

ADVERTISING AND
THE MEANING OF COMPETITION

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Abstract

Economists differ sharply in their views on the effects of advertising on consumer behavior. An equally unmistakable difference of opinion divides them over the meaning of competition. This paper explores the theoretical relationship between the two debates. My main point is that while the advertising debate is rooted in and stems from the competition debate, it is no less true and significant that understanding the nature of advertising would help us immeasurably in understanding the nature of competition.

A.INTRODUCTION

Whether we turn on the TV or pass by billboards along freeways, casual observation suggests the omnipresence of advertising in modern societies. The general public tends to view advertising as an irritating, inescapable nuisance. Along with this quasi-universal hostility, there is a widespread perception of advertising as a powerful economic and social force [see, for example, Winters(1978)]. Among economists, there are two schools of thought on the issue. According to traditionalists, who generally hold advertising in low esteem, its primary function is to artificially differentiate essentially similar products and psychologically manipulate vulnerable consumers. The traditionalists also believe that large, well-established firms enjoy a differential advantage in terms of ability to advertise. The neoclassicals harbor a much more benign view of advertising - for them, advertising essentially represents information which helps consumers who are rational but ignorant. They believe there are no significant barriers to advertising. In their opinions on the social desirability of advertising, the two sides could not be further apart. Ferguson(1974), Farris and Albion(1981) and Ekelund and Saurman(1988) provide relatively detailed accounts of the controversy.

There is an equally sharp division of opinion among economists on the meaning of competition. For the sake of convenience, we once again brand the two opposing sides on this issue traditionalists and neoclassicals. As far as the traditionalists are concerned, competition refers to the perfect competition paradigm of textbooks, which describes a particular market structure. By contrast, for the neoclassicals, the same term means cutting prices, providing better service, offering longer warranties and the

entire range of business activities firms undertake to gain an edge over their rivals. Thus, the traditionalists interpret competition as a static equilibrium while the neoclassicals view it as a dynamic disequilibrium process. McNulty(1968) provides an excellent overview of the competing definitions.

Product homogeneity and perfect information are two fundamental assumptions underlying traditionalist competition. Consumers and firms armed with complete knowledge buy and sell in a market for an identical product. In contrast, neoclassical competition rules out both assumptions. Neither buyers nor sellers have perfect information and the whole point of dynamic competition is heterogeneity - being better than one's rivals necessarily implies being different from them. This wide gulf between the traditionalist and neoclassical assumptions about product homogeneity and the state of information is, as we will see, what is ultimately responsible for the difference of opinion with respect to both advertising and competition.

We can trace the origins of the advertising controversy directly to differences in defining competition. The traditionalists' aversion toward advertising follows only too naturally from what competition means to them and the same can be said for the neoclassicals' favorable disposition. What is no less significant but much less noticed is that one's perceptions of advertising also strongly influence one's perceptions of competition. More than any other economic activity, advertising can shed light on the meaning of competition. To be more precise, a proper understanding of why and how consumers respond to advertising can tell us a great deal about which of the competing definitions of competition lies closer to the mark. In this paper, I attempt to provide a systematic analysis of the relationship between the two debates.

B.TWO VIEWS OF ADVERTISING

According to traditionalists, the primary role of advertising is to create differences among more or less identical products, differences which would not exist in the absence of advertising. Consumer tastes and preferences in a world with advertising differ greatly from those in a world without advertising. Consumers are neither sovereign nor rational; rather, they are easy prey to psychological manipulation by producers and advertising is the primary medium for such manipulation. According to the traditionalists, producers exert a powerful influence on consumer tastes. An extreme but telling version of the traditionalist hypothesis is that advertising and advertising alone can distort consumer preferences toward advertised products and brands. For example, the hefty premium teenagers willingly pay for their Guess jeans may be entirely due to provocative commercials and the associated product image rather than any authentic superiority over other jeans.

If advertising per se were a source of consumer loyalty and producer success, it must necessarily be true that some producers enjoy a differential advantage over their competitors in obtaining advertising resources. Otherwise, we would observe all sellers advertising their way to wealth and glory. In this connection, the traditionalists most often mention economies of scale in advertising and a large stock of consumer goodwill built up over the years through advertising as factors which favor bigger, more established firms over smaller firms and new entrants. Comanor and Wilson (1974), among others, elaborate upon these arguments as well as those of the previous paragraph. Further potential barriers to entry include the sunk nature of advertising costs[see Kessides(1986)] and capital market imperfections. Since the overall picture

which emerges is one of large incumbent firms using advertising to psychologically manipulate consumers and keep rivals at bay, the critical attitude of the traditionalists should come as no surprise at all.

