JOHN PHILIP JONES

THE IMPACT OF ADVERTISING ON PRICES *

I would like to make a comment on something quite different from what I talked about this morning. I would like to make a comment on the economic impact of advertising on society, and I want to pick up some points made by Mr Ioppolo. I would like to address the very controversial question, as it is very important for practitioners to have consciousness about this. What is the impact of advertising on prices?

It seems to me that advertising exercises certain forces which push prices up and certain forces which bring prices down. Let me try to elaborate very quickly on what those are.

The first force which elevates prices is obviously the cost of the advertising. I have never known a brand which in consumer price terms has anything like 20% of its budget in advertising. The figure for mass consuming, gauged in the United States, is in the bracket of 6-8% of net sales value, which brings it down to consumer price about 5%. Airlines is about 2%, retail stores is under 2%, perfumes and cosmetics maybe is 10%, but I have never known of figures so high as the ones given here. But the situation may indeed be different these days. So, the first thing that elevates prices is the cost of the advertising, we cannot gainsay that.

The second effect that influences prices upward — in other words, an antisocial effect — is the influence of advertising on demand schedules. By pushing the demand schedule to the right, it means that a given price generates a lot of volume demands. This has an automatic effect on increasing prices, essentially.

But there is a more subtle force at work as well. That advertising, by making a brand unique, by reinforcing the non-functional added values of the brand, actually restricts substitutability between that brand and its competitors. Which means, in essence, that the demand schedule is not only pushed to the right, it is tilted to the vertical, which makes the demand schedule more inelastic: thus the manufacturer is able to elevate the price without losing too much business. And there is no question at all, successful advertising to my mind has this effect, and it is precisely what Simon Broadbent was talking about today, of advertising protecting prices, generating better prices. That is precisely how to describe it in microeconomic terms.

* The text is a transcript of the recording.

So these two forces, the cost of the advertising and the influence of advertising on demand schedules, unquestionably push prices up. And if this was the total story, advertising would be an antisocial effect, it could not be justified in social terms. But, on the other side, there are two powerful forces which bring prices down.

One has been mentioned fairly briefly, which is the influence of advertising on creating demand, which makes possible long production runs and cost reductions. This object in front of me, a ball-point pen, costs presumably a very small number of lira: these things costed 20 dollars when they were first introduced. And unquestionably, in the creation of a market for these things, it was advertising that made some contribution, enabling exponential reductions in cost. And we are seeing this in product field after product field. So I do not think that anybody can dispute too much that in the creation of the market — Adam Smith said that many years ago — the vision of label is limited by the extent of the market, and advertising has always made a contribution to that.

There is, however, a second and more subtle effect and, I believe, a very important effect known as the « Steiner effect ». This was named after a well-known economist who worked for the Federal Trade Commission. What Steiner showed empirically was that although the advertising at the manufacturers' level had the effect of making demand more inelastic, as I have explained, it had an opposite effect at the retail level. What in effect it does at the retail level by improving knowledge of prices in the different retail outlets, it means the elasticity to demand is greatly increased at the retail level; it means that the retail price is brought down to the lowest reel in the category.

Now, this double effect on price means that advertising determines a tremendous contraction in retail margins and this can be in certain fields as much as 10%. An enormous reduction. This work has been validated by many people in other countries (notably the extensive studies by Michael Rickey in England, who did not give any attribution to Steiner, which is an unpardonable thing to do in the academic world): these double forces, in fact, tend to bring prices down.

Looking, as I have done, at a large number of individual cases, my own guess is that the forces connected with advertising pushing the prices up, and the forces bringing them down, more or less balance. My conclusion is that advertising has actually a fairly neutral effect on prices.

But we have a little thing called serendipity. We have something else that sneaks into the picture, that is the fact that advertising represents a transfer payment because of its presence in the media, which means in effect that every person in this room has a modest increase in his or her income, because of the inexpensive or free media we receive which is financed by advertising.

My general conclusion, which is in accordance with the 41 years I spent in the business, is that advertising has more economic good than economic bad. And I do believe that implicitly.