Foundation Course in Managerial Economics

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Lecture - 33
Monopolistic Competition - Advertising

Welcome to the final module of our discussion on monopolistic competition. We have looked at how the monopolistic competitive firm decides its level of output and prices and we have looked at the welfare implications or efficiency implication of a monopolistic competitive market output and we have discussed a lot about product differentiation and how does the firm differentiate between its products.

We said that the firm can create slightly different products. We took the example of the toothpaste or one can imagine say candy, ball pens etc. so the products are different but at the end of the day they are basically the same products. So the firms basically keep on striving to make their products different from other products available in the market.

And we said apart from creating different products, marketing, advertising, celebrity endorsement these are other tools by which monopolistic competitive firm creates perceptions in the minds of the consumer. They try to differentiate their product on the basis of these also.

So in this module we are going to discuss about advertising. What happens in case of advertising or brand names are they really helpful? What are their welfare implications on the society? These are some of the interesting things that we are going to discuss in this module. Now before we go on to talking about monopolistic competition let us discuss about the role of advertising in different market structures.

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We already have discussed this once when we introduced market structure. Let us just do a quick recap over here. Advertising helps in shifting the demand curve to the right. So but advertising also increases costs of firms. In competition and monopoly, industry level advertising may be done to shift the overall demand curve of the market to the right.

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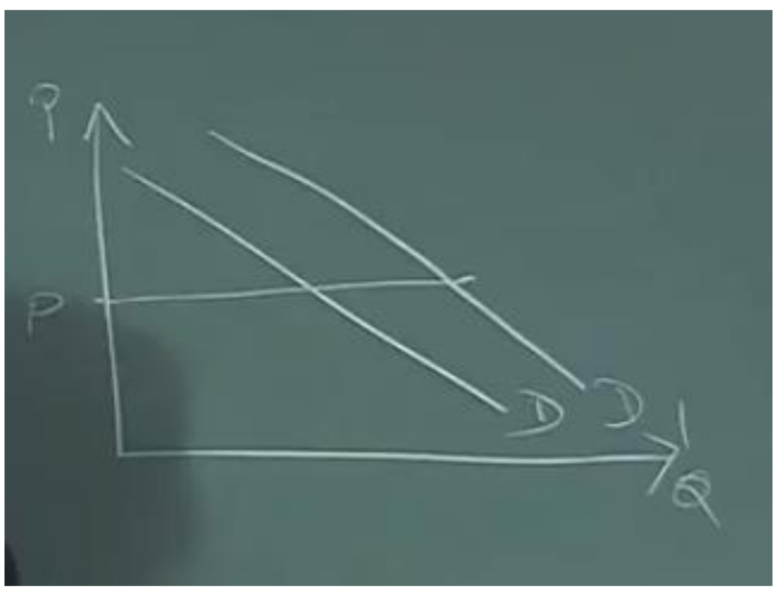

So as we know that so there is a demand curve in the market. So any amount of any advertisement in any kind of market structure what is that going to do? In any kind of market structure any amount of advertisement that is going to increase the demand for the product; so more and more people are going to know about the product. So they will enter the market. They will start wanting the product and hence at the same level of price at the same price more of the product will be demanded and hence the demand curve shifts to the right.

So this is what advertisement does. So advertisement basically shifts the demand curve to the right. However, the advertisement is done by a firm. When a firm does a advertisement it has to incur the cost of the advertisement. So when it incurs the cost of advertisement the cost for the firm goes up.

So there is both a positive and a negative aspect to advertisement for the firm. So the if the firm decides to advertise, its demand for its product is going to increase but if the firm decides to advertise it also has to incur a higher cost. So of the different kinds of market structure in which kind of market structure does it make sense for the firm to advertise?

Now in case of perfect competition where the firms are all selling more or less the same kind of product that is the products are homogenous in the eyes of the consumers. So it does not matter who is selling the milk or who is selling the eggs. To the consumers they are all same. So if one firm decides to advertise so obviously the demand for eggs is going to go up and the demand is going to shift to the right but there is no guarantee that these people are going to buy from this particular firm which has advertised; so obviously no firm in a perfectly competitive market setup is going to advertise.

However, in case of competition in perfect competition one can imagine industry level advertisement. So if there is a industry level advertisement where all the dairies together advertise about milk consumption or all the poultries together they advertise there is a industry level advertisement for eggs. So if you consume eggs it is good for health. So what happens?

The market demand curve shifts to the right and because of which price increases and more and more output product is sold in the market and for some time some period of time the existing firm actually have positive economic profit because firms have gone up because the demand for eggs has gone up. So similar is the case for monopoly.