At this point, it is worthwhile to briefly examine the origins of traditionalist thought. Joan Robinson(1933) and Edward Chamberlin(1933) recognized that the real world contained elements of both competition and monopoly, and pioneered the economic analysis of such mixed settings. Both also realized the superfluousness of advertising within the perfect competition model. As Chamberlin notes:

...advertising would be without purpose under conditions of pure competition, where any producer can sell as much as he pleases without it.[Chamberlin 1933, 72]

While Chamberlin does not proceed from a theoretical uncomfortableness with advertising to condemning it, Robinson does so. That explains why Robinson, more than anybody else, is responsible for a legacy of hostility toward advertising which influences many economists up to this day. She states:

...the customer will be influenced by advertisement, which plays upon his mind with studied skill, and makes him prefer the goods of one producer to those of another because they are brought to his notice in a more pleasing or more forceful manner. [Robinson 1933, 90]

...when a firm finds the market is becoming uncomfortably perfect it can resort to advertisement and other devices which attach customers more firmly to itself. [Robinson 1933, 101]

While it would be inaccurate to say that Robinson believes advertising to be the sole means of product differentiation, it is quite clear that she lays down the foundations of traditionalist thought in two respects: first, a belief that advertising per se can strongly affect buyer preferences and thus create buyer loyalty and market power and second, a presumption that advertising is socially harmful.

For their part, neoclassicals view advertising primarily as information.[See, for example, Nelson(1970, 1974), Ehrlich and Fisher(1982), Laband(1986)]. The starting point of the neoclassical position is that there are significant differences among brands and producers in terms of price, quality, warranty and so forth. In a world of ignorant consumers, the role of advertising is to inform consumers about substantial product differences which would exist even in the absence of advertising rather than to create cosmetic differences among essentially homogeneous products. Advertising does in no way affect the tastes and preferences of rational, self-interested consumers. What it does instead is to expand the consumer's relevant opportunity set by expanding his stock knowledge and in so doing, helping him to better satisfy his needs and wants.

The advertising-as-information hypothesis, combined with the assumption of the rational, self-interested consumer, suggests that advertising is most profitable for producers who offer consumers the best buys. That is, producers who are most likely to advertise are precisely the ones who are best at catering to consumer preferences. Nelson(1970, 1974) pioneered this line of reasoning, which is also evident in Klein and Leffler(1981), Leffler(1981) and Park(1990). The only barrier to advertising, so to speak, is an inability to please consumers rather than any sort of market imperfection. Rational buyers judge a product on the basis of its merits, and the ultimate basis of consumer loyalty and producer success is superior performance. Suppose the maker of detergent which invariably ruins clothes advertises heavily. While consumers may initially respond to the ads, the sales effect will rapidly vanish for two reasons - no repeat sales and unfavorable word-of-mouth communication. Conversely, the maker of a cheap, high-quality detergent would enjoy high returns from advertising. Thus,

advertising is information which directs rational consumers to superior brands and products. The neoclassicals' favorable disposition toward advertising is only natural.

The Nelsonian arguments outlined above extend to apparently non-informative advertisements, such as those featuring the Marlboro Man. Of course, even such advertisements do inform us that there is a cigarette brand called Marlboro. But how many of us do not already know of a cigarette by the name of Marlboro or a soft drink named Coca-Cola? This type of advertising, which may appear to carry hardly any information which is of value to consumers, is seized upon by the traditionalists as compelling evidence against the advertising-as-information hypothesis. Neoclassicals counter that even the most seemingly non-informative advertisements contain valuable information since advertising costs are unrecoverable sunk costs which the advertiser stands to lose should it fail to satisfy buyers; advertising can serve as a guarantee of quality in the face of quality uncertainty and provide useful information about the advertiser's future performance. Hence, the very fact that a firm advertises constitutes useful knowledge for consumers.

Before moving on, it bears mentioning that the intellectual roots of the advertising-as-information hypothesis lie in the ideas Hayek(1937, 1945) so forcefully put forth. In this connection, Hayek's main contribution was to highlight the central role of knowledge in economics and in doing so, motivate economists to move away from making assumptions about the state of knowledge and toward analyzing how economic agents acquire and use knowledge. By transforming information from an exogenous, static concept to an endogenous, dynamic one, Hayek gave inspiration and impetus to the economic analysis of information, the theoretically more rigorous

foundations of which were laid out by Stigler(1968). Once we accept the costliness of information, it becomes eminently plausible to suggest that buyers rely on advertising as a valuable source of information, all the more so if advertising is a relatively efficient method of providing information[see Ehrlich and Fisher(1982)]. The samples of Hayekian thought below reveal the seeds of neoclassical views.

