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INTRODUCTION TO MEDIA ECONOMICS

The study of media and communications has traditionally been dominated by non-economic disciplines. Analysis of media content, for example, can provide a means of understanding the societies we live in and our value systems. But economics is also a valuable subject area for media scholars. Most of the decisions taken by those who run media organizations are, to a greater or lesser extent, influenced by resource and financial issues. So economics, as a discipline, is highly relevant to understanding how media firms and industries operate.

This book provides an introduction to some of the main economic concepts and issues affecting the media. It is designed for readers who are not specialists in economics but who want to acquire the tools needed to unravel some of the more interesting economic features and pressing industrial questions surrounding media firms and markets. No prior knowledge of economics is assumed.

The first two chapters explain a number of broad and fundamental concepts relevant to the study of economics as it affects the media. This opening chapter introduces you to firms and markets and it examines the distinctive economic characteristics of media. Chapter 2 focuses on the relationship between these special characteristics and the corporate strategies that are commonly deployed by media firms.

These initial chapters are followed by six others, each of which concentrates on a particular sector of media activity, e.g. television broadcasting, print media publishing or 'new' media. Sector-specific chapters are not intended to offer stand-alone accounts of the economics of each media activity. Instead, they provide a framework within which two or three of the main economic concepts or questions that are commonly

associated with or best exemplified by that industry sector may be examined more closely. So, the structure of the book enables a series of economic themes and questions relevant to the media to be gradually and progressively opened up and explored. The final chapter examines what role media economics can play in informing public policy questions.

After studying this opening chapter, you should be able to:

- Identify the kinds of questions that media economics seeks to address
- Explain what a firm is, and its motivations
- Describe the different types of competitive market structures that exist
- Understand what is special about the economics of the media
- Identify and explain some of the key economic characteristics of the media

WHAT IS MEDIA ECONOMICS ABOUT?

Media economics combines the study of economics with the study of media. It is concerned with the changing economic forces that direct and constrain the choices of managers, practitioners and other decision-makers across the media. The economic concepts and issues introduced in the course of this book provide a basis for developing your understanding of the way in which media businesses operate and are managed.

Some attempts have been made to formalize a definition of media economics. Economics has been described as ‘the study of how people make choices to cope with scarcity’ (Parkin et al., 1997: 8). Scarcity is a familiar concept for most, and we are all economists to the extent that we have to decide how to make the best of our limited incomes or resources. According to Robert Picard, media economics ‘is concerned with how media operators meet the informational and entertainment wants and needs of audiences, advertisers and society with available resources’ (1989: 7). Likewise, Albarran’s definition of media economics focuses on ‘how media industries use scarce resources to produce content . . . to satisfy various wants and needs’ (1996: 5). For Alexander et al., media economics refers to ‘the business operations and financial activities of firms producing and selling output into the various media industries’ (1998: 2).

Media economics, then, is concerned with a range of issues including international trade, business strategy, pricing policies, competition and industrial concentration as they affect media firms and industries. These themes are explored below, as each of the main sub-sectors of the media is examined in turn. The predominant focus throughout the book is

'microeconomic' (i.e. to do with specific individual markets or firms), but some of the questions addressed also have a macroeconomic dimension.

MACROECONOMICS AND MICROECONOMICS

The distinction between macro and microeconomics is about whether that which is being studied involves large groups and broad economic aggregates or small well-defined groups and individual firms and sectors. Macroeconomics is concerned with very broad economic aggregates and averages, such as total output, total employment, national income, the general price level, and the rate of growth of the economy as a whole. These sorts of aggregates are arrived at by summing up the activities carried out in all individual markets and by summarizing the collective behaviour of all individuals.

One of the most commonly used measures of a nation's overall level of economic activity is its Gross Domestic Product (GDP). A country's GDP represents the sum of the value of all goods and services produced within the economy over a particular period, usually a year. Media goods and services represent a small but growing proportion of total economic activity in developed countries and, in the United Kingdom (UK) for example, they account for some 3–5 per cent of GDP.

In the UK, the long-term trend in GDP since the Second World War has generally been upwards and this, in turn, has facilitated a substantial increase in living standards. Within this overall growth trend, a second feature of movements in GDP has been short-term fluctuations around the trend. Rather than growing at a steady and consistent pace, economies tend to move in a series of up and down 'business cycles' which are characterized by four phases: trough, recovery, peak and recession (Lipsey and Chrystal, 1995: 500–5).

The overall performance of the economy has important implications for the business performance and prospects of firms in all sectors, including media. Indeed, the fortunes of most media firms are highly sensitive to the ups and downs of the economy as a whole. Many media firms rely on advertising as a primary source of income. Analysis of long-term trends in advertising shows that there is a strong association between the performance of the economy as a whole and levels of advertising activity. Revenues for media firms from direct expenditure by consumers are also clearly dependent on broader economic aggregates such as levels of disposable income and consumer confidence.

In theory, public policies on the economy (monetary, fiscal, etc.), and policies to promote or restrain growth or social welfare may have an effect

on the economic environment in which media firms and industries operate (Alexander et al., 1998: 9). For example, government control over the supply of money and over interest rates provides a means of influencing levels of investment and economic activity in general. However, it may be argued that the power of state authorities to exert such influence is waning. 'Globalization' means that it is increasingly difficult for open economies to predicate monetary and other economic policies on domestic considerations alone.

Whereas macroeconomics is about forces that affect the economy as a whole, microeconomics is concerned with the analysis of individual markets, products and firms. An economy is 'a mechanism that determines what is produced, how, when and where it is produced, and for whom it is produced' (Parkin et al., 1997: 21). These decisions are taken by three types of economic actors – consumers, firms and governments – and are co-ordinated in what are called 'markets'. Economics relies on certain assumptions about how these actors make their choices.

