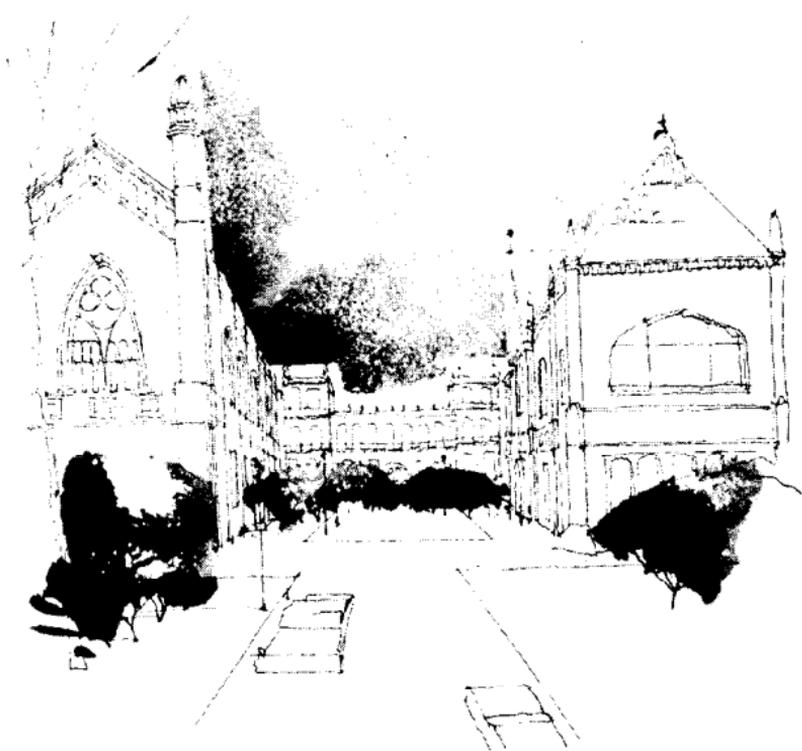


Selected Papers . No. 27

Government and Advertising : The Heavy Hand of Benevolence

By JAMES H. LORIE



**GRADUATE SCHOOL OF BUSINESS
UNIVERSITY OF CHICAGO**

JAMES H. LORIE

tion at the Graduate School of Business of The University of Chicago. He also is Director of the School's Center for Research in Security Prices (sponsored by Merrill Lynch, Pierce, Fenner and Smith Inc.), and is widely known as perhaps the nation's most ardent researcher into the movements and economic determinants of stock prices. Professor Lorie received the A.B. and A.M. degrees from Cornell University, and the Ph.D. degree from The University of Chicago. He has been on the faculty of the Graduate School of Business since 1947, and was for several years Associate Dean. He served as Consultant to the Board of Governors of the Federal Reserve System and as Senior Consultant for Joel Dean Associates, a management consulting firm; and is a director of several business firms. Professor Lorie has written and spoken widely on marketing, consumer spending, and business finance; and currently is preparing manuscript for two volumes on stock market research. This paper, based upon an earlier talk by Professor Lorie to the Grocery Manufacturers of America, was presented at an Executive Program Club Luncheon at the Sherman House, Chicago, October 26, 1967.

Government and Advertising: The Heavy Hand of Benevolence

THE LATE Henry Simons said that “the open season on consumers must be abolished.” He had in mind the disregard of consumer interest by the federal government through interference in free markets by catering to special interests on the farm, in labor unions, and in business. Recently, there has been strong evidence that members of the federal bureaucracy feel that the consumer needs protection not from government, allegedly the consumer’s friend, but from business, presumably the consumer’s enemy.

These views underlie the creation of the Consumer Advisory Council, the President’s Committee on Consumer Interests, the National Commission on Food Marketing, recommendations for legislation on truth in lending, mutual funds, automotive safety and other things, as well as some of the recent pronouncements by Donald Turner on the effects of advertising. The view that the consumer is helpless and a fool and needs protection by a benevolent government was expressed by two members of the staff of the Consumer Advisory Council as follows:

Perhaps the key difference between the consumer interest and every other special interest is the lack of organization existing to promote this special interest. People organize to protect their interests in almost every economic, social and professional category. But seldom do consumers. There’s no wonder therefore that the consumer interest is very often given only token recognition by policy makers.