The statement that, if people know everything, they are in equilibrium is true simply because that is how we define equilibrium. The assumption of a perfect market in this sense is just another way of saying that equilibrium exists, but does not get us any nearer an explanation of when and how such a state will come about. It is clear that if we want to make the assertion that under certain conditions people will approach that state we must explain by what process they will acquire the necessary knowledge.[Hayek 1937, 45]

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.[Hayek 1945, 77]

...I shall here not go into the familiar paradox of the paralyzing effect really perfect knowledge and foresight would have on all action. It will be obvious also that nothing is solved when we assume everybody to know everything... [Hayek 1948, 95]

At a theoretical level, the difference of opinion between the traditionalists and the neoclassicals is a matter of degree and emphasis. Some types of advertising appear to be traditionalist in nature while others seem neoclassical. Most economists of both sides would agree that there is at least some element of truth to the other side. Quite interestingly, E. H. Chamberlin had already recognized both the traditionalist and neoclassical views of advertising.

...It will be argued later that gains from this source(advertising) are possible because of (a)imperfect knowledge on the part of buyers as to the means whereby wants may be most effectively satisfied, and (b)the possibility of altering wants by advertising or selling appeal....[Chamberlin 1933, 72]

Having said this, it is quite clear that the two sides differ sharply over whether most of the advertising we observe represents artificial differentiation or information. In any case, all advertising necessarily both differentiates and informs in the following limited sense: commercials touting a brand of refrigerators called General Electric differentiate General Electric from other refrigerator makers as well as inform us of the existence of a certain brand of refrigerator. Nevertheless, our earlier discussions should make clear the nature of the debate, the resolution of which is not a matter of theory but fact.

Unfortunately, in this case even the facts themselves do not allow us the luxury of easy interpretation. Regardless of whether advertising is primarily artificial product differentiation or information, advertising boosts sales. Otherwise, it would not pay advertisers to advertise. Likewise, advertising has a positive effect on consumer loyalty under either theory - directly in one instance and indirectly in the other. This means that either theory is consistent with a positive empirical relationship between advertising and performance. In this connection, the large number of empirical studies which establish a positive relationship between advertising and profitability[see, for example, Comanor and Wilson(1967), Shepherd(1972) and Porter(1976)] fail to tell us anything meaningful. More generally, perhaps due to the inherent intractability of the issue at hand, existing studies fail to provide convincing evidence either way.

C.TWO VIEWS OF COMPETITION AND TWO VIEWS OF ADVERTISING

As mentioned in the introduction, there is a static interpretation of competition as well as a dynamic one. The traditionalists view competition as a specific market structure and static equilibrium while the neoclassicals perceive competition as a

continuous disequilibrium process. More concretely, the traditionalist interpretation corresponds to the textbook example of an atomistic wheat market of infinitely many price-taking wheat farmers while the neoclassical definition refers to competition as businessmen understand the term - offering discounts, giving away gifts and doing a thousand other things to keep your own business and lure away others' business. As we will see below, the advertising debate stems directly from these competing definitions of competition.

Product homogeneity and perfect information are two key assumptions of the perfect competition model. Since this model describes a certain market structure, we may regard product homogeneity as its point of departure - once we allow for heterogeneity, the very definition of a market becomes blurred. Therefore, the traditionalist vision of competition implicitly presupposes a well-defined market in which perfectly informed economic agents exchange an identical product.

In contrast, the neoclassicals would argue that product heterogeneity is the essence of competition. Producers compete with each other by trying to provide consumers with more satisfactory goods and services. That is, competition is a process whereby firms attempt to retain old customers and win away new ones by being better than and hence different from their rivals. Further, the neoclassicals do not assume perfect knowledge. Thus, one definition of competition is based on product homogeneity and perfect information while the other rests on the absence of both. In particular, the critical difference is the different assumptions regarding product homogeneity.

As noted earlier, product heterogeneity is a most troubling phenomenon for the traditionalists. For them, the perfect competition model is not only descriptive but also

normative - it is not just any state of affairs but one which is optimal or desirable. In particular, a perfectly competitive market entails the largest social surplus and the most efficient allocation of resources. The supposed optimality of perfect competition implies that deviations from its assumptions, most notably product heterogeneity, are somehow unnatural and undesirable. This explains why, for example, in his highly influential *Barriers to New Competition*(1956), Joe S. Bain, a leading traditionalist economist, contends that product differentiation is a significant source of barriers-to-entry and, not surprisingly, mentions advertising as a significant source of product differentiation. For advertising, more than any other economic activity, fits the description of a possible suspect in the crime of unnatural and undesirable product differentiation.