Each consumer, for example, is seen as having unlimited wants and limited resources. It is assumed that all consumers seek to maximize their total 'utility' or satisfaction. 'Marginal' utility represents the change in satisfaction resulting from consuming a little more or a little less of a given product. The law of diminishing marginal utility suggests that the more of a given product that an individual consumes, the less satisfaction he or she will derive from successive units of the product. The example used by Lipsey and Chrystal to illustrate this principle shows that, everything else being equal, the more films a consumer attends each month, the more satisfaction he or she gets. However, the marginal utility of each additional film per month is less than that of the previous one – i.e. marginal utility declines as quantity consumed rises (1995: 128–9).

THE FIRM IN ECONOMIC THEORY

In economics, production is defined as the conversion of resources – labour, land and capital – into goods and services. 'Firms' are establishments where production is carried out and industries consist of a number of firms producing a commodity for the same market. The concept of a media firm spans a variety of different types of business organization, from the online 'fanzine' publisher to the vast television corporation and from single proprietorship to major transnational Stock Exchange listed companies. What all media firms have in common is that they are involved somehow in producing, packaging or distributing media content.

All media firms are *not*, however, commercial organizations. Most countries have a state-owned broadcasting entity which takes the form of a public corporation and which is dedicated to 'public service' television and radio broadcasting. Many public service broadcasters (PSBs) rely on public funding (e.g. grants) but some depend, in part or in whole, on revenues derived from commercial activities such as sale of airtime to advertisers. Even when they compete for revenues from commercial sources, PSBs are usually distinguished from commercial firms by the fact that their primary goal is to provide a universally available public broadcasting service rather than to make a profit.

By contrast, it is assumed that a commercial firm's every decision is taken in order to maximize its profits. The assumption that all firms seek to maximize profits is central to the theory of the firm. It allows economists to predict the behaviour of firms by studying the effect that each of the choices available to it would have on its profits.

However, there are two commonly cited criticisms of the traditional theory of the firm and both are relevant to media. The first suggests that it is too crude and simplistic to assume that businesses are motivated purely by pursuit of profits. The case for profit maximization on the part of business owners is thought to be 'self-evident' but, in fact, some are undoubtedly motivated by alternative goals. These range from straightforward philanthropy to the desire for specific benefits associated with owning certain types of businesses. An alternative motivation – especially in the case of media firms – might well be the pursuit of public and political influence.

A second criticism is that the theory assumes that all firms will behave in the same way, irrespective of their size and organizational structure. In reality, a firm's institutional structure may have an important bearing on its priorities. Rupert Murdoch's involvement in the running of News Corporation shows how some media firms are closely managed by their owners. But the dominant form of industrial organization these days is the public limited company (or plc) under which, more typically, the day-to-day running of the firm is carried out not by the owners (or shareholders) but by managers.

When ownership and control of an organization are separate, its managers may decide to pursue goals other than maximizing profits and returns to shareholders. This conflict of interest is referred to as a type of 'principal–agent' problem. The managers appointed to run a media firm (agents) may not always act in the manner desired by shareholders (principals) but might, instead, have their own agendas to pursue. When the agent's goal is allowed to predominate then pursuit of profits may be superseded by, for example, a desire to maximize sales revenue or the firm's growth.

There are good grounds for questioning how well the broad assumptions of conventional economic theory apply in practice to the behaviour of media organizations. Nonetheless, to the extent that media firms and consumers make their decisions in a 'rational' manner and in pursuit of what are assumed to be their own individual goals (of, respectively, profit and utility maximization), there will be a role for government to play in creating a regulatory environment within which these individual goals are not achieved at the expense of societal welfare (Alexander et al., 1998: 14). The issue of supplying violent media content provides an example of an economic activity that realizes the goals of one set of economic actors (i.e. it contributes to the success and profitability of film and television programme-makers) but, arguably, may detract from overall well-being of society (ibid.).

A firm's profits are the difference between its revenues and costs. Costs in economic theory refer to all 'opportunity costs' – i.e. 'the cost of using something in a particular use is the benefit forgone by (or opportunity cost of) not using it in its best alternative use' (Lipsey and Chrystal, 1995: 185). So, as well as assigning costs to purchased or hired inputs, an 'imputed' cost must also be calculated for and assigned to any factors of production owned by the firm, especially the firm's own capital.

The concept of opportunity cost is important in economics. Our resources can be used in many different ways to produce different outcomes but, essentially, they are finite. All of the land, labour and capital available to us will be relatively more efficient in some activities rather than others. Opportunity cost is inevitable and requires firms to make trade-offs. The most productive outcome will be achieved when every worker, piece of land and item of capital equipment is allocated to the task that suits it best (i.e. the one that results in the most productive outcome).

For example, if we want more educational CD-Roms and fewer computer games, we might switch some of the creative, marketing and administrative personnel, the computers and production equipment involved in producing computer games into CD-Rom publishing instead. However, because game inventors will be less good at creating CD-Roms than original educational CD-Rom publishing personnel, the quantity of CD-Roms produced will increase by a relatively small amount while the quantity of computer games produced falls considerably. Similarly, CD-Rom creators can be reassigned to the task of producing interactive computer games but, because they are not as good at this activity as the people who currently make computer games, there will be an opportunity cost in terms of lost output. The opportunity cost of switching resources from computer games to CD-Rom production (or from CD-Roms to games) can be calculated as the number of games that must be given up in order to produce more CD-Roms (or vice versa).

In order to maximize profits, firms need to decide which overall rate of output would be most profitable (e.g. whether to produce 100,000 or 200,000 copies of a magazine). To do so, they need to know exactly what costs and revenues might be associated with different levels of output. The so-called 'production function' describes the relationship between input costs and different levels of output. Changes in relative factor prices (of labour, capital equipment, etc.) will result in a replacement of factors that have become relatively more expensive by cheaper ones. For example, the introduction of new print and desk-top publishing technologies in the magazine publishing industry in the 1980s and 1990s reduced capital equipment costs and allowed a reduction in labour inputs.

