One of the main sources of revenue for many media organizations is advertising. Consequently, patterns of advertising activity exert a very significant influence on the fortunes of the media industry as a whole. This chapter is concerned with the key arguments surrounding the economic role played by advertising, and with its impact on market structures and on consumer decision-making. It introduces you to the economic forces and factors which determine the extent of advertising activity in an economy, examining why levels of advertising vary from one country to another, and over time. It also considers the impact of new media technologies on patterns of advertising.

After studying this chapter, you should be able to:

- Understand why advertising takes place
- Identify and explain the factors which influence the amount of advertising activity taking place in an economy, and understand why it is cyclical
- Assess whether advertising is a beneficial or a harmful economic force
- Explain the problems firms face in deciding how much of their resources to devote to advertising

The Advertising Industry

Advertising is ubiquitous. Its roots can be traced back to the cave but, in the twenty-first century, its reach and influence have become virtually
inescapable. Over the last 50 years an increased willingness on the part of firms to invest in building awareness of themselves and of their wares has given rise to the rapid development of the advertising, marketing and public relations sectors. Advertising agencies have generated catchphrases, jingles and images to make brands familiar to audiences both across the globe and across generations.

Advertising is big business, and the industry it has spawned has grown quickly and diversified to keep pace with ongoing market changes and with the development of newer forms of media. Alongside the basic function of creating advertising messages, many agencies offer an array of specialist communication services, including provision of sophisticated market research information or consultancy related to sponsorship deals. The major advertising agencies in the world – of which WPP, Omnicom and Interpublic are currently the largest – are diversified multinational corporations with networks of operating subsidiaries and strategic alliances that provide clients with global audience reach as well as creative advertising ideas.

As advertising expenditure has grown in response to rising economic prosperity in the developed world, the advertising industry has flourished. According to estimates from Zenith Media (cited in Tomkins, 2000), global expenditure on advertising reached some $330 billion in the year 2000 – a sizeable slice of our collective resources. But even this understates the extent of advertising, because industry projections tend to focus on conventional media only – i.e. television, radio, press, cinema and ‘outdoor’ or billboard sites. This excludes some significant investment in other forms of advertising and marketing including, of growing importance since the late 1990s, expenditure on Internet advertising. It is suggested that around $7.5 billion was spent globally on Net advertising in 1999 (Zenith Media, 2001: 115) and expenditure on it is continuing to expand rapidly, particularly in the USA.

The growth of the advertising sector has brought about the establishment of various industry bodies including, in the UK, the Advertising Association (AA). Founded in 1924, the AA represents all branches of the industry and its functions include promoting the benefits of advertising, lobbying on behalf of its members and gathering information about all aspects of advertising (Meech, 1999: 29). Annual statistics compiled by the Association provide a clear picture of the extent of advertising activity both within individual sectors, such as television or radio, and across the media as a whole. The breakdown provided in Table 3.1 reveals a healthy pattern of growth in UK expenditure on advertising in all the major media in recent years.
### Why Does Advertising Take Place?

Why does all this advertising take place? Firms spend money on advertising in the hope of persuading consumers to buy their products. The general aim behind advertising expenditure is to try to increase sales and to reinforce consumers’ loyalty to particular brands.\(^1\) So, advertising is a form of competitive behaviour: it is one of the main tools that firms can use to compete to entice consumers to switch to their own product rather than that of a rival. Other tactics a firm might use to try to gain advantage over its competitors include making changes to the quality of the product so as to increase its attractiveness, or simply making adjustments to its price so as to undercut rivals.

According to the economic theory of firms, whether or not an organization is likely to engage in competitive behaviour depends on which kind of market structure it is operating within. As discussed earlier, the term ‘competitive market structure’ describes the kind of market situation a firm can find itself in, and is primarily to do with how many rivals it has, whether the market is open to new entrants, how similar the goods on offer are, and how much power each firm has in relation to market demand and over prices. Advertising generally takes place in market situations where firms have an incentive to engage in some form of competitive behaviour (Chiplin and Sturgess, 1981; Lipsey and Chrystal, 1995: 259).

Broadly speaking, the more competition that is present in a market, the greater the need to advertise. Thanks to globalization, most sectors of industry are now operating in a much more competitive environment than at any time in the past. In addition, deregulation and the wider

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1. When advertising is successful, it may cause the demand curve to shift outwards (reflecting an increased market share) and also to become steeper (as price elasticity is reduced). The concept of elasticity is discussed in further detail in Chapter 7.
availability of inexpensive technological know-how have served to intensify competitive pressures in many areas of industry. Consequently, there is an ever-increasing trend for firms to regard advertising as the best means of differentiating and drawing attention to their own brands, and this is reflected by growth in overall levels of advertising in recent years. As demonstrated in Table 3.1, total expenditure on advertising across the major media in the UK grew from £9.9 billion in 1995 to £13.4 billion in 1999.