The traditionalists' low opinion of advertising follows directly from their static interpretation of competition. In evaluating whether a given market is relatively competitive or not, the traditionalists tend to concentrate on structural factors such as the number of firms or the concentration ratio. What lurks not too deeply beneath this type of thinking is an implicit, perhaps unconscious belief in the validity of the cornerstone of the perfect competition paradigm - product homogeneity. Hence their inherent suspicion of and antagonism toward any economic activity which contradicts this belief, especially one so seemingly unproductive as advertising. In the absence of homogeneous products, there is no market and in the absence of markets, there is no market structure to analyze or use as a tool of analysis.

Once we allow for a substantial diversity of products in a given market, the concept of market begins to lose its relevance, as does the traditionalist ideal of competitive

markets, for we then have monopolists producing BMWs and Audis instead of perfectly competitive firms producing automobiles. Furthermore, the possibility that such diversity could promote rather than hinder social welfare also does not sit well with the traditionalists' idealization of their competition. Therefore, a plausible vindication of traditionalist competition, as a descriptive model and as an ideal, requires a trivialization of product heterogeneity. And, again, what better business activity for the traditionalists to point their fingers at as a persuasive example of purely superficial, socially wasteful product differentiation than advertising? The traditionalist assumption of perfect information also militates against an informative role for advertising. This lends further theoretical support to the traditionalist view of advertising as a source of trivial, socially undesirable product heterogeneity.

In stark contrast, the neoclassicals are perfectly comfortable with heterogeneous products. In fact, product heterogeneity is precisely what defines competition as they understand the term - the never-ending efforts of producers to outcompete their competitors by offering buyers greater satisfaction. That is, "competition" and "to compete" refer to the same thing and "to compete" means to cut prices, invest in R & D, advertise and so forth. The traditionalist assumption of homogeneous products contradicts the very notion of more satisfaction and less satisfaction, and hence the neoclassical definition of competition. The neoclassicals view product diversity as a key descriptive element of their competition as well as a socially desirable state of affairs since they believe it to result from a vigorous rivalry among sellers to satisfy the diverse preferences of buyers. What would discomfort them is not diversity but the lack of it. As Hayek(1948) puts it:

...the demands of those who believe that the variety of people's tastes should be disregarded and the constant experimentation with improvements should be suppressed in order to obtain the advantages of perfect competition. It would clearly not be an improvement to build all houses alike in order to create a perfect market for houses, and the same is true of most other fields where differences between the individual products prevent competition from ever being perfect.

Quite clearly, this passage reveals Hayek's clear understanding and disapproval of the traditionalist interpretation of competition.

Unlike the traditionalists, the neoclassicals do not assume perfect information. In particular, they do not assume consumers to possess complete knowledge about products and brands. Consequently, sellers find it in their own interest to reach out and introduce themselves to potential buyers. Advertising is a widely used tool in this endeavor. As noted earlier, the incentive to disseminate information is strongest for firms which can deliver the highest level of buyer satisfaction. The provision of information to buyers is essential for neoclassical competition. After all, what is the point of offering best buys if buyers are not even aware of them? For the neoclassicals, advertising is information and information is the lubricant which oils the wheels of competition, the intense marathon among firms to satisfy consumers.

D. TWO VIEWS OF MONOPOLY AND TWO VIEWS OF ADVERTISING

The flipside of the debate over the meaning of competition is the debate over the meaning of monopoly and market power. The more traditional analysis of monopoly, like the more traditional analysis of competition, is that which appears in textbooks - Harberger Triangle and all. This type of analysis forms the basis of the traditionalist definition of monopoly. It is static in that it focuses on the welfare consequences of an existing monopoly rather than on the question of how the monopoly came into being.

In a narrow sense, traditionalist monopoly essentially refers to a particular static equilibrium and market structure. In a more general sense, it refers to any market structure far removed from a perfectly competitive one.

The neoclassicals, on the other hand, pay greater attention to the issue of how a monopoly becomes a monopoly in the first place. That is, they are more interested in the dynamic process of monopolization than in the static description of monopoly. In terms of welfare implications, it makes all the difference in the world whether a monopolist is a monopolist because he happens to be the dictator's nephew or because he produces a better, cheaper product. Neoclassicals tend to give the benefit of the doubt to the monopolist - they believe much more in the superior performer than in the dictator's nephew. Furthermore, the neoclassicals pay much less attention to the static welfare losses of existing monopolies than their traditionalist counterparts.