The view, once widely accepted in this coun-

try, that competition forces business to serve the public is not even given a token nod in these remarks. The views expressed above are not limited to this country. In almost all of the countries of Western Europe, including the United Kingdom, there are extensive government programs to provide consumers with information about goods and services. The information is provided by programs of testing, informative labeling, and consumer education. In some countries, these programs are being expanded and efforts are underway not only to provide more information through government but also to regulate the amount and kind of information through advertising. The members of the staff of the Consumer Advisory Council have been so impressed by the need to protect the consumer that they are already bemoaning their lack of cabinet status and resources sufficient for their benevolent work.

The Constitution of the United States was based in part on the belief that people needed protection, primarily from the government, and that free, competitive enterprise was the most efficient engine for promoting the public good.

Shifts

Although free enterprise is widely admired, and is not mortally threatened by the current evidence of mistrust, the programs currently advocated or already in being may become important. At one time, the intellectual climate of this country placed the burden of proof for the necessity of interference with the market process on those who would interfere. Interference was presumed to be an error unless an overwhelming case could be made for it. In the present intellectual climate, the reverse is probably true—actions by the government to regulate business are presumed to be beneficent and the burden of proof is on those who oppose.

An amusing, skeptical statement regarding the need for and promise of governmental efforts to protect the consumer appeared in a recent article in *Consumer's Bulletin*, as follows:

In its programs for the consumer, the federal government in both the legislative and administrative branches might well ponder the example of the Boy Scout who came to a scout meeting with a black eye. When the scoutmaster asked what happened, he replied that he had tried to help a little old lady across the street. 'How in the world,' asked the scoutmaster, 'could you get a black eye doing that?' The scout replied, 'She didn't want to go.'

Donald Turner, currently head of the Anti-trust Division of the Department of Justice, gave two now-famous speeches on advertising, one in June of 1966 and one in February of 1967. His views are fairly well known, but I shall summarize them extraordinarily briefly. First, firms found guilty of violating the Sherman Act-and I hope all of my readers are representatives of firms distinguished enough to have been found guilty of violating the Sherman Act-might be required by the court to limit the level of their advertising as part of remedial action designed to restore the vigor of competition. Two, advertising frequently creates monopoly power by increasing concentration in an industry, limiting entry, and creating artificial or spurious differentiation in products.

These undesirable effects are to be offset by providing consumers with "true" and more relevant information about products and services. The information would of course be provided by the government. Members of the antitrust division, in order to justify intervention by the government in the operation of private markets, need to demonstrate a lack of effective competition, because of the still-dominant belief that such competition requires little intervention.

Mr. Turner believes that advertising prevents competition from being effective or, in other words, that it tends to create monopoly power. The primary serious justification for this view-and it is unusual that there is a serious justification-is a study by William S. Comanor, of Harvard, and Thomas A. Wilson, whose major finding is that firms with relatively high levels of advertising per dollar of sales tend to have relatively high rates of profit on stockholders' equity.

One of the hallmarks of monopoly power is persistence of high rates of profit, given the degree of risk of the company in question. Wilson and Comanor conclude that advertising causes the high rates of profit which reflect monopoly power. Further, the increase in profit rates is often very great-on the order of 50 per cent for those industries with very high levels of advertising per dollar of sales. For example, profit rates are 12 per cent rather than 8 per cent.

The monopoly power arises from the ability of advertising to create product differentiation and thus to impose barriers to entry.

Findings Err

There are several things wrong with these findings.

Jules Backman in his recent book, ***Advertising and Competition***, has studied the same relationship as Comanor and Wilson and found that intensive advertising tends to be accompanied by a higher reported rate of profit, but that differences in relative advertising expenditures explained only about 1/10th of the difference in profit rates. Backman uses different data and statistical techniques than Comanor and Wilson, but I shall not comment on these differences since they seem relatively unimportant as compared with what seem to me to be two conceptual fallacies in the Comanor and Wilson analysis.

