Fully explain how advertising can affect profits in competitive and non-competiti...

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This essay is going to examine how advertising strategies used in different market structures affects profits of the firms. This essay is being written based on Advertising, an article by Geoff Stewart, in which he examines " how do firms determine their advertising strategy". In this article he uses Monopolies as an example of a non-competitive market and Oligopolies as an example of competitive markets, so in this essay Monopolies and Oligopolies will also be used as examples. However other competitive markets include perfect competition and monopolistic competition.

A Monopoly is a market structure characterised by one firm and many buyers, a lack of substitute products and barriers to entry (Pass et al. 2000). An oligopoly is a market structure characterised by few firms and many buyers, homogenous or differentiated products and also difficult market entry (Pass et al. 2000) an example of an oligopoly would be the fast food industry where there is a few firms such as McDonalds, Burger King and KFC that all compete for a greater market share. In a Monopoly there is one firm that controls the market, and there is no similar products being sold by other companies.

Advertising is therefore used to encourage people to buy more of their product. In a monopoly there is a downward sloping demand curve, the reason for this is that a firm must lower the price to sell and extra unit of their product. For a monopoly to maximise profits it must have an equilibrium point where marginal cost equals marginal revenue, there is no reason for a firm to move from this equilibrium point because they are fulfilling their market plan. Using Figure 1 (Stewart, 2005) it can be explained why a monopoly firm would advertise.

Marginal cost is fixed and is the line MC and demand is line D, marginal revenue is line MR. As the firm wishes to profit maximise it sets output at level Qm where marginal revenue crosses marginal cost, this means price is set at Pm where the quantity reaches the demand curve. If a firm is going to advertise it is likely that it will cause demand to shift to the right, this is because more people are going to buy the product when it is being sold at the same price. This is represented by the shift D to D'.

After this shift the firm would increase output to Q'm, this is because marginal revenue would have shifted to MR' as more people are buying the product, this would lead to the firm increasing price to P'm as people are willing to buy the product at that price. The production costs would rise by the size of QmbzQ'm and as that is less than the increase in revenue, gross profit will increase. To decide whether it was profitable the increase in gross profit would have to exceed the cost of the advertising, and this is likely otherwise the advertising campaign wouldn't have been carried out.

Another possible outcome of advertising in a monopoly is that demand will become price inelastic, this means that a change in price has less of an effect on change of output. Figure 2 (Stewart, 2005) then shows how the from would increase price from Pm to P" m and reducing output from Qm to Q" m this would also mean gross profit would increase and it would be worthwhile carrying out an advertising campaign if the gross profit is greater than the cost of advertising. In an Oligopoly there is a few firms that compete with each other to gain market share and also maximise profits.

In an oligopoly it is unwise for the firms to get into price wars with each other, as it is usually unbeneficial to them. If a company was to raise the price of their product, they are going to loose out, because the other firms sell similar products at a lower price so the consumers will switch firms. On the other hand if a firm lowered prices to gain a consumers then other companies will also lower prices and this will lead to all the firms loosing out on revenue.

In a competitive market such as an oligopoly it is wise for them to compete in other ways such as advertising. It is also apparent that as changes in price affect all companies advertising is also likely to affect all companies. To help explain how profits are made through advertising in a competitive market Stewart uses game theory. Game theory is a technique that uses logical deduction to explore the consequences of various strategies that might be adopted by competing game players (Collins, 2000).

Table 1 (Stewart, 2005) is a simple view of two firms that have to choice of advertising or not advertising, if both firms were to advertise there profit would be 1, if one to was to advertise and the other didn't then the firm who is advertising will get a profit of 3 and the one not advertising will get 0, if they both don't advertise then they will both make a profit of 2. It is in the interest of the firms to advertise however because there is the possibility of them making more profits than not advertising. The choice to advertise is the firms dominant strategy and firms will always go for their dominant strategy.

Table 2 (Stewart, 2005) is used to describe how advertising in a market may increase demand in the market rather than market share. It is still in the firms' interest to carry out their dominant strategy in this case however it also maximises joint profit in this case. This shows that in a strategic setting, firms profit maximising actions may, but will not necessarily generate profit maximising outcomes (Stewart, 2005). In conclusion it can be seen that advertising in a monopoly is an effective way to increase profits.

This is because it shifts the demand curve to the right and then increases gross profits in turn and will usually results in profit as the advertising cost will probably be lower than the gross profits. There is also the possibility that it causes the demand curve to steepen which also leads to increased gross profits. Advertising in oligopolies can be seen as being more complicated as it involves more than one company, however firms will adopt advertising as a strategy to increase profits even though it may be more in their interest to not advertise and get greater profits.

Word Count: 1, 078 References Gillespie, A (2001) AS & A Level Economics through diagrams, Oxford: Oxford University Press Pass, C, Lowes, B and Davies, L (2000) Collins Economics Dictionary, 3rd ed, Glasgow: HaperCollins Powell, R (2003) Module 5: Business Economics and the Distribution of Income, Oxfordshire: Phillip Alan Updates Stewart, G (2005) Advertising, Economist, April 2005, pp14-16