'Marginal product' is the change in total product (or the total amount produced by the firm) that results from adding a little bit more or a little less of a variable input to a fixed input. The 'law of diminishing returns' suggests that if extra quantities of a variable factor (e.g. freelance technicians) are applied to a given quantity of a fixed factor (e.g. plant and equipment), the marginal and average product of the variable factor will eventually decrease. Picard offers the example of a television news director who is deciding how many news crews (whose labour represents the 'input') are needed to produce a newscast (the 'output'). The size of the marginal product increases at first, demonstrating increasing returns to scale, and then it begins to decline. According to Picard's example, the onset of diminishing returns occurs because, as more production crews are added and the use of production equipment has to be shared, the efficiency and productivity of each crew begins to reduce (1989: 53–4).

But contrary to what is implied by the law of diminishing returns, many media firms tend to enjoy *increasing* rather than diminishing marginal returns as their output (or, rather, consumption of it) increases. The explanation for increasing returns to scale in the media industry lies in the nature of the product and how it is consumed. The value of media content lies not in the paper that it is printed on or the ink or videotape that conveys its text or images but in the meanings, messages or stories that it has to offer – its intellectual property. This is an intangible and costs virtually no more to reproduce in large than in small quantities. The cost of producing a television programme or a film is not affected by the number of people who watch it. So, for media firms, the relationship between input costs and different levels of output tends to be skewed by the availability of increasing returns to scale.

COMPETITIVE MARKET STRUCTURES

As discussed above, the production function describes how costs vary at different levels of output. Firms that wish to maximize profits are not only concerned with costs but also need to know what revenues are associated with different levels of output. To a large extent this depends on what sort of 'competitive market structure' a firm finds itself operating in.

Economic theory offers us a model for analysing the different sorts of structures a market can have and the degree of competition between firms in that market. The competitive market structures within which media operate will have an important bearing on how efficiently media firms organize their resources and business affairs. The main theoretical market structures are perfect and imperfect competition (i.e. monopolistic competition and oligopoly) and monopoly. The distinction between these structures is largely dictated by the number of rival producers or sellers in a given market. This provides a significant indication of the 'market power' that individual firms possess and their ability to control and influence the economic operations in that market (e.g. to set prices). The less market power individual firms have, the more competitive the market structure they are operating in.

The structure of a market depends not only on the number of rival sellers that exist but on a variety of other factors, including differences in their product, the number of buyers that are present, and barriers to the entry of new competitors. Perfect competition and monopoly are at opposite extremes. In perfect competition, markets are highly competitive and open and each firm has zero market power. In monopoly, a single firm has absolute control over the market. Most firms tend to operate in some intermediate market structure rather than at the extremes.

Perfect competition exists when there are many sellers of a good or service that is homogeneous (i.e. exactly the same or not differentiated) and no firm(s) dominate(s) the market. In such a situation economic forces operate freely. Each firm is assumed to be a price-taker and the industry is characterized by freedom of entry and exit. So, under perfect competition, no barriers to entry exist – there are no obstacles (e.g. lack of available spectrum, or high initial capital costs) to prevent new rivals from entering the market if they wish. Monopoly, at the other extreme, involves just one seller, no competition whatsoever and (usually) high entry barriers.

It is very rare to find an example of perfect competition in the real world. Most industries, including the media, sell 'differentiated' products, i.e. products that are similar enough to constitute a single group (such as books) but are sufficiently different for consumers to distinguish one from another. In other words, they may be close substitutes but are not

exact substitutes as would be the case in perfect competition. Monopolistic competition exists when there are a number of sellers of similar goods or services, but the products are differentiated and each product is available only from the firm that produces it. Firms thus have some control over their prices.

If there are only a few sellers in a market but some competition exists for their products, either homogeneous or differentiated, the market structure is described as an oligopoly. How few is 'a few'? The most usual method of measuring the degree of oligopoly in a market is by applying a 'concentration ratio'. These measures show the proportion of, say, output or employment or revenue accounted for by the top four or five firms in the sector. In the media sector, concentration levels can be calculated on the basis of audience shares (as defined by ratings or readership figures). According to Lipsey and Chrystal, in an oligopoly 'each firm has enough market power to prevent it from being a price-taker, but each firm is subject to enough inter-firm rivalry to prevent it from considering the market demand curve as its own' (1995: 262). So, in an oligopoly firms have a greater degree of control over the market than in a monopolistic competition.

Oligopoly is the most common type of market structure that media firms operate in. The next chapter addresses the question of why it is that so many sectors of the media are dominated by a few large firms. In many cases, the answer is to be found in falling costs due to the economies of large-scale production. Economies of scale are prevalent in the media because the industry is characterized by high initial production costs and low marginal reproduction and distribution costs. Economies of scope – economies achieved through multi-product production – are also commonly characteristic of media enterprises. So there are major advantages in large size for firms that operate in the media industry.

The theory of imperfect competition says that cost advantages associated with size will dictate that an industry should be an oligopoly unless some form of market intervention or Government regulation prevents the firms from growing to their most efficient size. If no such intervention takes place, existing firms in the industry may create barriers to entry where natural ones do not exist so that the industry will be dominated by a handful of large firms only because they are successful in preventing the entry of new firms. But substantial economies of scale in any industry will, in themselves, act as a natural barrier to entry in that any new firms will usually be smaller than established firms and so they will be at a cost disadvantage.

MARKET STRUCTURE AND BEHAVIOUR

The expectation that the behaviour or conduct of firms may be determined by the market structures within which they operate is formalized in what is called the Structure–Conduct–Performance (SCP) paradigm. The SCP paradigm suggests that market structure (the number of firms, barriers to entry, etc.) will determine how the firms in an industry behave (e.g. their policies on pricing and advertising) and this conduct will, in turn, determine the performance of the industry in question – i.e. its productive efficiency (Moschandreas, 1994: 11). This model implies that the fewer firms in a market, the greater the likelihood of collusion, anti-competitive strategies and other inefficiencies.

More recently, some doubt has been cast on the causal links of the SCP paradigm by the theory of market contestability, as developed by US economists Baumol, Panzar and Willig. A market is 'contestable' if entry to it is possible. The theory of contestability suggests that the very fact that a market is potentially open to a new entrant will serve to contain the behaviour of monopolists – i.e. market contestability prevents the exploitation of market power to restrict output and to raise prices (Lipsey and Chrystal, 1995: 271). Contestable markets are therefore said to be susceptible to 'hit and run' entry (George et al., 1992: 276).