Now a monopolist need not advertise because it is the single seller in the market and there is the existing buyers are not going to go anywhere else whoever needs this product are going to come to this seller. So it does not really the producer to the producer it is not too much necessary to advertise yet the monopolist may decide to advertise again to increase the or shift the demand curve to the right so that it can charge a higher price and get a higher amount of profit.

Now what is the role of advertisement for the market structures which are in between perfect competition and monopoly and right now we are discussing about monopolistic competition. So in case of monopolistic competition advertisement is of utmost importance. Why is it so important because in case of monopolistic competition the firms are always trying to differentiate their products in the minds of the consumers. Hence advertising is a very powerful tool to create perceptions in the mind of the consumers. So in case of monopolistic competition the firms are going to advertise.

So coming back to the slides, the competitive firm will not engage in advertising since it is a price taker and would not like to increase its cost. In monopolistic competition firm level advertising will be done to differentiate the products. So also in the case of oligopoly with differentiated products. In case of oligopoly say for firms which are selling cars these are differentiated products and it would make sense for the oligopolist to advertise. Now we know so now we know what advertising does to the demand curve in the economy. Now what is the what are the social values of advertisement.

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Now there are various criticism against advertising like the following that advertising increases cost for everyone. So if the firm is advertising to differentiate its product, its cost is going to go up and when its cost goes up it has to charge a higher price to cover that cost. So basically the cost is going up not only for the firm but the consumers also end up paying a higher price.

Advertising have the potential to misrepresent facts and influence people's taste and choices. So this is another criticism against advertisement that like when we said that product differentiation is important we said that whether the products are different or not is not important. What is important is in the minds of the consumers the products should be different and that is what the monopolistic competitive firm is concerned about only.

It is only concerned about creating a perception in the minds of the people that the product is different. So if the same milk is packaged in different ways they can create different kinds of perceptions in the minds of the consumers and that is what is the fundamental criticism against advertisement that basically you are selling the same product but because it has been endorsed by a celebrity or you have a very flashy ad people are willing to pay more for the same product and advertising is anti-competitive as it creates perception of product differentials thus increasing markup over cost.

So the same product which could have been sold at a lower cost now because of advertisement the cost has gone up and the consumers end up paying a higher price for it and people end up paying higher prices for differences which are just notional. So these are the criticisms against advertisement and however there are arguments in defense of advertising.

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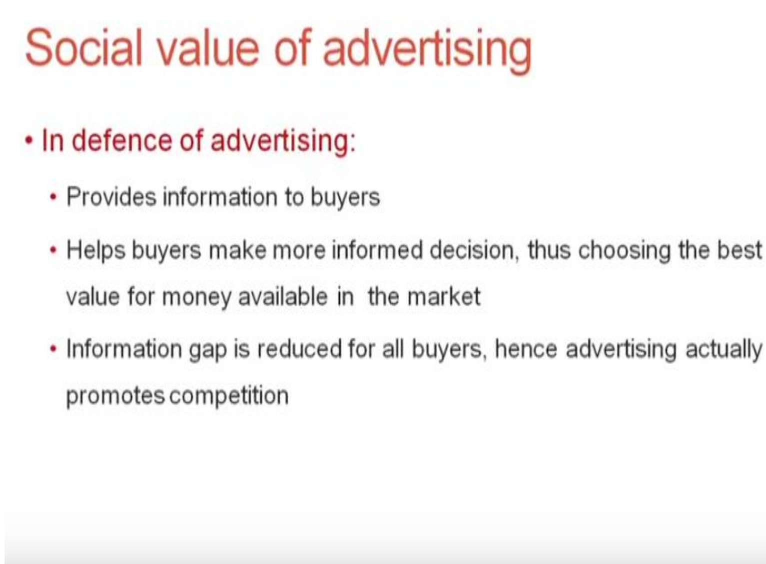

First is that it provides information to buyers. So the same way that the criticism is advertisement creates distortions in information in the minds of the buyers or it misrepresents facts or it creates information asymmetry in the economics through advertisement. In defense of advertisement,

advertisement is a very powerful medium through which information can be disseminated amongst the buyers.

It helps buyers make more informed decision thus choosing the best value for money available in the market. So basically buyers get to know what all are available in the market, at what prices and they get to choose and basically they are able to decide what which of the products gives them the best value for money.

Information gap is reduced for all buyers, hence advertising actually promotes competition. So it is the opposite argument that is provided that since advertisement reduces information gap so it increases competitive environment amongst the sellers in the market or amongst the products in the market so advertisement actually promotes competition.

