

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

Informational vs. Persuasive Advertising

- Informational advertising - only describes a product
- Persuasive advertising - shifts customers taste

Informative advertising

- What information does advertising delivers?
 - Direct and explicit information: Existence, Attribute, Location, Price

Some advertising gives direct information



Informative advertising

- What information does advertising delivers?
 - Information about product characteristics: some characteristics are preferred by everyone → demand increases
 - Some characteristics are preferred by some consumers but some consumers may dislike → those who like it want to pay more and those who do not like pay less → demand more disperse

**And you thought it was just
a pretty face.**



FIAT MULTIPLA. TOP GEAR CAR OF THE YEAR 2000.

FIAT

Some like but others don't



Informative advertising

- What information does advertising delivers?
 - Sometime information is not explicit. The information that advertising delivers may not in the content the ads?
 - Sometime, it is advertising behaviours that matter



14 #Diddy
Jay-Z
Lay-Z

Gillette
Champions

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 barriers to entry
 - spurious product differentiation
- Could be excessive

Effects of advertising on welfare (3)

Why could advertising be excessive?

- Before reaching the equilibrium, firms keep on "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 ↑ social welfare.

**Congratulations to Audi for winning
South African Car of the Year 2006.**



**From the Winner of
World Car of the Year 2006.**

Although anyone who has been behind the wheel of the much awarded A8 Series is well aware that it is without doubt the most sports sedan, it was gratifying to have that fact officially confirmed by 16 of the world's leading motoring journalists. When every one car around the world was scrutinised and tested, a combination of exceptional handling, driving performance and spacious interiors convinced the world's most discerning jury that the BMW A8 Series is without doubt, the world's finest car.

The BMW A8 Series Sedan range comprises of 500i, 520i, 525i, 530i and 540i. Prices start from R120 000. For more information visit www.bmw.co.za

BMW Finance
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www.bmw.co.za





**Congratulations to BMW for Winning
World Car of the Year 2006**



**From the Winner of Six Consecutive
Le Mans 24 Hour Races
2000-2006**



Vorsprung durch Technik audi.co.za

Well done to Audi and BMW for winning the beauty contest.
From the winner of the 2006 International Engine of the Year.



INTERNATIONAL
engine
of the year
awards 2006



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Reference and Further Reading

- Carlton, D.W. and J.M., Perloff.

Modern Industrial Organization. 4th Edition.

Pearson Addison Wesley Press, 2005.