Comanor and Wilson believe that intensive advertising causes high profit and Backman suggests that the direction of causality is the reverse. What is much more likely is that both intensive advertising and abnormally high profits are both caused by something else—namely, innovation. The innovation may be of many kinds, some of which may not be pleasing to Messrs. Turner, Comanor, and Wilson. The innovation may be in packaging, in distribution, in product characteristics, or in other things.

The variety and speed of change in consumer products in the United States are the result of the continuous quest for things which will please consumers more and, thereby, yield higher profits. Incidentally, antipathy to profits, which we find expressed in some quarters, is absurd. Profits are a sign that people have done good things. There should be an antipathy to losses. Losses are a sign that people have wasted resources, that they have used valuable resources to produce commodities and services which consumers don't value as highly as the resources which were used up. So there should be, in all economies, I think, great distaste for losses and admiration for profits.

I have said that both intensive advertising and abnormally high profits are caused by innovation. Variety and innovation cause more intensive advertising than would be required in a more static and less innovative economy.

An Investment

The second conceptual fallacy arises from the fact that advertising is frequently an outlay which creates a durable asset in the form of a consumer franchise: in other words, it's an investment. This was a major issue in the Borden Evaporated Milk case. In this case, persuasive evidence was introduced to indicate that consumers were willing to pay more for Borden milk than for milk of unknown brands

because the Borden name connoted reliability and quality.

These connotations had been built up over a century of advertising and the underlying attitudes are believed to be durable though certainly not permanent. Accounting conventions require that investments in plant or in machinery result in an increase in book value of the company and in the stockholders' equity but that an investment in advertising to create favorable attitudes not be so recognized. A natural consequence of such account practices is that apparent profit rates are higher for companies which advertise relatively heavily. This is an accounting artifact, and it should be taken into account in any serious study of the relationship between advertising and profit rates.

Incidentally, the same relationship that exists between advertising and rates of profit exists between expenditures for research and development and rates of profit. And the reason for the relationship is the same. First, research and development tend to be associated with high levels of innovation. Second, research and development create assets in the form of new ideas and products which are typically not acknowledged as assets by the accountant, with a consequent overstatement of the rates of profit for firms with high levels of research activity.

I think that the so-called scientific basis for the Turner proposals is basically deficient, and that those who instinctively distrust these proposals might do well to try to remedy the inadequacies in the Comanor and Wilson paper. Incidentally, these inadequacies are not taken care of very well by Mr. Backman.

A few years ago, the British Labor Party asked Lord Reith to form a commission to study the proper regulation of advertising by the government. The Commission's report was

submitted this year and was received by the Labor Party as a Government Paper. Lord Reith and his Commission made a recommendation which has not yet received official blessing in this country. The recommendation is for the creation of a National Consumers Board, which will not only provide free information-free in the sense that people pay through taxes-about products but will also act as a watchdog over advertising, judging the appropriateness of its amount and content. The Reith Commission fears that the consumer has lost his sovereignty over advertising. Consumers exercise sovereignty over commodities by buying or refusing to buy but, according to the Reith Commission, consumers have no power to control advertising through expenditures since advertising is typically free.

I'd like to point out to the Reith Commission that the volume of advertising on the Edsel dropped very sharply-in fact, one hardly ever sees a television commercial for the Edsel any more-and not because the Ford Motor Company wanted it that way. In the first six months after the introduction of the Edsel, advertising outlays for the Edsel were about \$11 million, and in the first six months after the introduction of the Mustang, advertising outlays were about \$9 million. The helpless consumer, so easily manipulated by Madison Avenue, confounded everyone. Advertising is associated by consumers with the advertised product, and advertising is undertaken only when it is expected to produce a sufficient increase in sales to provide a satisfactory rate of return. Consumer sovereignty is less direct for advertising than for commodities and other services, but it is still compelling.

Let us pause for a moment to consider the main proposal of Mr. Turner-the provision of information by government on what are

deemed to be the most relevant characteristics of goods and services, The kind of information which is to be provided is similar to that already provided by the Consumer's Union. It is surprising, in a way, that the government feels the need to provide services which are already being provided by private agencies. Subscribers to **Consumers Reports** had risen from 50,000 in 1944 to more than a million in 1966. The number of readers is presumed to be several times that number. The rapid growth of this publication reflects a willingness by consumers to pay for the kind of information provided. And the willingness is growing rapidly.