How media firms behave, in practice, under different market structures has been a concern for many media economists (Picard, 1989: 79–83; Wirth and Bloch, 1995; Albarran, 1996) and will be a subject of interest throughout this book.

WHAT IS SO SPECIAL ABOUT THE ECONOMICS OF THE MEDIA?

Because media and other 'cultural' output have special qualities not shared by other products and services, the application of economic theory and economic perspectives in the context of media presents a variety of challenges. Media output seems to defy the very premise on which the laws of economics are based – scarcity. However much a film, a song or a news story is consumed, it does not get used up.

Economics seeks to promote 'efficiency' in the allocation of resources. The notion of economic efficiency is inextricably tied up with objectives. But the objectives of media organizations tend to vary widely. Very many media organizations comply with the classical theory of the firm and, like commercial entities in any other industry, are primarily geared towards maximizing profits and satisfying shareholders. A good number, however, appear to be driven by alternative motives. For those who

operate in the public service sector, quality of output and other ‘public service’ type objectives form an end in themselves. Some broadcasting firms find themselves in between the market and the non-market sector – appearing to fulfil one set of objectives for an industry regulator, and another set for shareholders. Because objectives are hazy, the application of any all-embracing model based in conventional economic theory is difficult.

In free market economies, most decisions concerning resource allocation are made through the price system. But the relationship between price and resource allocation in the media is somewhat unusual, particularly in broadcasting where (notwithstanding the growth of subscription-based channels) many of the services consumers receive still do not involve a direct payment from the viewer. Without price as a direct link between consumers and producers, there is a failure in the usual means of registering consumer preferences with suppliers.

In terms of economics, production methods are said to be inefficient if it would be possible to produce more of at least one commodity – without simultaneously producing less of another – merely by reallocating resources. However, when it comes to the production of media output, this approach begins to look inadequate. For example, it might well be possible for a television company to redistribute its resources so as to produce more hours of programming output or bigger audiences for the same cost as before. But if this were to narrow the diversity of media output, could it be said to be a more efficient use of resources?

These questions about the efficiency of production and allocation belong to the branch of economic theory called welfare economics. Much of the work that has been carried out in the UK in relation to broadcasting economics and associated public policy issues – most notably by Alan Peacock and, more recently, by Gavyn Davies and others – belongs to this area. Implicit in this approach is the assumption that a ‘welfare function’ (i.e. a functional relation showing the maximum welfare that can be generated by alternative resource decisions) can be defined for society as a whole. Within such a conceptual framework, media economics can play a role in showing how to minimize the welfare loss associated with any policy choices surrounding media provision.

KEY ECONOMIC CHARACTERISTICS OF THE MEDIA

A good way of getting to grips with what is special about media economics is to consider the characteristics of the media as a whole that distinguish it from other areas of economic activity. One such feature is that media

firms often sell their wares simultaneously in two separate and distinct sorts of markets. Media industries are unusual in that they generally operate in what has been referred to by Picard as a 'dual product' market (1989: 17–19). The two commodities that media firms generate are, first, content (television programmes, newspaper copy, magazine articles, etc.) and, second, audiences. The entertainment or news content that listeners, viewers or readers 'consume' constitutes one form of output which media firms can sell. The audiences that have been attracted by this content constitute a second valuable output, insofar as access to audiences can be packaged, priced and sold to advertisers.

Audiences are the main currency for many media companies, as these provide advertising revenue which, as later chapters will discuss, is a primary source of income for commercial television and radio broadcasters as well as for newspapers and many magazines. Even non-profit-seeking media are concerned with audiences. Public service broadcasters, for example, must pay close attention to their ratings and the demographic profile of their audience because the audience utility or satisfaction they can demonstrate is normally central to negotiations surrounding what level of funding, whether public or otherwise, is made available to them.

The other type of media output – i.e. content – exhibits a number of interesting and unusual features, as have been noted by, for example, Blumler and Nossiter (1991) and Collins et al. (1988: 7–10). Media content is generally classified as a 'cultural' good. Feature films, television broadcasts, books and music are not merely commercial products but may also be appreciated for the ways they enrich our cultural environment. Many cultural goods share the quality that their value for consumers is tied up with the information or messages they convey, rather than with the material carrier of that information (the radio spectrum, CD, etc.). Messages and meanings are, of course, intangible. So media content is not 'consumable' in the purest sense of this term (Albarran, 1996: 28).

It is sometimes difficult to define what constitutes a unit of media content. This could describe, for example, a story, an article, a television programme, an entire newspaper or a radio channel. One way or another, the essential quality that audiences get value from is meanings, which are not, in themselves, material objects. Because the value of media content is generally to do with attributes that are immaterial, it does not get used up or destroyed in the act of consumption. If one person watches a television broadcast, it doesn't diminish someone else's opportunity of viewing it. Because it is not used up as it is consumed, the same content can be supplied over and over again to additional consumers.

So television and radio broadcasts exhibit one of the key features of being a 'public good'. Other cultural goods such as works of art also qualify as public goods because the act of consumption by one individual

does not reduce their supply to others. Public goods contrast with normal or private goods in that private goods (such as a loaf of bread, jar of honey or pint of Guinness) *will* get used up as they are consumed. As soon as one person consumes a loaf of bread it is no longer available to anyone else. A loaf of bread can only be sold once. But when an idea or a story is sold, the seller still possesses it and can sell it over and over again.

The consumption of private goods uses up scarce resources and therefore needs to be rationed (usually by the market and by prices). But public goods do not comply with this logic. The initial cost involved in establishing a public good may be high but then the marginal costs associated with supplying an extra unit of it are next to zero. The marginal cost involved in conveying a television or radio programme to an extra viewer or listener within one's transmission reach is typically zero, at least for terrestrial broadcasters. Likewise, the marginal cost of providing an online publication to one additional Internet user is negligible.