The traditionalists' preoccupation with and idealization of a perfectly competitive market structure are mirrored in their aversion toward monopoly as they define the term. Of paramount concern to them is the static efficiency losses associated with non-competitive markets. This explains why they view monopolistic market structures as per se undesirable, and worry so much about things such as firm size and mergers. It is this kind of logic which gave rise to the famous market concentration doctrine, pioneered by Bain(1951) and according to which higher industrial concentration facilitates collusion and hence the creation and preservation of socially undesirable monopoly power. As stated before, such a single-minded focus on market structure rests on an implicit assumption of product homogeneity and well-defined markets.

If monopoly is to be condemned outright without further deliberation, the same goes

for any economic activity which results in monopoly. While the traditionalists concern themselves mainly with the analysis of monopoly rather than monopolization, such a strongly critical attitude toward monopoly implies an equally unambiguous bias against monopolization. A producer can achieve monopoly power by differentiating its product and gaining the loyalty of consumers. McDonald's may not be able to set the price of all burgers but it obviously can set the price of its own burgers. By definition, McDonald's is a monopolist of McDonald's burgers although the validity of this statement depends critically on the strength of consumer loyalty McDonald's enjoys. If and when confronted with the question of monopolization as opposed to monopoly, it very much behooves the traditionalists to identify a socially harmful activity which differentiates and creates consumer loyalty, that is, a socially harmful means of monopolization.

Once again, this is where advertising comes into the picture. Whatever one's perception of advertising, there can be no question that it invariably differentiates the advertiser's product. The Marlboro Man reminds us of a particular brand of cigarettes and a bearded colonel named Sanders reminds us of a particular chicken fast-food chain. Once we re-define differentiation in this broad sense, it becomes clear that the whole point of advertising is to differentiate - to inform us of the many different brands and products out there. What is distinctive about the traditionalist view of advertising is a belief that advertising can, in and of itself, bring about consumer loyalty as well. An advertised brand enjoys greater consumer loyalty than an unadvertised one because and solely because it is advertised, the fundamental force at work being preference manipulation. Ronald McDonald commercials skew the tastes

of burger lovers in such a way that they develop a loyalty for McDonald's products. Therefore, advertising, or more precisely, the traditionalist perception of how advertising works, justifies and reinforces the traditionalists' hostility toward monopoly by justifying and reinforcing a negative perception of monopolization.

Neoclassicals do not dispute the static efficiency losses of non-competitive market structures so emphasized by the traditionalists. Where they do beg to differ is on the nature of monopolization. For them, firms acquire monopoly power primarily by being better at satisfying consumer needs and wants. Demsetz(1973, 1974) pioneered this line of thought, which represents the neoclassical critique of the traditionalist theory of monopoly. Indeed, competition as the neoclassicals understand the word is all about monopolizing by winning the consumer's confidence. Those burger eaters who profess loyalty to McDonald's do so for reasons which have very little to do with Ronald McDonald's domination of the airwaves and billboards. Rather, it is more beef, quicker service, greater convenience and other possible sources of satisfaction which attract them to the fast-food chain. As far as the neoclassicals are concerned, monopoly and monopolization are anything but dirty words. Instead, neoclassicals would translate monopoly as success in competition and monopolization as competition.

In a neoclassical world, advertising per se does not produce consumer loyalty. Rational consumers do not pay more for a advertised brand than an unadvertised one if there is otherwise no difference between the two. Advertising can neither distort preferences nor create a premium for the product image it generates. Instead, the relationship between advertising and buyer loyalty is an indirect one in the sense that

advertising facilitates but does not directly bring about buyer loyalty, which is based on superior performance. By providing information to consumers, advertising directs them toward satisfactory sellers and away from unsatisfactory ones. This is all the more so since, as was discussed earlier, providing information is more profitable for the former than the latter. Advertising promotes socially beneficial monopolization (i.e. competition) by helping the socially beneficial monopolist (i.e. successful competitor) to collect his rewards, socially beneficial in the sense that he is better than his competition at providing what the buyers demand.

Of particular significance to neoclassical monopolization is invention and innovation. In the words of Joseph A. Schumpeter (1950):

...But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition which counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization (the largest-scale unit of control for instance) - competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of existing firms but at their foundation and their very lives. This kind of competition is as much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly...