Members of the staff of the Consumers Advisory Council, however, feel that the growth is too slow and the deficiency must be made up by government programs or subsidies. It is hard to know by what criteria a civil servant decides the optimum rate of growth in the production of information, and indeed of other things, and the Consumers Advisory Council does not help us to an increased understanding. A careful reading merely indicates that they feel it would be better if consumers knew more-presumably on the same grounds that it would be better if consumers had a higher standard of living, lived longer, and were invariably law-abiding and happily married.

Freedom for the consumer permits him to allocate the resources among various available good things-from his point of view, No society, however affluent, ever runs out of things to want and strive for. Without even apparently feeling the need to justify dissatisfaction with the level of purchases of information about products, members of the staff of the Consumers Advisory Council assert that not enough is being expended for this purpose. Consumers may be competent to select presidents, wives, and husbands, and schools for

their children, but not to pick breakfast foods or to decide whether to subscribe to

Report. Apparently, only the federal government can make such decisions soundly.

Food Industry Target

The government is particularly dissatisfied with the manufacturers and distributors of food. These manufacturers and distributors are charged with impoverishing the housewife without enriching the farmer, and advertising is alleged to be primarily responsible. To illustrate the quality of analysis which underlies the so-called consumer movement and the recommendations concerning advertising, let us consider the food industry in detail.

The 85th Congress created a National Commission on Food Marketing which submitted its report about 18 months ago. The Commission was concerned about many things, including the retail price of food, and recommended a number of changes in public policy toward the food industry. To no one's surprise, they didn't refer to the effect of government subsidies and price supports.

Since the food industry is the focus of particular dissatisfaction, we should examine it. Whether the starting point for comparison be the end of World War II, the 1930's, the 1920's, or even some more remote date, one gets an impression of overwhelming change and innovation. Let me give some examples:

(1) In 1920, chains, including cooperative chains, accounted for 11 per cent of retail sales: in 1965, for over 90 per cent.

(2) In 1920, the average grocery store sold \$44,000 per annum; in 1963, \$215,000—both figures expressed in 1963 dollars.

(3) In 1929, over 50 per cent of retail sales by grocery stores were by stores with sales under \$50,000; in 1963, such stores accounted for less than 5 per cent, and stores selling over

\$1,000,000 a year accounted for over 50 per cent.

(4) Sales per retail employee increased by about 150 per cent in constant dollars between 1929 and 1963.

(5) In 1929, full-line grocery stores accounted for less than one-third of the retail sales; in 1963, for over 90 per cent.

(6) Between the end of World War II and 1963, the population increased by about 36 per cent; in the same period, the output of manufactured food products increased by over 90 per cent.

(7) Per capita consumption of canned and frozen fruits and vegetables has risen dramatically in the last 20 years, while the consumption of fresh fruits and vegetables has declined.

(8) The variety of food products has increased extraordinarily.

(9) The use of packaging, branding, and advertising has permitted consumer self-service to replace personal selling in the stores, with consequent increase in efficiency in retailing.

(10) There have been important changes in the relationship of grocery retailers to both their customers and suppliers, with increased competitiveness in all areas.

(11) The average size of food manufacturing firms and plants has increased dramatically, as has the relative importance to packaged and branded goods, advertising, and national distribution.

Rising Competition

That's just a brief summary. Much change has taken place. These changes have caused competition to become more intense. The growth in the relative importance of large, general-line grocery stores, changes in the technology of preserving food, and the ease of shopping by car means that the typical consumer today has many more stores competing

for his patronage, thus increasing competition among them.

Similarly, because of its greater size, its typical affiliation with some type of chain organization, and the greater efficiency of food transportation, the typical food store today has access to many more suppliers than formerly, with a consequent increase of competition among them. Innovation has been rapid, competition has been intensified, and there is much evidence of increased efficiency in manufacturing, transportation, wholesaling, and retailing.

Why is it then that our government is dissatisfied and its National Commission on Food Marketing issued the kind of report it did? This report is a sober, serious, and interesting document, yet many of its conclusions seem to rest on prejudice rather than analysis. Let us look at their major findings.