Hoskins et al. (1997: 31–2) note the widespread use of a Research and Development (R&D) analogy to exemplify the very high initial production costs and low replication costs which are characteristic of broadcasting and other media. Generally speaking, once the first copy of a media product has been created (in the expensive R&D phase), it then costs little or nothing to reproduce and supply to extra customers. Increasing marginal returns will be enjoyed as the audience for any given media product expands.

Conversely, there are relatively few savings available for media firms when audiences contract. In most other industries, producers can vary some of their costs up and down in response to how much of their product is being sold (they can cut back on purchases of raw materials if demand slows down). For broadcasters, however, the cost of putting together and transmitting a given programme service is fixed, irrespective of how many viewers tune in or fail to tune in. Similarly, few savings can be made by newspaper and other print media publishers when circulation fails to live up to expectations (although, unlike in broadcasting, marginal print and distribution costs are present).

ECONOMIES OF SCALE

Economies of scale, then, are a highly prevalent feature of the media industry. They will be mentioned and discussed frequently throughout this book so it is worth clarifying what is meant by the term. Economies of scale are said to exist in any industry where marginal costs are lower than average costs. When the cost of providing an extra unit of a good falls as the scale of output expands, then economies of scale are present.

Many industries experience economies of scale, especially those engaged in manufacturing (e.g. of cars) where larger production runs and automated assembly line techniques lead to ever lower average production costs. A variety of reasons may explain why economies of scale are present. Sometimes it is because large firms can achieve better (bulk) discounts on required inputs than smaller firms can. Often, scale economies are to do with the benefits of specialization and division of labour that are possible within large firms.

Economies of scale exist in the media because of the public-good attributes of the industry's product. For media firms, marginal costs (MC) refer to the cost of supplying a product or service to one extra consumer. Average costs (AC) are the total costs involved in providing the product or service, divided by its audience – the total number of users who watch, read, listen to or otherwise consume it. In most sectors of the media, marginal costs tend to be low, and in some cases they are zero. Marginal costs are virtually always lower than average costs. Consequently, as more viewers tune in or more readers purchase a copy of the magazine, the average costs to the firm of supplying that product will be lowered. If average production costs go down as the scale of consumption of the firm's output increases, then economies of scale and higher profits will be enjoyed.

ECONOMIES OF SCOPE

Economies of scope are also to do with making savings and gaining efficiencies as more of a firm's output is consumed. In this case, however, savings are created by offering variations in the character or scope of the firm's output. Economies of scope – economies achieved through multi-product production – are commonly characteristic of media enterprises and, again, this is to do with the public-good nature of media output.

Economies of scope are generally defined as the economies available to firms 'large enough to engage efficiently in multi-product production and associated large scale distribution, advertising and purchasing' (Lipsey and Chrystal, 1995: 880). They arise when there are some shared overheads or other efficiency gains available that make it more cost-effective for two or more related products to be produced and sold jointly, rather than separately. Savings may arise if specialist inputs gathered for one product can be re-used in another.

Economies of scope are common in the media because the nature of media output is such that it is possible for a product created for one market to be reformatted and sold through another. For example, an interview

with a politician which is recorded for broadcast in a documentary might also be edited for inclusion in other news programmes, either on television or, indeed, on radio: the same television content can be repackaged into more than one product. And the reformatting of a product intended for one audience into another 'new' product suitable for a different audience creates economies of scope.

Whenever economies of scope are present diversification will be an economically efficient strategy because 'the total cost of the diversified firm is low compared with a group of single-product firms producing the same output' (Moschandreas, 1994: 155). Strategies of diversification are increasingly common amongst media firms and this reflects the widespread availability of economies of scope. Economies of scope and economies of scale are important characteristics of the economics of media and these concepts will be developed and exemplified in later chapters.

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CORPORATE STRATEGIES

This chapter examines the relationship between the special economic characteristics of media and the corporate configurations that media firms tend to adopt. The vertical supply chain for media is introduced and strategies of horizontal, diagonal and vertical expansion are explained. Taking account of how media markets have been altered by recent technological and regulatory changes, the advantages and benefits available to firms from strategies of monomedia (single sector) and cross-media growth are analysed.

After studying this chapter, you should be able to:

- Understand what is meant by the vertical supply chain
- Distinguish between strategies of vertical, horizontal and diagonal growth
- Discuss the implications for media firms of 'convergence' and of 'globalization'
- Explain the principal motivations behind media and cross-media expansion
- Analyse the economic advantages associated with these strategies

THE VERTICAL SUPPLY CHAIN FOR MEDIA

In order to analyse an industry, one approach used by economists is to carry out a vertical deconstruction or disaggregation. The production of any good or service usually involves several stages that are technically

separable. Vertical deconstruction means breaking the industry's activities up into a number of different functions or stages so that each activity can be studied more closely. The concept behind the vertical supply chain is that the activities of an industry are ordered in a sequence which starts 'upstream' at the early stages in the production process, works its way through succeeding or 'downstream' stages where the product is processed and refined, and finishes up as it is supplied or sold to the customer.

This framework provides a useful starting point for analysing the media. For media industries, it is possible to identify a number of broad stages in the vertical supply chain which connect producers with consumers. The first is the business of creating media content (e.g. gathering news stories, or making television or radio programmes). Second, media content has to be assembled into a product (e.g. a newspaper or television service). Third, the finished product must be distributed or sold to consumers (Figure 2.1).

Essentially, the media industry is about supplying content to consumers. The aim is to make intellectual property, package it and maximize revenues by selling it as many times as is feasible to the widest possible audience and at the highest possible price. The first stage in this process is usually 'production'. The creation of media content is carried out by filmmakers, writers, journalists, musicians, television and radio production companies. Producers may sometimes supply content directly to consumers but, more generally, their output (e.g. television programmes) takes the form of inputs for a succeeding 'packaging' stage. This is when content is collected together and assembled into a marketable media product or service and it is carried out by, for example, newspaper publishers, television networks and magazine publishers. Finally there is 'distribution', which means delivering a media product to its final destination – the audience.

