Does advertising increase consumer prices?

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ADVERTISING ASSOCIATION

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The advertising industry has an awkward relationship with price. We rarely set price objectives with our clients – let alone celebrate price effects – although our industry's own studies conclude that this is the very basis of profitable long-term returns for an advertiser.[1]

We are, perhaps understandably, uncomfortable rather than surefooted in the whole area of advertising and prices. The prosaic conclusion of 'the man in the street' and of many commentators and even policymakers – that advertising puts prices up, if only to pay for the cost of the activity itself – is accepted without argument.

In reality, as we shall see, advertising's relationship with price – and prices, more generally – is more nuanced than it might appear to be on first inspection. There are concrete arguments to be made that advertising serves to both increase *and* reduce prices, depending on our chosen lens (whether we see advertising as a 'persuasive' activity or merely an 'informative' one), and whether we are looking at this activity at a general or advertiser-specific level.

Wearing our strategy and effectiveness hats, the industry should be wrapping its arms more materially around its own findings. Price should be understood as something that advertising can influence – as one of the most commercially powerful levers it can pull – rather than just a separate, standalone variable in the marketing mix. By supporting pricing levels, we can create more profitable returns for our clients from their advertising activity.

It is equally legitimate to claim, however, that in many other ways advertising serves to *lower* prices. Advertising can and does promote more competitive pricing across a category, most obviously among retailers or on behalf of individual market players. It acts as a guarantor of demand and so contributes to economies of scale, which then benefit consumers in the form of lower prices or more rapid innovation. By doing so, advertising works – at its grandest – systemically to oil the engine of capitalism. And as markets and advertising budgets continue to migrate online, this downward influence on price seems increasingly obvious.

Furthermore, advertising funds or co-funds much of our media consumption: consumption that we would otherwise bear the full cost of as consumers.

[1] Binet, L. and Field, P. (2015). *The Long and the Short of It: Balancing Short and Long-Term Marketing Strategies.* London: IPA.

That these apparently contradictory findings can be reconciled is not an authorial sleight of hand; first of all, this is because we can and should draw a line between *relative* pricing (that is, the pricing one market player can achieve versus another, which advertising can demonstrably influence, at least on occasion) and *absolute* pricing at a market level, where the case 'against advertising' is far from clear-cut.

Secondly, this is because, as pointed out earlier in this publication,[2] the very term 'advertising' can be so misleading – as a collective noun comprising the competitive and often contrary actions of so many agents, in so many different categories – that it would be simplistic to advance a 'one-size-fits-all' answer to the question of advertising's relationship with price.

Indeed, in the 35 years since the Advertising Association first tackled the relationship between advertising and price,[3] much diligent academic work has been carried out at both a macro and micro level. A short 'primer' such as this can only hope to call out the most salient of their arguments and reach a working conclusion.

Advertising puts prices up

Let us first contemplate the business 'case for' and the social 'case against' advertising: that it puts prices up.

At its most basic, the cost of advertising – like all other corporate business building activities – must be borne by someone in the buying chain, most obviously in the form of reduced profits for the advertiser, unless this cost is passed on in the form of higher prices to the consumer (although even this is a gross simplification, as we shall see).

Sizing the effect

Working backwards from average, long-run advertising spend-to-sales ratios (and allowing also for retailer margin), Professor John Philip Jones of Syracuse University concluded that advertising's share of consumer price approximates to four pence in the pound.[4]

This, if you like, is the 'brand tax' referenced by some commentators, albeit a levy that is actually far less than most consumers themselves estimate and, even then, is of tangible value to them as a basic guarantor of quality.

For goods and services that are sold indirectly, however, even this simple premise – that advertising puts prices up because it is a cost that must be passed on to the consumer – is not as straightforward as it first appears, not least because an underlying motivation of much consumer advertising is to achieve better trading terms with the retail 'middleman'. That retailer's inclination or ability to pass any price increase on to the consumer will hinge, in turn, on the competitiveness and transparency of their market. It is quite common, therefore, for advertising to transfer margin back from retailer to manufacturer, and for the consumer price to remain unchanged.[5]

A more sophisticated argument

A more sophisticated argument supporting the case that advertising puts prices up is that it shifts the demand curve, translating into 'more sales at the same price, or the same sales at a higher price, or (more rarely) greater sales at a higher price'.[6]

[2] Bullmore, J. J. D. (2016). *What is advertising?* The Advertising Association.
[3] Littlechild, S. (1982). *Relationship Between Advertising And Price*. Economics Committee for the Advertising Association.
[4] Jones, J. P. (2014). The Economic Effects of Advertising. In: H. Cheng (ed.) *The Handbook of International Advertising Research*. Hoboken, NJ: John Wiley & Sons Inc.
[5] The so-called Steiner Effect, confirmed by Reekie's work for the Advertising Association. Reekie, W. D. (1979). *Advertising and Price*. Economics Committee for the Advertising Association.
[6] Jones, *The Economic Effects of Advertising*.