An inventor of a new good or service is, by definition, a monopolist in the traditionalist sense. Furthermore, we can expect a host of legal barriers such as patents and non-legal barriers such as the technical difficulties associated with imitation to deter the entry of competitors, at least for some time. Consider the invention of diet sodas and their production by a single patentee. Clearly, there are dynamic welfare gains stemming from the production and sale of diet sodas. At the same time, the presence of only a single seller in the diet soda market means there will also be static welfare losses. Neoclassicals tend to emphasize the dynamic gains whereas the

traditionalists attach much greater significance to the static losses. Informative advertising helps innovators reap the fruits of their efforts. After all, even a cure for cancer may not be commercially viable in the face of widespread ignorance among the public. Thus, advertising promotes innovation and neoclassical competition.

E.TWO VIEWS OF CONSUMER SOVEREIGNTY AND TWO VIEWS OF ADVERTISING

We can conceive of the difference of opinions over the meaning of competition and monopoly alternatively as a difference of opinions over consumer sovereignty. The difference is clear cut - the traditionalists feel gullible consumers are passive players without much of a say in the economy while the neoclassicals believe rational consumers with well-defined preferences dictate what will and what will not be produced. If we think of the marketplace as an election in which consumers vote with their cash, the traditionalists would be tempted to cry foul over fraud and vote-rigging by the candidates whereas the neoclassicals would be predisposed toward declaring the election free and fair. One school of thought firmly rejects the notion of consumer sovereignty and the other espouses it in no less unequivocal terms.

The traditionalist view of consumers as economic agents of secondary importance corresponds to and stems from a view of producers as the dominant economic agents. The overall picture which appears to motivate this line of thought is one of large, all-powerful corporations which thrive by exploiting rather than serving the interests of helpless individual consumers. Such firms are accused of abusing their size and dominant market positions to charge exorbitant prices and make excessive profits. Furthermore, they are alleged to protect themselves from competition by driving out smaller competitors and new entrants through unfair practices such as collusion and

predatory pricing. It is not hard to see the intimate connection between this kind of thinking and the traditionalist perception of competition and monopoly. Also, it is this rather paternalistic view of the consumer which no doubt underlies at least part of the modern consumer protection movement and certain government policies.

In a world of powerless consumers and powerful corporations, advertising becomes an omnipresent, omnipotent instrument of massive propaganda. Hapless consumers are subject to a constant bombardment of subliminal corporate messages, messages which successfully urge them to drive this car or use that toothpaste. Consumer tastes and preferences are anything but independent; advertising allows corporations to exert a significant, if not decisive, effect on their formation. That is, consumers do not rely on producers to satisfy their well-defined needs and wants but, to a large extent, it is producers who define those needs and wants. Let us hear from John K.

Galbraith(1958):

The even more direct link between production and wants is provided by the institutions of modern advertising and salesmanship. These cannot be reconciled with the notion of independently determined desires, for their central function is to create desires-to bring into being wants that previously did not exist...

According to an extreme interpretation of the traditionalist position, best personified by Galbraith(1958, 1967), advertising does much more than merely lead Pavlovian consumers to specific brands and products. Rather, it is the engine which drives the corporate-dominated modern economy by providing corporations with the customers they need for their survival. Advertising is the means of mass producing customers for corporations engaged in mass production of goods and services. Predictably, a paternalistic perception of the consumer entails intellectual antipathy toward advertising, a widespread and highly visible business activity aimed at consumers.

In contrast to their traditionalist counterparts, the neoclassicals have a strong faith in the ability of the economy to discipline producers into serving consumer interests. For them, consumers are neither powerless nor at the mercy of large, powerful firms; they are motivated instead by rational self-interest and capable of independently forming their own tastes and preferences. Most significantly, it is consumers who determine the fate of producers in the elections of the marketplace by voting with their wallets. Those firms which succeed in effectively catering to consumer demands will thrive while those which do not will fail. As far as the neoclassicals are concerned, firm size is nowhere near as meaningful as the causes of firm size. For them, large corporations are large because they have served consumers well in the past and they will remain large if and only if they continue to do so. Again, it is obvious that this philosophy of consumer sovereignty is closely linked to neoclassical views of competition and monopoly.

Both rationality and sovereignty are bounded by ignorance. In the face of pervasive ignorance, consumers will find it difficult to exercise either. Utility maximization by rational but ill-informed individuals will mean little and buyers who are aware of only one seller will be captives of that seller, whether they like it or not. The neoclassicals' advertising-as-information hypothesis implies a beneficial impact of advertising on consumer rationality and sovereignty. Armed with greater knowledge and hence a larger opportunity set, consumers will be able to use their rational judgment over a wider range of alternatives as well as enjoy greater freedom of choice. Knowledge is power and advertising, by providing knowledge, empowers consumers. Just as better-informed voters are better able to place better-qualified candidates in office, better-

informed consumers are better able to reward more efficient firms and punish less efficient ones. The neoclassicals largely believe in consumer sovereignty, the ability of consumers to impose discipline and accountability on producers, and they consider advertising to be an invaluable instrument and protector of consumer sovereignty.