Distribution of media output takes place in several different ways and, for some products, is quite a complex phase. Television and radio services are generally transmitted over the airwaves or conveyed via broadband communication infrastructures. Distribution of pay-television services, however, involves encryption and subscriber management activities as well as transmission of signals. Newspapers and periodicals are usually conveyed to the consumer via another intermediary – newsagents – or they may be delivered directly to the home or to places of employment on

FIGURE 2.1 The vertical supply chain for media

a subscription basis. Electronic distribution over the Internet is another possibility for most types of media content.

All of the stages in the vertical supply chain for media are interdependent. For example, media content has no value unless it is distributed to an audience, and distribution infrastructures and outlets have no value without content to disseminate. No single stage is more important than another: all are interrelated. So, the performance of every firm involved in the supply chain will be threatened if a 'bottleneck' develops – i.e. if one player manages to monopolise any single stage in the chain. If one company gains control over all the substitute inputs at an upstream stage, or all of the facilities required for distribution, then rivals will be put at a considerable disadvantage and consumers are also likely to suffer.

The interdependent relation of different phases in the supply chain has important implications for what sort of competitive and corporate strategies media firms will choose to pursue. The desire for more control over the market environment may act as an incentive for firms to diversify into additional upstream or downstream phases. Vertical integration refers to the extent to which related activities up and down the supply chain are integrated or are carried out jointly by 'vertically integrated' firms whose activities span two or more stages in the supply process. Media firms may expand their operations vertically either by investing new resources or by acquiring other firms that are already established in succeeding or preceding stages in the supply chain.

CHANGING MARKET STRUCTURES AND BOUNDARIES

Economics provides a theoretical framework for analysing markets based on the clearly defined structures of perfect competition, monopolistic competition, oligopoly and monopoly. In practice, many media firms – especially broadcasters – have tended to operate in markets where levels of competition have been strongly influenced by technological factors (e.g. spectrum scarcity) or by state regulations (e.g. broadcasting licence requirements) or by both. These factors have held back competition. In addition, the traditional tendency for media organizations to operate in quite specific geographic markets, and to be closely linked to those markets by their product content and the advertising services they provide within those markets, has curtailed levels of domestic and international competition in some, though not all, mass-media products and services.

However, things are changing. Many of the traditional legislative and technical constraints have recently given way to more competitive market structures. In print media, new technology has reduced some of the high

production costs which used to impede industry entry (Picard, 1998: 123–4). In broadcasting, a steady expansion in the means of delivery (via cable, satellite and, more recently, digital technology) has removed spectrum scarcity and opened up markets to new service providers (Brown, 1999: 17). In audiovisual production, lower capital costs of digital equipment have reduced technology-based entry barriers. And some new content creators have been successful in exploiting the distribution access offered by the growth of the Internet.

But just as new technologies and liberalizing legislation have done away with some of the conventional entry barriers affecting media markets, one or two other new barriers have sprung up in their place. The development of pay television has added extra stages to the vertical supply chain for broadcasting and some of these new stages have been particularly prone to monopolisation. In the UK, for example, ownership of the dominant encryption and conditional access technology required to charge viewers for satellite broadcasts has remained under the control of a single proprietor, News Datacom (a sister company of BSkyB). The term 'gateway monopolist' is used to describe firms that gain control over some vital stage in the supply chain or 'gateway' between the broadcaster and viewer. If left unrestrained by regulators, such gateway monopolists clearly threaten to create new entry barriers in the broadcasting sector (Cowie and Marsden, 1999).

More generally, the traditional boundaries surrounding media markets are being eroded. National markets are being opened up by what is sometimes referred to as 'globalization'.

> The communications revolution has . . . caused an internationalization of competition in almost all industries. National markets are no longer protected for local producers by high costs of transportation and communication or by the ignorance of foreign firms . . . Global competition is fierce competition, and firms need to be fast on the uptake . . . if they are to survive.
> (Lispey and Chrystal, 1995: 258)

The emergence of a borderless economy and more international competition has naturally affected media markets and firms across the globe (Carveth et al., 1998: 223). The transnational integration of markets that were previously just national markets through, for example, the European Union and North American Free Trade Agreement (NAFTA), has accelerated the process. Throughout the 1990s, policy-makers in the USA and Europe sought to develop initiatives which supported the development of a 'global information society'. To some extent at least, their hopes have been realized by the dramatic growth of a truly transnational and borderless distribution infrastructure for media in recent years – the Internet.

So, changes in technology are also helping to erode traditional market boundaries. And it is not just geographic market boundaries that are being affected but also product markets. Technological convergence has blurred the boundaries between different sorts of media and communication products and markets. The term 'convergence' is used in different ways but, generally speaking, it refers to the coming together of the technologies of media, telecommunications and computing. Digital technology – the reduction of pieces of information to the form of digits in a binary code consisting of zeros and ones – is the driving force behind convergence. Sectors of industry that were previously seen as separate are now converging or beginning to overlap because of the shift towards using common digital technologies.

The implications of convergence are far-reaching. With the arrival of common digital storage, manipulation, packaging and delivery techniques for information (in all types of media content), media output can more readily be repackaged for dissemination in alternative formats. For example, images and text gathered for a magazine, once reduced to digits, can very easily be retrieved, reassembled and delivered as another product (say, an electronic newsletter). Digitization and convergence are weakening some of the market boundaries that used to separate different media products.

Convergence is also drawing together the broadcasting, computing and information technology (IT) sectors. According to consultants KPMG, '[u]ltimately, there will be no differences between broadcasting and telecommunications' (Styles et al., 1996: 8). More and more homes are now linked into advanced high capacity communication networks and, through these, can receive a range of multimedia, interactive and other 'new' media and communication services as well as conventional television and telephony. Because of the potential for economies of scale and scope, the greater the number of products and services that can be delivered to consumers via the same communications infrastructure, the better the economics of each service.