First, the Commission pointed out that in 1964 food corporations spent over \$2 billion on advertising and \$680 million for trading stamps. The Commission generously conceded that these amounts were "not entirely wasted" because consumers received premiums in exchange for stamps and because advertising helped to pay for television programs, newspapers, and magazines. Nevertheless, the Commission feels that a "substantial portion" of advertising and sales promotion is wasteful and results in higher costs and prices. The pernicious effects of advertising and other activities to promote sales are increased spreads between farm prices and retail prices of food products, high retail prices, and increased concentration in food manufacturing with attendant increases in market power.

Growth of Processing

Let us consider the first complaint. It is astounding that the critics of advertising of food products so often fail to consider the

rather complex interrelationships between advertising and the many changes in the processing and distribution of food products in this country in the last 50 years. When America was largely rural, national marketing of food products was rare and products were generally sold without much processing and without packaging, branding, and advertising. In those days, the spread between farm prices and retail prices was slight. There's been a steady increase in the amount of processing of foods available in this country, and in the variety of foods available, and in the convenience with which foods are available.

Foods are frozen, dried, canned, and packaged in an enormous variety, with a very marked reduction in gross margins at the retail level and in the amount of work necessary for the housewife to get dinner on the table. I'm not going to comment on the quality of the dinner-I don't mean in terms of calories-amino acids, vitamins, and minerals. I think the main thing in cooking these days is **to** know the proper thawing times.

Providing convenience, variety, and processed food products adds value to the raw materials provided by the farmer and thus increases the spread between the prices he receives and those paid by the consumer. Further, packaging, branding, and advertising have increased productivity per man hour in retail food establishments and permitted reduction in gross margins in such establishments to extremely low levels.

Advertising has helped make possible the extraordinary stream of new products, has helped reduce the need for personal selling, has stimulated competitive emulation, and has helped produce **a** high level of reliability and quality in food products.

The second complaint, related to the first, is that advertising causes high prices. By ignoring the dynamism in the food industry, and

the role of advertising in making it possible, the National Commission on Food Marketing concludes that advertising is the cause which, if eliminated, would permit a reduction in the price of food. In the short run, the conclusion is probably right. But, even in the intermediate run, the elimination of advertising would dampen the process of competitive innovation and would remove one of the major guarantees of quality that the consumer has.

Differentials

Incidentally, and ironically, in the Soviet Union the free market for food sells at a higher price than is obtained in the government stores. Marshall Goldman, the foremost American student of Soviet advertising and marketing, attributes most of the differences to the premium the consumers are willing to pay for the better quality and service in the free market. The free market, unlike the government stores, advertises to attract both suppliers and customers. Thus, there is a positive correlation between the intensity of advertising and the level of prices, but it would be a mistake to say that the advertising was either wasteful or the cause of the high prices.

In this connection, I'd like to point out a great irony which I mentioned—namely, that the Soviet Union is encouraging the increased use of advertising. Goldman, in his study on advertising in the Soviet Union, describes reasons for this encouragement in the Soviet Union in a book called ***Soviet Marketing, Distribution in a Controlled Economy***, published in 1963 by the Free Press of Glencoe, which is located in New York City.

Advertising identifies the maker of the product for the consumer and thereby compels the maker to produce products which compare favorably with those of competing makers.

Let me elaborate. There was a time when the Soviet Government believed that it could

set appropriate standards for manufacturers of food and other things. These standards were typically set in simple, physical terms and the plant manager, by meeting these physical criteria, discharged his official obligation even though he produced things which the consumer didn't like to buy. The Soviet Union recognized that the purpose of production was to please consumers, to some extent at least. The Government was unable to adequately set complete and relevant criteria for production so that the consumer was pleased, and the result was much merchandise which was undesirable from the point of view of the consumer. It is for that reason that advertising has been encouraged.

Incentive Absent

When the maker is unknown and when goals are established in highly simplified terms by the government, as they were in the Soviet Union, the maker frequently can meet his goals without making products satisfactory to consumers. Further, there is no incentive to make products more satisfactory. When the goal is not only to make the product but to sell it, and when the maker must be identified by branding and advertising, the maker is placed under pressure to produce a product which the consumer prefers.