F.TWO VIEWS OF ADVERTISING AND TWO VIEWS OF COMPETITION

From the above, it is clear that differing interpretations of competition lie at the root of the advertising controversy. More to the point, how one views competition virtually defines how one views advertising. One interpretation of competition leads to an unflattering perception of advertising while another entails a much more benign picture. In the final analysis, the advertising controversy centers on the way in which advertising affects consumer behavior and it is on this central issue that the debate over the meaning of competition has a direct, decisive bearing.

What is much less appreciated than differences of opinion over competition coloring differences of opinion over advertising is the converse. That is, how advertising works can tell us a great deal about the relative merits of the competing definitions of competition. If advertising is primarily information, then this would lend credibility to the neoclassical definition of competition whereas a finding that advertising is primarily artificial differentiation would bolster the traditionalist definition of competition. Understanding how advertising actually affects consumer behavior will help us immeasurably in understanding competition. Not only is the advertising controversy rooted in debate over the meaning of competition but resolving the former will greatly help us in settling the latter as well.

Let us first accept the neoclassical vision of advertising so that the real world is

a world of imperfect information and advertising is essentially information. Since supplying information is costly, firms will do so if and only if it is profitable. As we noted previously, the neoclassicals believe supplying information to be highly profitable for firms which do a good job of satisfying buyers and less profitable for firms which do not. And, satisfying buyers is what neoclassical competition is all about. The notion of relative firm performance inevitably implies a great deal of product heterogeneity in the real world and this, in turn, lends support to the neoclassical vision of competition in which producers woo the votes of the rational consumer by trying to offer him better buys. Consequently, if the basic role of advertising is to provide consumers with information, it must be that the basic goal of competition is consumer satisfaction.

For the neoclassicals, product diversity is dynamic and driven by invention and innovation. The wide array of goods and services we see around us results from a Schumpeterian process of creative destruction in which new, superior products drive out and replace old, inferior ones. Neoclassical competition amounts to gaining the consumer's approval and this is best achieved by providing them with better, more efficient means of fulfilling their desires. The producers who get the highest number of votes from rational consumers are those who are best at creating useful new goods and services and improving upon existing ones. Success in invention and innovation is a prerequisite for success in neoclassical competition. Furthermore, buyer demand for information is strongest for inventions and innovations since they are, by definition, mostly unknown. The unmistakable implication is that returns from providing information are highest for the most creative firms. Consequently, if advertising were

indeed information, it would both reflect and promote innovative activities. In doing so, it helps lend validity to the dynamic, Schumpeterian vision of competition espoused by the neoclassicals.

Now let us instead accept as more valid the traditionalist definition of advertising so that the real world is a world of relatively perfect information and advertising mostly represents artificial differentiation of essentially identical products. According to the traditionalists, advertising per se is a direct source of consumer loyalty and market power in the sense that buyers will pay a premium for advertised goods and services even if they happen to be virtually identical to unadvertised ones. What makes a brand or product better than its rivals in the eyes of the consumer is advertising itself (or to be more precise, the image creation and taste manipulation brought about by advertising) by producers with a differential advantage in obtaining advertising inputs rather than any intrinsic merit of the advertised product. Hence, a world in which advertisers advertise to introduce cosmetic differences must be a world in which product superiority and product heterogeneity are largely imaginary rather than real. In other words, a world in which product homogeneity would hold as a reasonable approximation of reality in the absence of advertising would lend support to the traditionalist definition of competition as a market structure.

Moreover, the relative absence of substantive product diversity implied by the advertising-as-artificial differentiation hypothesis suggests the secondary importance of creative activities in an economy envisioned by the traditionalists. What is of primary importance is well-defined markets consisting of given, homogeneous products. If it were possible for firms to win consumer loyalty and market power by

advertising, their incentive to create new, better products would only be weaker. The resulting predominance of well-established goods and services militates against an informative role for advertising since consumers are likely to be knowledgeable about what they are already familiar with. Therefore, if advertising artificially differentiated, it would be at once a cause and symptom of a relative paucity of innovative activities. As such, it would bolster the traditionalist interpretation of competition.

