On the Competitive Effect of Informative Advertising

Kurt R. Brekke*  Michael Kuhn†

November 2008.
Work in progress. Do not quote.

Abstract
This paper challenges the robustness of the pro-competitive effect of informative advertising. In their seminal work Grossman and Shapiro (1984) find that informative advertising results in lower prices, and that firms may benefit from advertising restrictions. A crucial assumption in their model is that demand in the monopoly segment is perfectly price inelastic. Replicating their model in a Hotelling duopoly version, we show that results are in fact reversed if we allow for price elastic monopoly demand. The reason is that the marginal consumer informed about only one product is more price responsive than the marginal consumer informed about both products. We then use general demand (and advertising cost) functions and derive exact conditions for when informative advertising is pro-competitive.

Keywords: Informative Advertising; Price Competition; Product differentiation

JEL Classification: D83; L13; M37

*Norwegian School of Economics & Business Administration. Department of Economics. E-mail: kurt.brekke@nhh.no
†University of Rostock.