Nonetheless, the decision by specific firms about whether or not to engage in advertising or other sorts of competitive behaviour is determined, to a large extent, by which kind of market structure the company is operating within. Perhaps surprisingly, firms that operate in ‘perfectly’ competitive markets do not need to compete actively to stoke up demand for their own product because, in theory, none has any influence over the market. It is assumed that in the rather utopian circumstances of perfect competition, there is no point in any individual firm spending money to advertise its wares because each firm’s goods are exactly the same as everyone else’s and consumers are perfectly well aware of this.

At the other end of the scale, in very uncompetitive market circumstances such as a monopoly or a monopolistic market structure – where there are no close substitutes for an organization’s products – the firm has no rivals to worry about. So, monopolists also have relatively little to gain from expending resources on advertising.

On the other hand, firms operating in an oligopoly market structure are strongly motivated to advertise. Oligopolists do, indeed, have a degree of market power but they are aware that their rivals also have some power to influence the market. So competitive behaviour – e.g. advertising or price competition – is a particular feature of oligopolistic market structures. In the real world, a very great and increasing number of industries operate in imperfectly competitive or oligopoly situations. So, at the most basic level, it is the competitive behaviour of firms operating in oligopoly market structures that fuels advertising activity. And as global competition continues to intensify, patterns of advertising expenditure will reflect this trend.

ARE FIRMS IN CONTROL OF THEIR OWN MARKETS?

US economist J.K. Galbraith has put forward an interesting theory about the role of advertising. He suggests that firms use advertising to control their own markets (Lipsey and Chrystal, 1995: 321). Galbraith points out that firms have to make sizeable investments in developing and launching
new products but, despite market research, they cannot be entirely certain how well these new products will be appreciated by consumers and how profitable they will turn out to be. Firms are exposed to and threatened by the unpredictability of future events, especially changes in patterns of demand or fashions or technology. So, to make the future less unpredictable, firms invest vast sums of money in advertising.

According to Galbraith, expenditure on advertising is intended to manipulate market demand and to guard against sudden unexpected shifts in public tastes. Advertising expenditure enables companies to sell what they themselves want to produce rather than what consumers would want to buy. At the same time, firms decide not to produce some new products that consumers might actually like to buy. This allows them to cut the risks and expenses involved in launching untried products which, even if they are successful, might well simply undermine the market for existing products.

So, from Galbraith’s point of view, consumers appear to be the hapless victims of corporations. We are forced, by the manipulative power of advertising, to buy things we do not necessarily want and we are deprived of those products we might like to have. Can this really be true?

Even though the purpose underlying firms’ expenditure on advertising is to try to increase demand for particular products, wholly unexpected shifts in consumer demand sometimes occur. At times, the demand for new categories of products or services cannot just be explained by manipulative advertising; it has to do with more basic changes, or with some technological innovation. For example, the general success of the motor car or of the washing machine can hardly be put down to brainwashing by advertisers, even if advertising may persuade us to opt for one brand of these products rather than another. Likewise, the explanation for escalating interest in Internet services in recent years seems to owe more to technology, consumer convenience and fashion than to the efforts of advertisers. So, although advertising plays an important part in shaping demand, the view that firms can effectively control their own markets is not entirely a convincing one.

Where advertising seems to be most effective is in shifting and determining the pattern of demand among existing products which are similar to each other. In other words, advertising is likely to have more of a bearing on which brands rather than which products consumers will want to buy. It undoubtedly helps to create and sustain loyalty to particular brands but it is unable to dictate overall trends in consumer demand, nor can it hope to overcome the influence of technology, fashion or the media on the sorts of products people express a wish for.
INFORMATIVE VERSUS PERSUASIVE ADVERTISING

Advertising has two related aspects: it sets out to inform consumers of the characteristics of the various products available, and it tries to influence consumers by altering their tastes or preferences and, hence, their purchasing decisions. Informative advertising – giving consumers more information about what is available to them – can be seen as playing a useful role in making the market system work more effectively. It fulfils a valuable function in facilitating the interaction of consumers and producers. The second function – persuasion – is more questionable in terms of its impact on consumer welfare.