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Now let us look at a couple of examples about the impact of advertising as has been studied in literature. First we take the example of a case which was this was published in the journal of law and economics and authored by Benham in 1972.

What Benham basically did was he studied the market price for eye glasses in different states of the United States of America. In the USA he studied the price of eye glasses in different markets across different states and price advertising in some of these states was prohibited and in some of these states price advertisement was allowed.

And when Benham studied the prices of eye glasses across these different states he found that price of eye glasses were actually lower in states where there was advertisement and the states which had prohibited advertisement the price of eye glasses were actually higher. So this gives a this is this gives clear evidence that advertisement thus provide information about prices amongst consumers and there it creates a kind of competitive environment for all the sellers in the economy because of which prices go down in the market.

On the other hand if there is in states where there was no advertisement there was probably less information and prices settled at a higher level in these markets. Another example that is given is advertising is a signal of quality. So it is firm’s willingness to spend on ads is a signal to the consumers that it is confident about repeat buyers. So expensive ads indicate that the quality of the product must be good.

So let me take an example of say breakfast cereal. Say there are 2 firms who are coming up with a new variety of breakfast cereal which they are introducing into the market. Now one of the firms is very confident about the quality of the breakfast cereal that it is introducing and it knows that once people start consuming it they there will be repeat buyers of this breakfast cereal because it is so good.

On the other hand there is another seller in the market who have come up with another variety of breakfast cereal and they know that it is it may not be so good and people may not like it and yet since they have already produced it they have to sell it in the market. So what are they going to do? Which of these 2 types of producers is going to spend more on advertisement. So you could probably spend 2 minutes thinking about it which of the 2 sellers is probably going to spend more on advertising their products.

Now the first firm which has developed a very good quantity breakfast cereal who knows that once people start consuming it they are going to buy it repeatedly. It makes sense for this firm to spend more on advertisement because they know that what they spend on advertisement as they rope in or bring if they have a very high quality advertisement or very expensive advertisement it is probably going to bring in more and more consumers for this breakfast cereal and the demand curve is really going to shift to the right and is going to continue. These buyers are going to repeatedly buy the breakfast cereal once they are hooked on to it. So they are going to spend lot of money on advertisement to rope in as much as many consumers as possible.

On the other hand the other firm knows that I have to sell this breakfast cereal first and probably people are not going to buy it again. So it does not make sense for me to spend too much on advertisement or spend too much money on advertisement because in any case there are not going to be probably repeat buyers. So he is not going to put so much money into advertisement. So that means indirectly that means that advertising is a signal of quality. When a consumer sees a high quality advertisement a high expensive, a grand expensive advertisement the it is a signal to the buyer that the firm is confident about its product is confident about the quality of its product and hence the buyer is going to buy it.

On the other hand if the buyer sees a poor quality advertisement or not a very a very budget budgeted advertisement which is not so grand is not so expensive so that kinds of kind of hints the consumer that probably the firm is not too confident about its product hence it is cutting down on advertisement cost.

So expensive ads indicate that the quality of the product must be good. Now this was our discussion on advertisement and very closely following behind the advertisement is another signal in the market which is brand name. Brand name is another signal in the market and and you will understand that brand name itself differentiates the products.

You can have the same jeans probably but having a brand name with the jeans creates a whole lot of difference and sometimes the buyer is willing to pay a much higher price for a branded pair of jeans than a jeans which is not no one knows the name of the company. So brand names in themselves are product differentiators.

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So what is the economics of brand names? Now similar to advertisement you will have the almost similar kinds of arguments in favour of and in defense of brand names so look at looking at the critics of brand names, brand names may create notional differences about products in the minds of consumers. Consumer's willingness to pay higher for brand names is thus irrational. Removal of government protection of trademarks may actually reduce the markup over costs.

So brand names, critic of brand name is as I already gave the example of the jeans it could be probably the almost the same similar quality of jeans but because one has a brand name a tag which the consumers are going to they are almost paying for the tag.

Sometimes few years back I remember there was that there was a case against a very reputed brand of t-shirts. A consumer had actually sued the sued this particular company because the tag or the label of the brand had got ripped off and the consumer basically the customer said that I had paid so much money for the brand name itself and if it is not showing or it is ripped off from the t-shirt then this t-shirt is of no value to me.

So this is the kind of impact that the brand name creates and basically it creates a notional difference about products in the minds of the consumer. So basically the cost is the same but the producer the buyer ends up paying a much higher markup over cost because of the brand name. So removal of any protection of trademarks etc. may actually reduce the markup over costs.

