Department of Justice

ADVERTISING AND COMPETITION

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ADVERTISING AND COMPETITION

Although there are many aspects of advertising that deserve critical study, I should like to discuss briefly today the question of whether advertising and similar promotional effort is likely to enhance the growth of monopoly in our economy. As we all know, the protection and promotion of a competitive economy is one of our basic governmental policies, and one which we believe to be eminently sound. It is therefore quite appropriate to ask whether advertising hinders in any significant way the achievement of competitive goals; and, if it does hinder in one or more respects, what public corrective policies might be appropriate.

Let me begin with an obvious point. Advertising provides economic benefits to society, benefits which lie chiefly in providing highly useful information. In a complex and varied economy such as ours, new firms are constantly entering into production, new products are constantly being introduced, and old products improved. Some means are required, therefore, to insure that potential customers are made aware of these new alternatives. Greater information, by widening market areas and bringing buyers into contact with sellers, increases competition. We all recognize that competition requires some degree of information regarding the alternatives which are available as among competing buyers and competing sellers, and thus more information is likely to promote and facilitate the functioning of a competitive market.

Nevertheless, while advertising provides gains to society in the form of expanded information about firms and products, we need to consider, also, the nature of the costs which exist and how these are likely to balance with potential gains. All economic activities involve some cost in that they are associated with the using up of resources. This applies as much to the production of advertising messages as to the production of automobiles. Whether in some industries advertising costs are excessive in relation to what we get out of them is an important and difficult question. But my primary concern today is the relation of advertising to competition and monopoly power, and it is to this question that I now turn.

There is no doubt that advertising efforts comprise an important form of rivalry among firms. Whether what appears on the TV commercial is a pretty girl, soft music, or demonstration, the advertiser's message usually is that one product is better than another. At the same time on another channel, or on the same channel at another time, someone else is likely to be inviting listeners to "move up" to a competing product. This is competition of a kind. We should recognize, however, that this form of rivalry is likely to be considerably different in economic effect from those forms of competition which are concerned with the prices established in the market, and the possibility at least exists that the former may be at the expense of the latter.

Advertising outlays affect not only the rivalry which exists among established firms, but also they are likely to have an important influence on conditions affecting the entry of new firms into the marketplace. While consumers may not accept the view that one product is better than another simply because a pretty girl or a famous person says so, they at least are introduced to the names of specific firms and products, and this tends to distinguish established products from those produced by small firms and new ones. What has become important is not so much the context of an advertising message, but rather the mere fact that it has been advertised. Thus, we note the frequent description of a product as "advertised in Life."

This is not to say that consumers are irrational - although they sometimes are - or that it does not make good sense to choose an established and well-known product over one which is unknown. In many cases, there is considerably uncertainty as to the relative merit of alternative products. When a consumer, therefore, decides to buy an established brand rather than a cheaper but unknown product, he may simply be doing his best to cope with the problem of uncertainty and to minimize the risks to him that the product will not do the job for which he is buying it. Because of this quite expectable behavior, a new entrant typically is likely to be compelled to sell at a price below that of established brands or else incur heavy selling costs in penetrating the market. This helps to explain the phenomenon of unbranded products which sell at prices substantially below those of heavily advertised products, even where there is little real difference between them.

To an extent, the increased barrier to entry created by advertising is a price we have to pay for providing consumers with information. But when heavy advertising and other promotional expenditures create durable preferences going beyond the relative superiority of the product, resistent to anything but major countervailing promotional campaigns, we may well question whether the price has not become too high. If heavy advertising expenditures thus serve to raise the barriers to entry, the adverse competitive consequences are important not only because new firms are kept out, but also because frequently it is the prospect of new entry which serves as a major competitive restraint upon the actions of existing firms. Moreover, where the numbers of firms in an industry are few, this potentiality may be the most significant competitive factor that inhibits firms from setting high prices and achieving extensive monopoly rewards.

Traditional antitrust policy has repeatedly stressed the relationship between the conditions of entry and the existence of monopoly results. It is specifically on this basis that a number of business practices have been attacked as imposing unacceptable restraints on competition. We should hardly be unconcerned if heavy advertising outlays lead both to more concentrated market structures and to the establishment of high monopolistic prices, and it seems clear that they can and do.