The distinction between information and persuasion has been a major preoccupation in historic texts devoted to the economics of advertising. To summarize briefly, those who see advertising as being informative in nature tend to view it as a necessary expenditure that keeps markets competitive in a world where imperfect knowledge is a fact of life. They argue that, if we didn’t have advertising, then the transaction costs (i.e. all of the costs involved in negotiating and completing a deal) of any sale or purchase – especially those to do with the search for goods and for knowledge about their attributes – would be higher and, as a result, buyers would be worse off. Not only would they have to pay more for their goods and services, but the probability of their making a wrong choice would be increased. The greater the variety of goods and services offered for sale, the more difficult it is for the consumer to judge the capacity of the good to satisfy a particular want before he or she buys it and the more the consumer will value objective information to help him or her to make the right choice.

Not surprisingly, many who work in the advertising industry take the view that advertising helps people to make choices in an over-supplied world. But if the information provided by advertising is not objective, then the choices it engenders may not be good ones and the effect of advertising will be to diminish rather than to enhance the overall welfare or utility of consumers. Those who view advertising as being primarily persuasive regard it as leading to excessive differentiation of products, resulting in prices and profits higher than those arising in an ideal competitive world (Chiplin and Sturgess, 1981: 74–7). Think, for example, of the amount Coca-Cola and Pepsi spend on advertising when, arguably, there is relatively little difference between their products. Those who argue that too many resources are being allocated to advertising are, to some extent, saying that consumers are being bombarded with rather too much information and that it pays firms to advertise beyond the point at which the advertising messages provide any benefit to consumers. They are also suggesting that the persuasive spin put upon product information by
advertisers results in incomplete, misleading or distorted messages rather than a useful resource for consumers.

Is advertising generally harmful or beneficial to the operation of markets? On the one hand, consumers have to pay a higher price for products to cover the cost of advertising but, on the other, they benefit from widespread information about the range and availability of competing goods and services, and this facilitates their decision-making. In its role as a source of information for consumers, advertising can be a pro-competitive force leading to an improved allocation of resources. Counteracting such a force, however, is a possible anti-competitive effect caused by the use of advertising as a means of preventing potential rivals from gaining entry to markets.

ADVERTISING AS A BARRIER TO MARKET ENTRY

An important criticism of advertising relates to its effect on competitive market structures. It is suggested that firms use advertising to put up barriers to market entry which prevent other firms from competing with them (Chiplin and Sturgess, 1981: 112). The basic argument here is that the millions of pounds invested every year in building up recognition for their brands by, for example, Procter & Gamble, Kellogg’s or Elida Fabergé make it difficult or impossible for potential new entrants to encroach on their product markets unless they also have the scale of resources and the will to match this expenditure. In other words, heavy advertising is a means of imposing high set-up costs on new entrants and this, in turn, serves to deter would-be rivals.

Advertising is a feature of oligopoly market structures. Oligopolists not only have to worry about competing with their existing rivals to build and defend market share, they also have to worry about potential competition from firms that might be tempted to enter their industry. If there are no natural barriers to entry, oligopolist firms will earn pure profits just in the short run and until such time as other firms enter their industry. Oligopolists can protect their profitability in the long run only if they can find ways of creating barriers that prevent entry.

One method of keeping out potential new entrants is called ‘brand proliferation’ (Lipsey and Chrystal, 1995: 269). Differentiated products – i.e. products that are similar but with some discernible differences in their attributes – usually have several characteristics that can be varied over a wide range. Thus, there is room in the market for a large number of similar products each with a somewhat different range of features or characteristics. Consider, for example, the current range of breakfast
cereals or cars. Although the multiplicity of brands that manufacturers make available is, undoubtedly, at least partly a response to consumers’ tastes, it may also be partly the result of a deliberate attempt by existing players to discourage the entry of new firms. When existing suppliers sell a wide array of differentiated products this makes it difficult for a new firm to gain entry on a small scale. Brand proliferation means that, in effect, all the potential niches are already occupied. The larger the number of differentiated products already being sold by existing oligopolists, the smaller the market available to a new firm entering with a single new product.

Alternatively, existing firms can create barriers to entry by imposing on new entrants significant fixed costs associated with setting up operations in that market. This is an important tactic if there are no economies of large-scale production to provide ‘natural’ barriers to entry. Advertising is one means by which existing firms can impose heavy set-up costs on new entrants (Griffiths and Wall, 1999: 127). Advertising, of course, has effects other than creating barriers to entry. As discussed above, it may perform the useful function of informing buyers of their alternatives. Indeed, a new firm may find it necessary to advertise even if existing firms don’t bother, simply to call attention to its entry into an industry.

Nonetheless, advertising can operate as a potent entry barrier. Effective brand-image advertising means that a new firm will have to advertise in order to catch the public’s attention. If the firm’s sales are small then advertising costs per unit sold will be large (Lipsey and Chrysal, 1995: 270). Unit costs will only be reduced sufficiently to make a new entrant profitable when sales volumes are large, so that the fixed advertising costs needed to break into the market are spread over a large number of units.

