social welfare < 0
- So, at the equilibrium, a small decrease in advertising expenditure would $\uparrow$ social welfare.

Reference and Further Reading

Carlton, D.W. and J.M., Perloff.
Modern Industrial Organization. 4th Edition.
Pearson Addison Wesley Press, 2005.