STRATEGIC RESPONSES OF MEDIA FIRMS

The ongoing globalization of media markets and convergence in technology between media and other industries (especially telecommunications and computers) have caused many media firms to adapt their business and corporate strategies. As traditional market boundaries and barriers have begun to blur and fade away, the increase in competition amongst the media has been characterized by a steady growth in the number

of perceived distributive outlets (or 'windows') which are available to media firms.

The logic of exploiting economies of scale creates an incentive to expand product sales into secondary external or overseas markets. As market structures have been freed up and have become more competitive and international in outlook, the opportunities to exploit economies of scale and economies of scope have increased. Globalization and convergence have created additional possibilities and incentives to re-package or to 'repurpose' media content into as many different formats as is technically and commercially feasible (book, magazine serializations, television programmes and formats, video, etc.) and to sell that product through as many distribution channels or windows in as many geographic markets and to as many paying consumers as possible.

The media industry's response has been marked. Media firms have been joining forces at a faster pace than ever before. They have been involved in takeovers, mergers and other strategic deals and alliances, not only with rival firms in the same business sector, but also with firms involved in other areas of the media and even with firms in other industries (e.g. telecommunications) which are now seen as complementary business areas.

Convergence and globalization have strengthened trends towards concentrated media and cross-media ownership, with the growth of integrated conglomerates (e.g. Time Warner/AOL, Pearson, Bertelsmann) whose activities span several areas of the industry. This makes sense. Highly concentrated firms who can spread production costs across wider product and geographic markets will, of course, benefit from natural economies of scale and scope in the media (Hoskins et al., 1997: 22; Corn-Revere and Carveth, 1998: 64–5). Enlarged, diversified and vertically integrated groups seem well suited to exploit the technological and other market changes sweeping across the media and communications industries.

At least three major strategies of corporate growth can be identified and distinguished: horizontal, vertical and diagonal expansion. A **horizontal** merger occurs when two firms at the same stage in the supply chain or who are engaged in the same activity combine forces. Horizontal expansion is a common strategy in many sectors: it allows firms to expand their market share and, usually, to rationalize resources and gain economies of scale. Companies that do business in the same area can benefit from joining forces in a number of ways, for example by applying common managerial techniques or finding greater opportunities for specialization of labour as the firm gets larger. In the media industry the prevalence of economies of scale makes horizontal expansion a very attractive strategy.

Vertical growth involves expanding either forward into succeeding stages or backward into preceding stages in the supply chain. Vertically

integrated media firms may have activities that stretch from creation of media output (which brings ownership of copyright) through to distribution or retail of that output in various guises. Vertical expansion generally results in reduced transaction costs for the enlarged firm. Another benefit, which may be of great significance for media players, is that vertical integration gives firms some control over their operating environment and it can help them to avoid losing market access in important upstream or downstream phases.

Diagonal or 'lateral' expansion occurs when firms diversify into new business areas. For example, a merger between a telecommunications operator and a television company might generate efficiency gains as both sorts of services – audiovisual and telephony – are distributed jointly across the same communications infrastructure. Newspaper publishers may expand diagonally into television broadcasting or radio companies may diversify into magazine publishing. A myriad of possibilities exists for diagonal expansion across media and related industries. One useful benefit of this strategy is that it helps to spread risk. Large diversified media firms are, to some extent at least, cushioned against any damaging movements that affect any single one of the sectors they are involved in. More importantly perhaps, the widespread availability of economies of scale and scope means that many media firms stand to benefit from strategies of diagonal expansion.

In addition, many media firms have become what are called **transnationals** – corporations with a presence in many countries and (in some cases) a decentralized management structure. Globalization has encouraged media operators to look beyond the local or home market as a way of expanding their consumer base horizontally and of extending their economies of scale. For example, UK media conglomerate EMAP plc acquired several magazine publishing operations in France in the mid-1990s and has since expanded heavily into the US market. Swedish group Bonnier, which specializes in business news and information, expanded into the UK in autumn 2000 with the launch of a new daily newspaper, *Business AM*, in Scotland.

The basic rationale behind all such strategies of enlargement is usually to try and use common resources more fully. Diversified and large scale media organizations are clearly in the best position to exploit common resources across different product and geographic markets. Enlarged enterprises are better able to reap the economies of scale and scope which are naturally present in the industry and which, thanks to globalization and convergence, have become even more pronounced.

This leads towards what Demers calls the 'paradox of capitalism' – that increased global competition results in *less* competition in the long run (Demers, 1999: 48). Even with a loosening up of national markets and

fewer technological barriers to protect media incumbents from new competitors, the trend that exists in the media – of increased concentration of ownership and power in the hands of a few very large transnational corporations – clearly reflects the overwhelming advantages that accrue to large scale firms.

MANAGERIAL THEORIES

The economic characteristics of media output and the market changes discussed above provide a compelling explanation for why profit-maximizing media firms should pursue strategies of expansion. But there are alternative schools of thought on what it is that drives firms – media or otherwise – to expand. Other approaches suggest that expansion is usually more to do with satisfying the personal interests of managers rather than with maximizing profits.

Most firms these days take the form of a public limited company (or plc) and are run by managers rather than by owners (or shareholders). Ownership and control of the firm are therefore separate and, because managers have different objectives from shareholders, a divergence from profit maximization becomes possible.

> Principal–agent analysis shows that, when ownership and control are separated, the self-interest of agents . . . [in this case, media managers] . . . will tend to make profits lower than in a 'perfect', frictionless world in which principals . . . [in this case, media shareholders] . . . act as their own agents.
> (Lipsey and Chrystal, 1995: 318)

Managers are, of course, concerned with keeping up profits, but they also have their own personal concerns. Marris – an influential management theorist – suggested that a principal aim of managers is try to expand the firms they are running, at all costs, and irrespective of whether it would make the firm more efficient or more profitable (Moschandreas, 1994: 284–5). The suggestion by Marris, Williamson and other managerial theorists is that growth of the firm is the main objective because this raises managerial utility 'by bringing higher salaries, power, status, and job security' (Griffiths and Wall, 1999: 91).