A recent study of consumer goods industries found a significant correlation between the proportion of industry sales devoted to advertising and the average profit rates which were earned. Industries with high advertising outlays tended to earn profit rates which were about 50% higher than those which did not undertake a significant effort. Since, moreover, average profit rates in this study reached nearly 8% after taxes on stockholders' equity, it is likely that these additional gains represent monopoly rewards. They represent price levels which can be explained only on the basis of restrictions on competition.

Let me refer you to some more interesting statistics. We all know that the packaged soap industry tends to be highly concentrated. In 1958, for example, the largest four firms accounted for 74% of total industry shipments and the largest eight firms, 85%. This refers specifically to packaged soaps which are sold to consumers and tend to be heavily advertised. In the case of bulk soaps, however, the picture is quite different. The largest four firms accounted for only 30% of industry output, and the largest eight firms only 45%.[1] Bulk soaps tend to be sold to institutions or businesses and we should not expect to find them advertised as heavily because business customers are much better informed as to product quality and much less vulnerable to the kind of blandishments that seem to influence the average housewife.

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1 / Subcommittee on Antitrust and Monopoly, Concentration Ratios in Manufacturing Industry, 1958, p. 132.

In the case of detergents, the picture is similar. The largest four firms in packaged detergents account for 90% of output, while the largest four firms in bulk detergents account for only 47%.[2] While there may be many factors which are responsible for these differences, it is not unreasonable to suspect that the size of advertising outlays is an important one.

For heavy advertising expenditures may promote industrial concentration in a number of ways. In a competitive industry we normally expect to find firms entering and leaving the market during any given period of time. Although the exit of firms will continue, entry will be made more difficult as a result of the barriers created through extensive advertising. To the extent that consumers are unable to evaluate the relative merits of competing products, the established products may have a considerable advantage and it is this advantage that advertising messages tends to accentuate. High entry barriers interfere with the normal process through which increases in demand are met at least in part by new firms.

A further significant factor is the existence of economies of scale in advertising and other forms of promotion. To the extent that larger firms can provide more messages per dollar than their smaller

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2 / Ibid.

rivals, they will have a strong competitive advantage, and this will be so even if smaller firms spend proportionately as much. Economies of this sort lead directly to the expansion of larger firms relative to their smaller rivals and thereby to more concentrated market structures. These advantages, moreover, may be held not only by firms which have a large share of specific markets, but also by those who deal on a nationwide basis in a number of related product areas.

It is in this respect that the quantity discounts given by television networks raise serious questions. While these discounts may in part represent real cost savings, I believe it highly doubtful that the savings should be passed along to purchasers of television time. If the discounts have the effect of accentuating the growth of larger firms and of promoting a tendency toward concentrated market structures throughout consumer goods industries, it may well be appropriate public policy to prohibit or at least drastically limit them, even if this means higher network profit margins for large purchasers than for small.

While I have been considering the general aspects of this problem, I should like to note briefly the competitive effects of advertising in a specific industrial situation, that of the prescription drug industry. As most of you probably know, this is an industry which earns very high rates of return, in many years approximately double the average profit rate in all manufacturing. In 1964, for example, the average rate of return after taxes for 12 major pharmaceutical firms came to nearly 19%.[3/] Firms in this industry tend to spend large sums on advertising and other forms of selling and promotion. In Senate Committee hearings on the Drug Industry, the Committee found that major pharmaceutical firms spend on average nearly 25% of total sales revenues on selling, which is about four times the amount allocated to research.[4/] It seems unlikely that these expenditures would be made if they did not play an important profit-making role; it is plausible that they have been a major factor, though of course not the only one, in the achievement of very high returns.

Even when small firms have developed a new product and the patent needed to protect it, they are likely to find it difficult to get

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3/ Federal Trade Commission, Report on Rates of Return for Identical Companies in Selected Manufacturing Industries, 1955-1964.

4/ Subcommittee on Antitrust and Monopoly, Report on Administered Prices in the Drug Industry, 87th Cong., 1st Sess., 1961, p. 31.

doctors to use it. Doctors are like the rest of us, and where there is a high degree of uncertainty about the relative merits of competing drugs, they tend to use the drug which is most familiar. And this frequently means those drugs which have been most heavily advertised and promoted. Doctors are swamped by the outlays of established firms - as Dr. Goddard recently described it, they are "under siege." Their prescribing patterns are undoubtedly affected. While this process may have many effects, an important one appears to be adverse effects on competition: high profits have not led to extensive entry and to competitive price reductions.