The 'sales' half of this equation has long had the lion's share of the advertising industry's attention, not least because it is often more quickly visible than any price effects (which tend to accrue to the advertised brand over time, rather than immediately). Sales effects also, of course, conform to our 'folk wisdom' of how advertising works, as expertly unpicked by Paul Feldwick earlier in this publication.[7] So, most advertising is still typically undertaken to 'sell more' than to 'sell the same at a higher price', even though it may not just be *easier* to do the latter (because you don't have to steal share), but also more *profitable* (because price effects incur no 'cost of sales' and so fall straight to the bottom line).[8]

It's a surprising blind spot for our industry. After all, as management legend Peter Drucker once noted, "If you can't charge a premium price for your product then you don't have a brand!".

Under this latter model – 'sell the same at a higher price' – advertising is used to make a brand less price-elastic, less 'commoditised' if you like. Very few advertisers set out with this explicit intention (only 7% of Effectiveness Award winners from the IPA cite price support as a primary objective, compared to 65% who cite sales growth),[9] but it is precisely these price effects that create a superior long-term return for the most successful advertisers, as demonstrated in Les Binet and Peter Field's review of the IPA's Databank, *The Long and the Short of It*.[10] Drawing on data sourced from hundreds of effectiveness case studies, Binet and Field found definitively that "Reducing price sensitivity is more profitable than increasing volume. The most profitable campaigns support volume *and* price" (the authors cite campaigns and brands as diverse as Land Rover, easyJet and Fairy liquid as evidence of this 'win–win' effect).

In his less heroically broad, but nonetheless impressive, contribution to the advertising and price canon, Charles Young of Ameritest starts from a similar premise: 'The ability to charge premium prices is the reason why businesses that own brands are generally more profitable than businesses that do not.'[11] Their higher returns on investment (ROIs) in turn then become the future source of advertising funding.

Young then goes on to tease out the different price expectations created by 11 different Tylenol commercials pretested by his company in the US, demonstrating a variation of 18% across them (from $4.05 to $4.81). Noting as an aside that rational information was less strongly correlated to price expectation than any emotional component (in line with Binet and Field's own findings), he concludes: 'By overlooking advertising's role in supporting premium pricing, and the corresponding contribution it can make in support of higher profit margins, advertisers run the risk of underestimating the return they can make on their advertising investment.'[12]

So, although it is rarely deliberately deployed to do so, we must conclude that advertising *can* support pricing at an individual brand level.

[7] Feldwick, P. (2016). *How does advertising work?* The Advertising Association
[8] It is perhaps surprising that so many advertisers in mature markets still insist on setting volume growth targets, which by definition not every brand can achieve. Such is the tyrannical grip of growth on the corporate imagination!
[9] IPA Effectiveness Awards Case Studies. Available at: http://www.ipa.co.uk/effectiveness/case-studies.
[10] Binet and Field, *The Long and the Short of It*.
[11] Young, C. (2012). Price impact: The Advertising Premium. *Admap*. London: Warc.
[12] Ibid.

Advertising brings prices down

Let us now inspect the opposite case: that advertising actually *reduces* prices – an outcome that we might caricature as 'social good'. There is a case to be made, however, that prices that are *too* low can imperil good business practice (for example, in the area of sourcing; see Tesco's travails of a few years ago)[13] and perhaps even company or market fortunes.

Funding our media consumption

Let us start again with an irrefutable truth: by co-funding much of the content we consume, advertising at the very least brings down the price of the media we use. Although taken for granted as a kind of 'invisible contract' between media owner and audience, advertising revenue has long been the reason we can consume commercial TV and commercial radio for free and our 'paid-for' newspapers and magazines at a steeply discounted rate.

More recently, and perhaps more opaquely, advertising income – or at least the future prospect of income – also explains why services like Google, Facebook and Instagram are free at point of use. Deloitte estimated this 'transfer cost' from consumer to advertiser to be in the region of £10 billion per annum.[14]

Encouraging price competition

Just as we saw previously, however, there are also more straightforward ways in which advertising serves to bring prices down. At its most basic, price is a powerful competitive tool. Companies communicate their prices via advertising, to the benefit of both brand and consumers (if low prices are not communicated, they simply reward existing customers without attracting new ones, reducing the incentive to compete on price). So, at an individual advertiser and even market level, advertising's *informational* role serves to make prices transparent and competitive; consider the grocery retail wars or even the standalone price advertising of brands such as McDonald's or the 'never knowingly undersold' John Lewis.