We have just seen that empirically establishing whether advertising is information or artificial differentiation would help us greatly in ascertaining whether competition is dynamic or static. That is, we can view empirical support for the advertising-as-information hypothesis as indirect empirical support for the competition-as-dynamic disequilibrium process hypothesis and the same goes for the advertising-as-artificial differentiation and competition-as-static equilibrium hypotheses. Unfortunately, empirically distinguishing between the two theories of advertising is much easier said than done. In particular, both theories predict a positive empirical relationship between advertising and performance since both imply a positive theoretical relationship between advertising and consumer loyalty although they differ radically in how they view the actual mechanics and welfare descriptions of the said relationship. Those drastic differences are precisely what matter the most but conventional empirical tests on the effects of advertising cannot tell us anything about them. Also, there is no obvious theoretical reason why traditionalist and neoclassical effects of advertising cannot both come into play so that advertising artificially differentiates as well as informs, further complicating any attempt at meaningful empirical analysis of the issue.

G. CONCLUDING REMARKS

In this paper, I have explored the relationship between differences of opinion among economists over two issues - how advertising affects consumer behavior and what competition means. As was self-evident throughout, the advertising controversy is rooted in and stems directly from divergent interpretations of competition. Somewhat less obviously, empirically resolving the question of whether advertising represents information or artificial differentiation can tell us a great deal about which vision of competition is more relevant. Thus, the debate over advertising not only originates from but can also help us resolve the debate over the meaning of competition. It must be noted that the traditionalist-neoclassical dichotomy is relative rather than absolute; there is an element of truth to both schools of thought, as reasonable members of both camps would readily agree. Be that as it may, there is a clear difference between the two in terms of what is and is not emphasized as well as what conclusions are drawn.

As we have already discussed, empirical studies which focus upon the relationship between advertising and measures of performance, such as rate of return, fail miserably since they cannot even begin to distinguish between the two theories of advertising. What is instead required is an empirical research program centering on the question of exactly how consumers respond to advertising. That is, it makes more sense to investigate the effects of advertising at the level of the consumer since that is ultimately where the advertising debate takes place. To the extent possible, we need to isolate the effects of factors such as superior quality on consumer behavior from the effects of advertising itself. The biggest impediment to this empirical approach is availability of data - how do we measure and quantify quality, for example?

Another promising avenue of empirical research would be to focus on the relationship between advertising and innovation. As stated earlier, inventive and innovative activities lie at the core of the neoclassical definition of competition. According to the neoclassicals, a firm's innovative success has a significant positive effect on both its performance and advertising. In other words, more innovative firms enjoy higher rates of return as well as advertise more. Park(1990) addresses this issue using time-series data for ninety-two firms and finds mixed evidence. However, this line of empirical research also suffers from serious data problems. Most notably, it is not clear whether there are any variables which can capture innovative success with any reasonable level of accuracy.

Underlying the differing philosophies over the effects of advertising and the meaning of competition are widely divergent philosophies over the following key question - what makes brands and firms succeed or fail? Or, what amounts to the same, why do consumers prefer certain brands and products over others? The two schools of thought vary enormously how they answer these questions. Traditionalists tend to be much more pessimistic than neoclassicals on whether firms succeed and consumers choose for the right reasons. Large, well-established firms succeed largely by using various differential advantages over their smaller rivals and using their dominant market positions to exploit consumers. Manipulating defenseless consumers through advertising is an integral element of this socially undesirable process. On the hand, neoclassicals believe whether a firm succeeds or fails depends largely on how well it satisfies rational consumers with independent tastes. Innovation in particular plays a decisive role. Advertising promotes such socially desirable success by helping

to break the barrier of consumer ignorance. Again, an empirical research program for investigating how advertising works would be of immense value in the important task of evaluating whether firms do well by hindering or promoting social welfare.

Finally, the differences between the traditionalists and neoclassicals outlined in this paper suggest that the two schools of thought also differ sharply with respect to their views on the economic role of the government. Not surprisingly, traditionalists generally advocate at least some regulation of advertising, in order to prevent the producers from psychologically exploiting vulnerable consumers. At a broader level, the traditionalists tend to favor an active competition or antitrust policy; concentration of economic power in a relatively few large firms would be the inevitable result of a passive policy and such concentration would be socially undesirable since the winners would have won not on the basis of consumer approval but due to various market imperfections, such as better access to the capital markets and advertising resources. By contrast, neoclassicals generally argue against regulating economic activities, including advertising. They attribute whatever concentration of economic power which occurs in the economy not to any market imperfections which favor certain producers over others but to rational consumers' choosing those producers who best provide what they need and want. Advertising, by enlightening consumers with knowledge, particularly about new goods and services, facilitates the exercise of consumer sovereignty. For the neoclassicals, the only activity which needs to be regulated is government regulation itself. The two schools of thought on competition have clearly led to polar opposite viewpoints on advertising policy, competition policy and more generally, the proper role of government in the economy.

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