What are the most appropriate methods of dealing with such problems? There is some room for dealing with the adverse consequences of heavy advertising and other promotional expenditures within the confines of antitrust law. I have already suggested elsewhere that if it should be deemed appropriate to permit mergers of a particular kind to be defended on the ground that they promote substantial economies of scale, the defense should not extend to promotional economies.

I would also suggest that it would be quite appropriate to impose, for a period of time, an absolute or percentage limitation on promotional expenditures by a firm or firms that have obtained undue market power through violations of the Sherman Act. A classic purpose of a remedial decree in such cases is to dissipate the consequences of unlawful acts, and if limitations on promotional expenditures would help, they are appropriate even though the promotional expenditures as such were and are lawful.

There may be other corrective measures which can be developed under antitrust law, but as of now I believe the most effective remedies are along other lines. One avenue is an expansion of the law on false and misleading advertising. While this may make some contribution, however, regulation of this sort involves terribly difficult problems. Without necessarily subscribing entirely to his pessimism, I believe Professor Johnson has aptly described the difficulties:

> ... The really difficult problem is the omission or concealment of relevant information, such as that though it tastes good it will kill you several years before your time, or that it makes no noise because it is designed to use considerably more electricity and wearsout faster than rival models. Problems of this sort have become especially acute in modern times, in consequence of advancing medical knowledge and the increasing technical complexity of consumer goods, especially those containing machinery, which make it difficult for the consumer even to know what characteristics of a product are important to his welfare. But governmental control or censorship of advertising does

> not seem likely to be very effective in overcoming this type of deception, because the government cannot readily force advertisers to advertise the defects of their products, and forbidding one type of appeal may simply cause it to be replaced by another of an equally undesirable sort. In the United States, for example, the prohibition of cigarette advertising stressing cancer-risk-reducing qualities has simply led cigarette advertisers to adopt campaigns that insidiously encourage youngsters to smoke. Moreover, government intervention in advertising aimed at preventing misleading appeals ought in fairness to apply also to the alternative of personal selling, and this seems an impossible undertaking. 5/

As Professor Johnson and others have suggested, I believe the most promising approach is to introduce new sources of consumer information. It is the extent of uncertainty about therelative merits of competing products which contributes to the large effect of advertising, and this suggests that Government policies be directed toward neutral vehicles of information which tend to deal directly with the uncertainty. We all know that such consumer research organizations as Consumer Reports tend to promote informed consumer judgment, and we can reasonably surmise that reports of that kind, if generally circulated, would significantly limit the ability of advertising to enhance degrees of monopoly power, to say nothing of enabling consumers to spend

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5/ Harry G. Johnson, The Canadian Quandary, pp. 283-284.

their dollars more fruitfully. A similar service exists for physicians in the form of the Medical Letter, which is published by a group of physicians, and designed to supply technical information about the therapeutic value of new drugs. In both of these areas, a major difficulty is that these publications are produced by non-profit organizations and that they frequently face difficulties in obtaining the funds required for adequate testing and evaluation. One prospective solution would be governmental efforts in this direction, either direct government evaluation and publication, or financial support for private organizations of this type. In the case of drugs, for example, there is much to be said for providing government funds to the organization which publishes the Medical Letter so that its publications may be supplied free to all doctors. In addition, the letter could be expanded to insure that doctors receive their first information about a new drug from this source rather than from the lips of a detail man.

Let me sum up. Advertising often plays a role analogous to that played by market concentration. We have taken a dim view of excessive concentration precisely because it leads to monopoly results, and this is a major element of the rationale which underlies the laws prohibiting anticompetitive mergers. Current policies which tend to emphasize the role played by concentration may well need to be supplemented by those concerned directly with the adverse influences of advertising and other promotional efforts on competition. We should begin to consider seriously how best we might promote and develop other methods of supplying information to consumers - methods which would give the consumer much better and more useful information than he now gets and at lower social cost; which would thus decrease the impact, profitability, and amount of private advertising expenditures; and which would consequently improve competition in many industries by lowering barriers to entry.