Advertisers have always had substantial advertising budgets to assert their price competitiveness. The newsbrands marketing agency Newsworks estimates that approximately half of newspaper advertising revenue is dedicated to price campaigns.[15] The tectonic shift of the last few years towards online advertising – in all its forms, and with its inherent action bias – has, if anything, compounded this tendency for advertising to be used at least in part as a 'price shout', and for the *overall* impact of advertising at a market level therefore to be to keep prices both honest and low.

Less obviously…

Jones highlights two other broader, less visible ways in which advertising keeps prices down: its contribution to economies of scale, and to the reduction of 'search costs'.

The first of these he retraces as far back as Adam Smith, a pioneer of economics, and his ground-breaking appreciation that 'the incentive to produce on a large scale only existed if there was a ready market for the output'.[16] Large scale, of course, in turn allows for lower prices.

This predictability of demand is a critical 'hidden benefit' for advertisers (and for the consumer, who enjoys the consequential pricing, quality and innovation upside), and is at odds with the popular misconception that its main contribution is to create short-term sales spikes. As Feldwick has noted: "Much advertising does not fit this pattern (of short paybacks for incremental sales) and is no less 'effective' for all that."[17]

Search costs – that is, the costs borne by the consumer in order to compare their options in any market, especially highly priced ones – have also existed for centuries, but these have collapsed in recent years with the advent of the Internet and the ready 'read across' provided, for example, by price comparison sites. This collapse has been advanced not just by the promotion of those services but by its newly exaggerated informational role more generally. See www.comparethemarket.com and/or www.moneysupermarket.com for more details.

The net effect of advertising on prices

In the end, then, we must conclude that advertising's effect on prices – whether for a particular brand, category or overall market – is the delta between the upward and downward effects it *simultaneously* creates, and between the 'persuasive' claims of any one brand to be 'worth paying more for' and advertising's informative role as 'market-maker' more generally. Advertising's price effects cannot easily be disentangled, nor generalised. An individual advertiser might use advertising either to support a price premium or, conversely, to shout about their low prices, or price matching. And it would seem that the ongoing shift to digital is – for now at least – ushering in more price comparison than 'brand advantage' campaigning.

Changing our lens

Stepping back from the question that has been set and asking ourselves 'What influences consumer prices?', rather than 'Does advertising increase prices?', inclines us to believe that advertising has a beneficial effect on pricing at an overall level. Price levels are largely set by the degree to which a market is monopolistic, and advertising tends to encourage competitive oligopoly, with pricing transparent and comparable.

And so we conclude – at this point in the cycle at least – that the overall effect of advertising on price levels, in most markets and for the economy as a whole, is likely to be to reduce prices, even if it can advance an individual advertiser's price point or resilience. In short, advertising can increase the price paid for an iPhone but not for mobile phones more generally – it increases the prices of brands, that is, rather than of markets – in much the same way as it tends to impact on brand share rather than market size.[18]

Want to read more? Stephen Littlechild's original work can be found here

https://goo.gl/BBZ1yx

[13] Butler, S. (2016). Tesco delayed payments to suppliers to boost profits, watchdog finds. *The Guardian*. Available at: https://www.theguardian.com/business/2016/jan/26/tesco-ordered-change-deal-suppliers.

[14] Advertising Association/Deloitte (2015). *Advertising Pays 3: The value of advertising to the UK's culture, media and sport*.

[15] Newsworks. Available at: http://www.newsworks.org.uk/Facts-Figures.

[16] Jones, *The Economic Effects of Advertising*.

[17] Feldwick, P. (1988). *Advertising works 5: papers from the IPA Advertising Effectiveness Awards*. London: IPA.

[18] A full bibliography is available at www.adassoc.org.uk/publications/advertisings-big-questions.

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Laurence is a Founding Partner of strategic creative agency 101 and was previously Co-Founder and Chairman of Fallon London, twice named *Campaign* magazine's 'Agency of the Year'. He has worked on some of the world's most famous brands and campaigns, from Stella Artois to Coca-Cola, Cadbury, Sony, the BBC and Skoda.

Laurence is a Fellow of the IPA, a member of its Effectiveness board and an IPA Effectiveness Hall-of-Famer. An advertising columnist for the *Sunday Telegraph*, as well as *Campaign*, he has edited two books on marketing best practice. Laurence was the only agency strategist named in the Financial Times' Creative Business Top 50, was a founding member of c&binet (the Department for Culture, Media & Sport's creative industries think tank) and a founding trustee of the Marketing Academy (the not-for-profit marketing leadership mentoring organisation).

Married with three daughters, he is a Trustee of Somerset House, Chairman of the British Independent Film Awards and a keen marathon runner.