The combined use of brand proliferation and of heavy advertising sometimes acts as a formidable entry barrier. This explains why some of the biggest advertisers often sell multiple brands of the same product. For example, amongst the top 20 advertisers in the UK in 1999 were washing powder manufacturers Procter & Gamble and Lever Brothers; shampoo manufacturers L’Oréal Golden, Van den Bergh and Elida Faberge; car manufacturers Renault, Vauxhall, Ford, Volkswagen and Peugeot; and breakfast cereal manufacturers Kellogg’s and Nestlé Rowntree (Advertising Association, 2000: 227).

To some extent, the debate about advertising and market structures is not really about the effects of advertising per se since both sides agree that it can work as a powerful barrier to entry. Instead, it is about whether or not barriers to market entry are a good thing or not and whether one market structure is better than another. Competition is normally considered a prerequisite for efficiency and, therefore, open and more competitive markets seem preferable to monopolised ones. If however, by keeping
rivals out of the market, advertising enables firms to increase their output and to achieve economies of large-scale production, then arguably this might serve to benefit consumers. The economies of scale created by concentration of ownership in the washing powder industry, for example, means that (provided there is sufficient competition to prevent monopoly pricing) consumers should enjoy lower product prices than would be possible under a more fragmented and competitive market structure. So, provided that firms do not become so large that they can extract monopoly profits, consumers might occasionally benefit from the anti-competitive effects of advertising (Parkin et al., 1997: 424–5).

ADVERTISING AND THE PERFORMANCE OF THE ECONOMY

In recent years a great deal of detailed analysis of advertising and economic data has been undertaken by commercial agencies for the purpose of forecasting future advertising trends. In the UK, extensive historic data is compiled and analysed by the Advertising Association each year and it provides compelling evidence of a link between levels of economic wealth and of advertising activity.

Examined over a long period of time, expenditure on advertising has tended to grow as a proportion of the national economy. Advertising expenditure can be defined in various ways, for example including or excluding production costs, new media and alternative promotional expenditures. Likewise, the performance of the economy can be defined and calculated in different ways, including by Gross Domestic Product. GDP measures the total value of all productive output in the whole economy, usually over a one year period and is probably the most widely used benchmark of general economic performance. When expenditure on advertising is calculated as a percentage of GDP, the pattern that emerges indicates that as the national economy has grown over time in real terms, advertising has not just grown in parallel, but it has grown even faster. So the amount of advertising activity in an economy is related to the size and growth rates of the economy itself, and advertising has tended to account for a progressively more significant proportion of GDP as time goes on.

The relationship between wealth and levels of advertising does not simply apply to the UK. It is also clearly observable in other developed economies and can be demonstrated by a bivariate analysis of GDP per capita (i.e. the productive output of the country divided by the number of inhabitants) and advertising expenditure per capita. As demonstrated in Figure 3.1, the pattern which emerges from international comparisons
shows a strong and positive association between economic wealth in any country and the level of advertising expenditure it enjoys. This correlation is disturbed only occasionally when, for example, government restrictions on advertising hold back levels of expenditure on commercial airtime. Generally speaking, richer countries such as Switzerland enjoy a much higher level of advertising expenditure than poorer countries such as Greece and Portugal (Advertising Association, 2000: 22).

Why is this? There have been two arguments about the relationship between advertising and living standards. One is that advertising stimulates the levels of consumption that are found in countries with high per capita incomes. This perspective implies a causal connection between high levels of advertising, high consumption and, in turn, higher levels of economic activity and growth. The other viewpoint is that advertising is a ‘waste of resources’ that can only be afforded by rich countries (Chiplin and Sturgess, 1981: 7).

Historic UK data shows that the growth in advertising as a proportion of GDP is not exactly steady and continuous. Advertising growth is cyclical and it reflects, in an exaggerated way, the ups and downs of the economy at large. In periods of economic expansion the proportion of GDP spent on advertising increases; the converse is true in recession. Figure 3.2 shows advertising as a proportion of GDP over 44 years. It demonstrates how advertising, when expressed as a percentage of GDP, peaks at the top of economic boom periods such as in 1973 and 1989. By the same token, expenditure on advertising bottoms out at the lowest point in the economic
cycle, such as in 1975 at the height of oil crisis or in the more recent recession in 1993. Advertising tends to gallop ahead more quickly than the economy in boom periods, but then slumps more quickly in recession.