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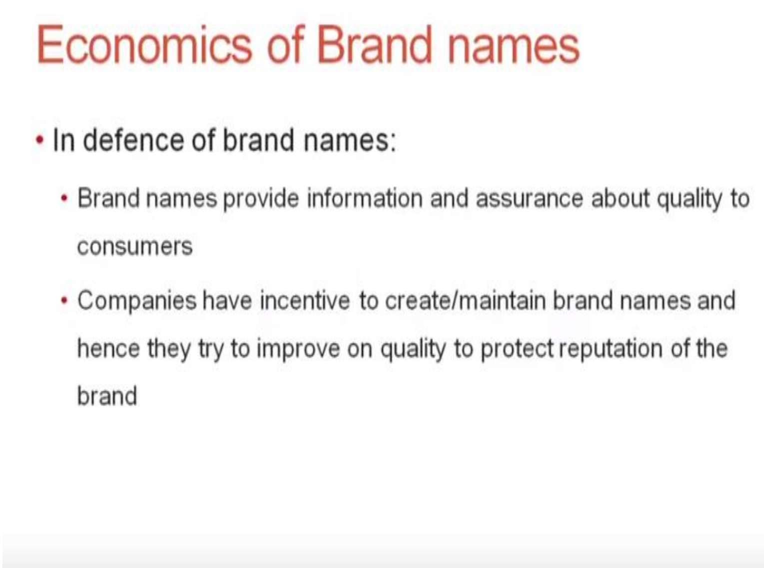

Now in defense of brand names, brand names provide information and assurance about quality to consumers. Companies have incentive to create or maintain brand names and hence they try to improve on quality to protect reputation of the brand. So similar to advertisement brand names provide information and assurance about quality to consumers because the brand name is established. So it is kind of assurance to the consumers that whatever the brand is claiming or the company is claiming that is true and it kinds of kind of assures the consumer and this assurance is what the consumer is paying the money for.

And since the brand name has its impact of product differentiation so all the companies have incentive to create or maintain the brand names and to try to create or maintain brand names they try to improve on the quality and to protect the reputation of the brand they will keep on improving the quality or the product that they are offering in the market and that is the kind of assurance that brand name provides to the consumers.

So to retain the reputation of a brand the quality is assured by the company and that assurance is the markup over the cost that the buyer is paying is basically a cost of that assurance or that is the willingness to pay for that assurance if one may one could imagine it that way. So basically we have discussed how the firms can create different kinds of products by making the products different themselves but also they can create notional differences about the products in the minds of consumers through tools like advertisement and brand names.

And we have discussed the pros and cons of advertisement and brand names and there are people there are arguments in favour of advertising and brand names that they uphold the quality of the product the brand name etc. and they provide information and on the other hand there are criticisms against advertisement and brand name in the sense that they create unnecessary differences in the minds of consumers because of which the consumers end up paying a higher price over cost.

So this ends our discussion on monopolistic competition and this discussion on advertisement and brand name is not completely confined to monopolistic competition. It holds true for any market structure but since in monopolistic competition advertisement and brand name plays a huge role so I included it in the discussion on monopolistic competition and basically monopolistic competition is the example of monopolistic competition is the maximum that we are going to find around us.

Most of the market most of the products operate in monopolistic competitive market framework or market structure and we see lot of product differentiation that happens all around us. Different firms are trying to create different kinds of products so different ways of product differentiation and because of which at the end of the day each of these small firms which are catering to a clientele of their differentiated product.

So each of these firms end up producing at excess capacity and hence it is not a perfectly efficient outcome as in the case of perfectly competitive market but nevertheless it is a better situation than monopoly outcome where the firm gets, firm basically ends up making supernormal profit. It makes a more than a positive economic profit while in the case of monopolistic competition the firms at least earn only zero economic profit in the long run.

They charge a price which is equal to their average cost and not more than their average cost although the markup is still there because of the excess capacity that is existing in the case of monopolistic competition and however monopolistic competition is better in a in the sense that in monopolistic competition the consumers get a whole variety of choices to choose from.

They get a whole variety of differentiated products which make them better off. So even if the difference is notional in the minds of the consumers but still it is providing some utility to the consumer when he is buying a soap which is better packaged than any other soap no matter not mattering that the soap may be same in the 2 packages.

Yet the utility or satisfaction or the pleasure that the consumer is getting from buying a better packaged soap or the utility that the consumer is getting from buying a product which has been advertised by his favourite celebrity that also nevertheless improves the consumer surplus of the different consumers in the market and creates more and more product differentiation; creates more and more varieties of products to choose from for the consumers. Hence monopolistic competition is probably provides a more interesting market scenario to the consumers than the perfect competition. Thank you.