The preference may be based on things not deemed important by the government—such as minor alterations in packages, sizes, and flavors—or improvement may be in uniformity of texture; or it may be in other things. In any case, the Soviet Union now recognizes to an increased extent and an increasing extent the role that branding and advertising plays in stimulating, nay, compelling, the quest for progressive improvement as defined by the consumer rather than by the government. The irony of course is obvious: that we can learn of the virtues of advertising from the Com-

munists. Advertising, branding, and identification of the maker causes the maker to become responsive to consumers.

The third complaint of the National Commission on Food Marketing is that advertising causes increased concentration and market power in food manufacturing. There have been a number of acknowledged exceptions to the allegations of increasing concentration such as meat packing, freezing of fruits and vegetables, butter manufacture, and others. Nevertheless, there is general evidence of increasing concentration, especially when measured by the market share of the largest 10 or 20 firms, rather than by the conventional four firms.

What hasn't been shown by the Commission, or by anyone else, is that advertising has caused whatever increased concentration is observable or that this increased concentration is either caused by or has been accompanied by a decline in the effectiveness of competition.

Merger Note

It is true that entry into grocery manufacturing requires more capital than formerly and that this can be a barrier to the entrance of small firms. The barrier is not insuperable, however. It is wryly amusing to note that Clorox was an outstanding success in home laundry bleaches, in competition with much larger firms, and that the Supreme Court voided the acquisition of Clorox by Procter & Gamble on the grounds that such a large firm as Procter & Gamble could preempt the home laundry bleach market and prevent the potential competition of small firms. In other words, the small firm was so successful that a large firm wanted to acquire it, and the voiding of the merger was on the grounds that small firms couldn't be successful.

General studies of the relationship between advertising and concentration fail to show any

positive effect. Further, the rapidly proliferating production lines and products of large manufacturers can cause increased competition at the same time the concentration ratios rise together with barriers to entry. Profit rates in the grocery manufacturing industry have not been abnormally high.

In my opinion, the National Commission on Food Marketing has not proved the necessity of additional regulation, though, like all good commissions, they view the current situation with moderate alarm and feel that increased governmental intervention would help.

The main recommendations are that firms planning to merge give prior notice to the government; that firms not be allowed to combine for the purpose of purchasing more cheaply; that corporations with sales above a specified amount be required to submit annually to the SEC for publications data on sales, expenses, and profits in which its annual shipments exceed a specified minimum.

Continuous Review

The Commission also recommends that the F.T.C. continuously review the market structure and composition of the food industry and report annually to Congress on the need for legislation.

Further, the Robinson-Patman Act should be reviewed with the especial purpose of considering the wisdom of permitting price discrimination in order to meet competition. Obviously, it wouldn't do for an act designed to preserve competition to permit it. There are a number of other recommendations including such things as uniform consumer grade labeling and the encouragement of farmers to form organizations to diminish competition and raise prices. I have never been able to understand why competition by non-farmers is to be encouraged to protect consumers, while

competition among farmers is to be discouraged in the interest of raising prices.

A. V. Dicey, one of the great students of British history, gave a series of lectures in 1905 at Harvard which resulted in a book called *Law and Public Opinion in England in the Nineteenth Century*. In that book, he said something superficially paradoxical. He said that no man goes so far as the man who does not know where he is going. His remark was a reference to the remarkable series of so-called progressive legislation in England in the nineteenth century. The humane members of the government were concerned with what seemed to be patent abuses in the English economy, and they passed a series of laws dealing with child labor, labor by women, and ultimately, labor by men. What started as an effort to prevent the exploitation of children ended in reasonably detailed regulation of hours, wages, and investment.

The first step, which almost certainly did great good, led to a destination which no one imagined or perhaps even desired. Dicey's view in 1905 was that efforts by the government to remedy abuses would diminish the vitality, adaptability, productivity, and inventiveness of the English economy and impair its relative efficiency and ability to compete in the world economy.

Dicey's thesis is unprovable, but its applicability to the regulations of advertising should be considered. None of us, even the most ardent apologists for advertising and for free markets, will pretend that all is well, that there is no abuse, that nothing is improvable. The bland assumption, however, that efforts by government to bring about improvement will succeed is one which I think deserves serious questioning. The case for more regulation as made by Turner and Reith is weak and the history of most governmental regulation is depressing.