To understand why advertising is cyclical, it is helpful to carry out more detailed analysis of advertising expenditure data. Advertising is sometimes broken down into ‘display’ and ‘classified’. Display advertising (the bulk of advertising expenditure) is total advertising minus financial notices, classified and advertising in trade or technical journals. Classified is recruitment, housing, personal advertisements, etc. Different sets of factors will affect the performance of each of these two categories.

The two primary forces which appear to determine the growth or decline of display advertising expenditure are consumers’ expenditure and company profits (Advertising Association, 2000: 20). The close correlation between company profits and display advertising expenditure suggests that, perhaps not surprisingly, companies can afford to and do spend more on advertising when times are good. Likewise, the correlation between consumers’ expenditure and display advertising expenditure suggests that companies are willing to spend more when consumer spending and confidence are buoyant, i.e. when advertising expenditure is more likely to translate into increased sales. In short, advertising expenditure expands along with consumer expenditure, but is reined back when company profits are under pressure.

Classified advertising expenditure is dependent on a variety of factors, such as the state of the housing market, the second-hand car market and
employment levels. Statistics published annually by the Advertising Association suggest that the level of unfilled job vacancies is a key determinant of recruitment classified expenditure (2000: 23). It is mainly recruitment advertising which pushes up classified and, thus, total advertising expenditure during economic booms.

The strength of the relationship between advertising cycles and the state of the economy has been questioned and some would argue that advertising expenditure should continue to grow, irrespective of the performance of the economy. Patrick Barwise of London Business School, for example (cited in Tomkins, 2000), suggests that advertising by firms with established brands is essentially a defensive activity, carried out in order to protect their market share rather than in the hope of boosting sales. Likewise, according to Andrew Ehrenberg of South Bank University, ‘[m]ost advertising is not trying to sell. It’s just maintaining your position in a competitive market’ (cited in Tomkins, 1999a). Be that as it may, historic trends in advertising clearly demonstrate the prevalent tendency for firms to cut back on advertising expenditure as soon as an economic downturn looms into view. As John Hegarty, Creative Director of advertising agency Bartle Bogle Hegarty, has explained: ‘[r]ecession is always a problem for the advertising industry, in the sense that clients feel that advertising is the first thing they can switch off’ (cited in Smith, 1998: 1).

The apportionment of advertising between different sectors of the economy is not static, but varies in response to alterations in the market structure of particular industry sectors. These alterations may reflect policy changes that are designed to promote or limit competition in a particular market. For example, advertising expenditure data by product sector in the UK in the 1980s shows how the deregulation of the UK financial services industry in the mid-1980s and the accompanying increase in competitive behaviour on the part of banks and building societies was reflected in an immediate and sharp increase in advertising expenditure by banks and building societies. In the 1990s, international deregulation of telecommunications brought about a great upsurge in advertising expenditure within this sector as new rivals emerged to compete with long-standing incumbents in the UK, across Europe and elsewhere.

The emergence of markets for successful new products or service innovations often has reverberations in the advertising sector. In the early part of the year 2000, a boom in the number of Internet start-ups created something of a bonanza for the advertising industry as many new ‘dotcom’ companies launched campaigns (using conventional media, such as billboards and television) as a means of raising awareness of themselves and their online businesses. A subsequent downturn in investor confidence in dotcom start-ups has since diminished some of this rich vein of new billings for advertising agencies. Even so, it is expected that expenditure
on advertising by dot.com companies will, by itself, add around 3 per cent growth to total advertising in the USA and the UK in the year 2000 (Killgren, 2000: 7).

THE FIRM’S ADVERTISING DECISION

The decision each firm takes about how much of its resources to devote to advertising depends on what it believes this investment can achieve. What companies expect in return for their expenditure on advertising varies: whereas some simply want an effective marketing campaign, others believe that advertising agencies play a broader role in creating and managing their long-term brand strategies.

Systems of remuneration for advertising agencies have changed considerably in the UK over the last 10–15 years. Up until the late 1980s, most agencies expected to be paid a commission on ‘gross billings’ (i.e. the cost of all advertising space purchased on behalf of the client), usually at a rate of 15 per cent. US radio comedian Fred Allen coined the definition of an advertising agency as 85 per cent confusion and 15 per cent commission. The commission-based mode of payment not only encouraged agencies to concentrate their efforts on expensive media outlets but, more significantly, it ignored whether the advertising campaign supplied to the client was in any way effective or not. Nowadays, advertising agencies are generally paid on a flat fee basis and, in the UK, around one-third of their clients favour the concept of ‘payment by results’ (Hall, 2000b: 5). This approach raises a perplexing and long-standing question surrounding firms’ expenditure on advertising – namely, how can the effectiveness of advertising be measured?

