

3.2: Economic Effects of Advertising

LEARNING OBJECTIVES

After studying this section, students should be able to do the following:

1. *Recognize* the key role advertising plays in our economy.
2. *Discuss* the economic rationale for creating, accepting, and using advertising.

Advertising Is a Major Industry

Advertising supports the core principles that shaped our nation: free speech, competition, and democracy. Since colonial times, advertising has provided a source of vital information about our open, market-based economy. Two Nobel Laureates in economics, Dr. Kenneth Arrow and the late Dr. George Stigler, praise the value of advertising: “Advertising is a powerful tool of competition. It provides valuable information about products and services in an efficient and cost-effective manner. In this way, advertising helps the economy to function smoothly—it keeps prices low and facilitates the entry of new products and new firms into the market.”

U.S. advertising accounts for about 2.5 percent of the country’s \$14 trillion gross national product. American consumers rely heavily on advertising to influence how they spend some \$9 trillion annually on various goods and services. A 1999 study by one of the country’s premier econometric modeling firms, the WEFA Group, and Nobel Laureate in economics Dr. Lawrence R. Klein further underscored this economic impact. The study found that advertising played a key role in generating 18.2 million of the 126.7 million jobs in the United States in that year. The report further concluded that advertising expenditures contributed between 12 and 16 percent of private sector revenues throughout the country, in rural as well as urban areas.

A later study, conducted in 2005 by the financial analysis firm Global Insight, demonstrated that advertising helps to generate more than \$5.2 trillion in sales and economic activity throughout the U.S. economy annually. That represents 20 percent of the nation’s \$25.5 trillion in total economic activity. This economic stimulus provided support throughout the economy for more than twenty-one million jobs, or 15.2 percent of the U.S. workforce. The purpose of the study was to quantify the economic and employment impacts of advertising. The study removed intervening effects (like consumers simply buying a product to replace an old one or a depleted one) to measure the role of advertising itself.

Advertising plays a strong role in the economy:

- It provides useful information to consumers that tells them about product and service choices, as well as comparing features, benefits, and prices. With more complete information, consumers and businesses often choose to purchase additional products and services.
- It “causes an economic chain reaction that (a) generates a net gain in direct sales and jobs due to the promotion of the industries’ products and services, (b) generates indirect sales and jobs among the first level suppliers to the industries that incur the advertising expenditures, and (c) generates indirect sales and jobs among all other levels of economic activity as the sales ripple throughout the economy.”

Advertising also plays a significant role in the business cycle. As the broader economy shifts between periods of growth and recession, advertising shifts its focus. During downturns, like the one we’re in now, ads may focus on the price of a product or service. If one company curtails advertising in order to cut costs during a downturn, another company might boost ad spending to grab customers and grow its market share. Advertising helps stimulate economic growth. In a country in which consumer spending determines the future of the economy, advertising motivates people to spend more. By encouraging more buying, advertising promotes both job growth and productivity growth both to help meet increased demand and to enable each consumer to have more to spend.

Economic Rationale to Create Advertising

Companies spend money on advertising because it increases sales of existing products, helps grow adoption of new products, builds brand loyalty, and takes sales away from competitors. Although the exact return on investment (ROI) varies tremendously across industries, companies, campaigns, and media channels, studies have found that a dollar spent on advertising returns \$3–20 in additional sales. To compete and grow in today’s diverse, ever-changing marketplace, businesses must reach their target customers efficiently, quickly alerting them to new product introductions, improved product designs, and competitive price points. Advertising is by far the most efficient way to communicate such information.

Economic Rationale to Accept Advertising

The economics of advertising extends to the media channels that depend on advertising revenues. Many forms of advertising support the creation of content and make that content available at a much lower price (or free). For example, roughly 75 percent of the cost of a newspaper is supported by advertising. If newspapers contained no advertising, they would cost four times as much to buy on the newsstand. Broadcast radio and TV rely exclusively on ads—people get news, music, and entertainment for free while advertisers get an audience. Forms of media that the public takes for granted would be extremely expensive to the reader or viewer or would simply be out of business without the revenues advertising produces. The demand created by advertising helps the economy to expand.

Advertising supports the arts. Advertisers need music that calls attention to the brand. Musical artists visit ad agencies to meet with directors of music and pitch songs to them that they can use in ads. They come to agencies because they know that companies spend tens of millions of dollars on media buys. “The major record labels don’t have that kind of money,” says Josh Rabinowitz, senior vice president and director of music at Grey Worldwide. What’s more, “TV ads give you the kind of heavy rotation you can’t get on MTV anymore. In the very near future, some of the best bands will produce jingles.”

For example, Jonny Dubowsky, lead singer and guitarist for Jonny Lives! uses corporate sponsorships to get exposure for his indie band. The band debuted a single on an EA video game and launched a video at nine hundred American Eagle stores. For those with (slightly) different musical tastes, it’s worth noting that “rock star” Barry Manilow wrote advertising jingles before he crossed over to recording songs. His credits include the Band-Aid song (“I am stuck on Band-Aid, cuz Band-Aid’s stuck on me”) and the theme for State Farm insurance (“And like a good neighbor, State Farm is there”).

Economic Rationale to Use Advertising

The perspective called the **economics of information** shows how consumers benefit from viewing advertising. By providing information, advertising reduces consumers’ search costs (time spent looking for products) and reduces disutility (unhappiness or lost value) from picking the wrong products. Advertising performs the following functions:

- *Describing* new products and what they do
- *Alerting* consumers to product availability and purchase locations
- *Showing* consumers what to look for on store shelves
- *Helping* them differentiate among competitive choices
- *Advising* them of pricing information and promotional opportunities
- *Saving consumers money* by encouraging competition that exerts downward pricing pressures

Key Takaway

Advertising is a major industry. It contributes to the economy directly (via the jobs it creates to produce ad messages) but also indirectly as it stimulates demand and provides information about other products and services.

EXERCISES

1. Advertising is “the glue that holds our culture together.” Evaluate this statement and decide whether you are in agreement with it or not. State and defend your position.
2. Describe the economic rationale for creating, accepting, and using advertising.
3. List and describe the six information subjects relevant to consumers that advertising addresses.

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