Many advertising clients put the ‘payment by results’ approach into operation by means of a sales-based model of compensation. In other words, the fee the advertising agency receives is calculated by reference to the impact of the advertising campaign on client sales. This seems fair, to the extent that the motivation behind advertising is simply to sustain or improve demand for the firm’s products or services. However, some advertising clients regard this approach as too simplistic and prefer to measure their agencies’ success by, for example, tracking studies that focus on perceptions of the firm and its brands.

The question of how to measure the effectiveness of advertising expenditure is important since, unless some idea can be gained about what return advertising will bring, firms will naturally find it very difficult to decide how much to spend on this activity. The two most common ways of researching the effectiveness of advertising involve either measuring the
success of advertising in communicating its message, or direct tests of
the effects of advertising on sales or profits. Both of these methods, how-
ever, have serious weaknesses.
In the case of testing people's ability to recall advertising messages,
the obvious weakness is that this approach doesn't yield any reliable
information about the impact on sales. How often does a clever visual
or punch-line in an advertisement create a lasting impression but without
successfully projecting the brand or having a discernible effect on demand?
Studies that look more broadly at how advertising has affected percep-
tions of the firm and its brands suffer from the same problem—the impact
of this expenditure on the firm's financial performance is not addressed.
The capability for interactive advertising (e.g., on the Net) brings another
way of measuring effectiveness: the number of responses an advertise-
ment elicits can be counted. All in all, however, proof that advertising has
engaged viewers' attention, has communicated a message successfully or
has improved a brand or a corporate image is not the same as demon-
strating an impact on profits.

So, for many advertisers, the second method—looking directly at sales
seems more useful, since the whole point of advertising is usually to boost
sales. But there are also problems with this second method, to do with
establishing any direct causal link between what a firm spends on adver-
tising and what happens to sales. One immediate problem to be taken into
account with direct testing is that advertising is not, itself, a homogene-
ous product. The effect on sales that a given expenditure on advertising will
achieve depends, to a great extent, on the quality of the advertising
campaign that has been purchased. Not all advertising agencies have equal
talent. In the UK, for example, those advertising campaigns which seem
to most clearly demonstrate a profitable return for clients are acknowl-
edged each year by the Institute of Practitioners in Advertising (IPA)
effectiveness awards competition. The way in which a firm's sales move
or fail to move as a result of a campaign devised by one particular agency
may not be a reliable indicator of how sales will typically or more generally
respond to investment in advertising.

Another problem is that of time lags. It may take some time before
advertising starts to have the desired impact on sales. Advertising might
inspire an initial trial which might then result in positive recommendations
to friends and, in turn, be followed by further purchases. Advertising
may communicate its message successfully but at a time when the con-
sumer is not yet in a position to make a purchase. So it may take some
time before advertising has a visible impact on sales. It is often argued that
consumers need to be exposed to a certain amount of advertising before
they will respond but once they do respond, not much advertising is
required to retain their loyalty. Advertising gradually builds up and then
reinforces the positive perceptions of a product or brand or, in a sense, the ‘goodwill’ that is needed to ensure habitual purchasing of it. Indeed, the future earnings potential that investment in advertising is thought to have generated for a firm is sometimes recognized when famous brands are valued and accounted for as assets on a company balance sheet.

To deal with time lags, a regressive model is sometimes used to measure the effect of advertising. Advertising which has taken place in a previous period (say, the first quarter of 1999) is compared with current sales (in the first quarter of the following year). But a further and more insurmountable difficulty with measuring the effectiveness of a firm’s expenditure on advertising is that of the behaviour of rivals. How do you disentangle the effect of advertising on demand for your product from the effect caused by whatever your rivals have been up to simultaneously in terms of advertising or not advertising their own wares, or implementing competitive price reductions, or instigating product changes or other special promotional efforts? It is virtually impossible for any firm in an oligopoly or a competitive market situation to isolate the impact of its own advertising investment from the impact on demand caused by the behaviour of its rivals.

So, the problems of measuring the effects of advertising are not simple and, in particular, it is very difficult to establish proof of some degree of causality, i.e. that x expenditure on advertising will have y given effect on sales (Carter, 1998: 6). How, then, do firms decide on their advertising budgets?

Economists who have considered this question – especially Cowling et al. (1973), Chiplin and Sturgess (1981) and Duncan (1981) – acknowledge that many firms simply use some kind of ‘rule of thumb’. The decision taken about what level of resources to devote to advertising is often based on customary practice or what amounts to intuition rather than on any attempt to calculate expected returns. Sometimes advertising is regarded as discretionary rather than necessary expenditure and firms simply spend whatever they think they can afford at a given time. This approach is reflected in historic data, discussed above, which demonstrates the sensitivity of overall levels of advertising to company profits and to fluctuations in the economy at large. But the discretionary approach is often criticized on the basis of being too unscientific and unlikely to achieve great results.

Many firms set their advertising budget as a given proportion of sales or of assets. The pre-determined percentage of either previous or predicted sales is a particularly popular method – e.g. this year’s advertising budget may be set at the rate of 10 per cent of last year’s sales – and it offers various advantages. It is easy to calculate and it is quite manageable in financial terms, in the sense that the advertising budget will go up or down directly in accordance with the firm’s fortunes.
But how does the firm decide what proportion of sales the advertising budget should represent? Analysis of historic sales and advertising figures reveals some very wide disparities between the proportions opted for by different firms. For example, according to statistics compiled by the Advertising Association (1996: 226), advertising accounted for just 5 per cent of what consumers spent on baby care products in 1994 but for a massive 44 per cent of consumer expenditure on double-glazing! Should the advertising budget be set at 5 per cent or 44 per cent of sales? Many firms examine what their competitors are spending and set their own advertising budget as a similar proportion of sales or assets. But there is no guarantee that the level set by competitors is optimal.

Some economic theorists have tried to provide a more scientific answer to this question. Dorfman and Steiner have suggested that, when it comes to deciding what proportion of sales income to devote to advertising, there are two things that firms should take into account: first, ‘advertising elasticity’ or how responsive sales are to changes in advertising expenditure and, second, ‘price elasticity’ or how responsive sales are to any change in price (Chiplin and Sturgess, 1981: 45). The reason why consumers’ reactions to any price change should be taken into account in setting the advertising budget is because it would be inefficient to spend money on advertising if the same money invested in a price reduction would boost sales by a greater amount. If sales are more responsive to fluctuations in price than to changes in levels of advertising, this implies that a lower proportion of sales income should be devoted to advertising.

The Dorfman Steiner approach may have merit in theory but it is by no means easy to put into operation. Price elasticity refers to the responsiveness or sensitivity of demand to upward or downward movements in the price of a product. Likewise, the concept of advertising elasticity refers to the responsiveness of demand to changes in levels of advertising expenditure on that product. The problem is that it is virtually impossible to calculate advertising elasticity in ‘real world’ circumstances because of constant changes and the unpredictable behaviour of competitors.

ADVERTISING AND NEW MEDIA

The growth of new media such as the Internet and digital television has provided advertisers with a range of new communication channels through which they can address messages to their target audience groups. At first glance, the arrival of additional supplies of audience access seems to be a positive development, allowing for more specialist targeting and, potentially, lower advertising costs. However, the growing popularity of new
media inevitably erodes mass audiences which, from the point of view of many advertisers, makes consumers more difficult to reach.

Just as newspaper proprietors were concerned about the development of advertising-supported broadcast media in the 1940s, so too the current generation of media players is anxious to assess the likely threat to commercial revenues posed by the development of the Internet, interactive television and other new multimedia products and services. The question they face is to what extent the rise of alternative avenues of communication with consumers may come at the expense of conventional advertising media and to what extent they may simply expand the overall advertising market. Will the growth of advertising in new media be incremental to or a substitute for traditional mass market advertising?

The capacity for interactivity facilitated by digital technology is a major concern for traditional advertising media. The Internet has already established itself, especially with younger audiences, as an important medium and interactive television is also well on its way towards gaining acceptance. Interactivity is, of course, driving the process of fragmentation of audiences into ever narrower niches and specialisms. More significantly, interactivity has the potential to provide advertisers with extensive information about the tastes, preferences and habits of particular sections of the audience. The facility for advertisers to get to know their target customer base – to learn about and speak to individual tastes amongst niche audiences – is a valuable advantage that conventional mass media cannot provide.

The Internet is now beginning to compete with traditional media for a share of some major advertisers’ marketing budgets. According to the UK’s Institute of Practitioners in Advertising, ‘the number of companies allocating more than 5 per cent of their budgets to Internet marketing rose from 8 per cent to 14 per cent in the third quarter [of 2000]’ (cited in Hall, 2000c: 6). The Internet is clearly better suited to some forms of advertising than others; for example, to provide classified rather than display advertisements, and to aim commercial messages at specific audience subgroups. Consequently, some conventional media – particularly those newspaper and magazine publishers who rely on targeted classified advertising – will find that their revenues are more threatened by the growth of the Internet than others.

New media such as the Internet, digital television and WAP2 mobile phones offer users more choice and control over what sorts of entertainment or information services they wish to receive. On the one hand,

2. WAP or Wireless Application Protocol is a technology that allows consumers access to the Internet on their mobile phones.
personalized and interactive media consumption make it possible for advertisers to collect useful feedback and to foster closer and more effective two-way communication with relevant consumers. On the other, the cost of attracting the attention of large audiences via tailored one-to-one marketing is much more significant than via a campaign conveyed across conventional mass media. The price of advertising on the Internet, for example, currently running at around £30 per thousand ‘page impressions’ in the UK, is not far behind the price of a direct mail shot and is considerably more expensive than the cost per thousand (of around £10 and £3 respectively) for a 30-second commercial either on network television or radio (Oliver, 2000: 57). On a cost per capita basis, ‘micro’ marketing may prove expensive but, for some advertisers at least, it is also less wasteful than mass advertising in mainstream media.

Paradoxically perhaps, as audiences for traditional media have fragmented, the cost of reaching a mass of consumers has increased. The growing price and waning influence of advertising expenditure on mainstream television channels such as the four main ‘over-the-air’ networks in the US or the ITV network in the UK is a source of frustration for many advertisers, yet they are powerless to reverse the changes in lifestyle and in patterns of media consumption which make mass marketing an increasingly expensive exercise.

We live in an era in which famous brands are highly valued. So, even as audiences fragment across media catering to ever narrower sets of tastes, many advertisers continue to rely primarily on mainstream conventional media to create the mass consumer brands of the future. The greater ability of conventional media to reach mass audiences and to establish famous brands still remains a strong selling point. According to Hegarty, ‘[w]hat makes a brand is fame, and that comes from communicating with people en masse’ (cited in Smith, 1998: 1). So, despite the fact that, in the UK as elsewhere, newspaper circulations are declining and television audiences are beginning to fragment, ‘advertising prices are still being pushed up because the advertiser’s need to find fame is more urgent than ever’ (Hall, 2000a: 3).

So far at least, it seems that extra channels of communication and better opportunities for tailored marketing have stimulated incremental demand for advertising rather than diminishing appetites for commercial space in traditional media. For this reason, the arrival of new media is seen by many as a complement to rather than a substitute for conventional mass media. The effect of the Internet on advertising markets has been likened to ‘adding a couple of lanes to the motorway – it just means that overall traffic levels get higher’ (Gottlieb cited in Hall, 2000a: 3). ‘Micro’ marketing via new media is adding extra volumes of advertising activity rather than replacing mass marketing.
But new digital and interactive media are still in their infancy and until their full capability as marketing vehicles is understood, the future for advertiser-supported conventional media like television, radio and newspapers is uncertain. Traditional media are protected only so long as they remain the most convenient route to mass audiences. As new niche services continue to splinter audiences, the perceived level of substitutability between new and traditional advertising media will inevitably increase.

A fragmented audience is not the only problem facing advertisers. Some new media offer users the ability to bypass advertising altogether. For example, the emerging generation of digital video recorders, such as those offered by TiVo (manufactured by Royal Philips Electronics of the Netherlands) and ReplayTV (manufactured by Panasonic, a subsidiary of Matsushita of Japan), allow viewers to skip over the advertisements when they watch recorded television. Digital video recorders – also known as Personal Video Recorders (PVRs) – can record and store programmes by type in response to pre-selected choices made by the individual viewer and, at the same time, can edit out programme credits or other unwanted interruptions, including commercial breaks.

The ability for viewers to skip advertising has been heralded by some as ‘the end of commercial television’ (Lewis, 2000: 2). But opinions vary on how exactly PVRs will affect viewing habits. Video cassette recorders have always offered viewers the option of fast-forwarding to avoid commercial breaks in recorded material and this has not undermined advertiser-supported television broadcasting. PVRs, however, make it much easier to side-step advertising. The question is, to what extent will audiences continue to watch much of their television ‘live’, in spite of the greater convenience of recording thanks to PVRs?

According to Ave Butensky, President of US industry body the Television Advertising Bureau, (cited in Tomkins, 1999b: 19), viewers ‘will figure out how to switch the television on and how to change the channel, but beyond that, they don’t want to know. Basically, they’re couch potatoes.’ If, as Butensky suggests, most viewers ignore the arrival of the PVR and continue to flick passively between ‘live’ television channels, then audiences will not be able to skip over advertising breaks and commercial broadcasters have little to worry about. Many viewers will, however, undoubtedly be tempted by the possibility of their own customized pre-recorded programme schedule, and so PVRs will continue the process of erosion of audiences for conventional broadcast channels as well as making it progressively more difficult to entice audiences to watch television advertising.