So the reasons why managers try to expand the firm may be because, first, salary levels for senior management are quite closely linked to the scale of a firm's activities. For example, the Chief Executive of British Telecommunications (BT) earns more than the Chief Executive of Scottish Media Group (SMG) or of the Stirling Observer. Fast-growing rather than

static firms also give higher remuneration to managers. In addition, as a firm grows, its senior managers become powerful captains of industry and are often invited to join prestigious industry bodies, such as the Confederation of British Industry (CBI). The senior manager of a large media firm clearly has a powerful and politically influential role.

Another reason why managers try to 'build empires' may be because it makes it more difficult for their firm to be taken over by a predator. Senior managers usually want to avoid takeover and the risk of replacement by a new management team. By expanding – e.g. through acquisition of several smaller companies – a firm makes itself a more expensive and difficult target for takeover. The less prone a firm is to takeover, the greater the job security of its senior managers.

Most scholars of industrial economics accept that managers have some element of discretion to pursue goals other than profit maximization, and that managerial agendas can sometimes help explain corporate behaviour. On the other hand, deterministic approaches to expansion on the part of the firm tend to emphasize profit maximization as the fundamental motive. The remaining sections of this chapter draw on recent empirical research carried out in the UK for examples of what sorts of benefits and advantages accrue, in practice, as media firms expand.[1]

ADVANTAGES OF HORIZONTAL EXPANSION

In general, horizontal expansion – i.e. expansion in a firm's market share, either through internal growth or by acquisition of another firm with a similar product – may be motivated by the profit-maximizing firm's desire for greater market power (e.g. the ability to exercise some control over price) or by efficiency gains. The net impact of expansion on market performance and, ultimately, on societal welfare generally depends on the trade-off between these two possible outcomes. Whereas the achievement of efficiency gains (an improved use of resources) may be seen as serving the public interest, the accumulation of market power and market dominance may lead to behaviour and practices which run contrary to the public interest.

The relationship between the size and efficiency of firms depends largely on the availability of economies of scale: on whether marginal costs are less than average costs as output expands (Martin, 1993: 21). Economies of scale, which are frequently cited as the most important motive for

1. The findings of this research are reported in fuller detail in Doyle (2000).

horizontal mergers or acquisitions (Griffiths and Wall, 1999: 90–1), are a particularly prevalent incentive for expansion by media firms.

The experience of a sample of UK television broadcasting companies in 1996 provides evidence that large broadcasters are more profitable than small ones (Figure 2.2). The correlation between market share and profitability suggested by this data is largely to do with economies of scale.[2] The factors other than size which are most likely to have a bearing on the financial performance of individual media companies are variations in managerial efficiency and niche product positions. The relationship between size and performance may, of course, be subject to some additional complexities.[3] Nonetheless, the evidence provided by this sample group confirms that television broadcasters enjoy greater economies of scale (and, in turn, higher profits) as their market share expands.

This correlation is not entirely surprising. As previous writers have noted, extensive product-specific economies of scale exist in the broadcasting industry because, once a delivery infrastructure is in place, the marginal costs of providing the service to an additional viewer (within one's

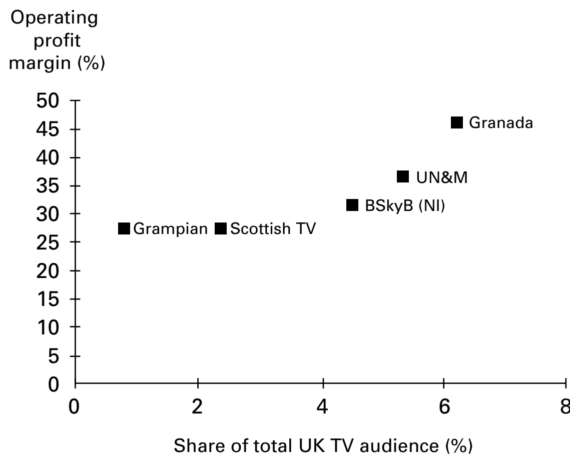

FIGURE 2.2 Market share and operating profit margins in television broadcasting in 1996

Note: Figures compiled drawing on Broadcasters Audience Research Board (BARB) ratings, company annual accounts and estimates for divisional analysis. News International (NI) is the largest shareholder in satellite broadcasting BSkyB. United News & Media (UN&M), like Granada, Scottish Television and Grampian Television operated one or more regional terrestrial services in 1996.

2. According to findings gathered from interviews carried out in 1997 with senior managers across this group of UK media firms.
3. Different delivery systems for television in the UK have different cost and revenue structures, partly reflecting technology but also because of (uneven) regulation.

transmission area or 'footprint') are zero or extremely low (Cave, 1989: 11–12). The overhead costs associated with providing a given service tend to be equal, regardless of audience size and so, *ceteris paribus*, economies of scale arise as larger audiences are translated into more revenue.

Economies of scale are present in virtually all sectors of the media, from magazine publishing to radio broadcasting to music publishing. Consequently, horizontal expansion is an advantageous strategy for most media firms. In newspaper publishing, for example, the marginal costs involved in selling one additional copy of the same edition of a newspaper are relatively low, so product-specific economies of scale will arise as circulations expand. Marginal costs are positive since (unlike broadcasting) the product is delivered in a tangible form, involving some printing and distribution costs. But editorial overheads tend to be the largest single component of expenditure for print media publishers and these do not necessarily change as consumption of the product expands or contracts. The editorial overheads associated with publishing any given newspaper title tend to be 'fixed', regardless of actual circulation volume, and so economies of scale can be gained as larger levels of readership are translated into more revenue.

The widespread availability of economies of scale in the media industry is generally associated with low replication costs for media output. Initial production costs (the cost of creating the first or master copy) may be high but then very few marginal costs are incurred as the product is replicated and distributed or sold over and over again to ever greater numbers of consumers. However, even within the expensive initial content production phase, economies of scale may be present. Firms engaged in content production may find that marginal costs (say, the cost of creating one additional hour of a television drama) are lower than average costs (total production costs divided by the number of hours of drama already produced) as output expands.

As the output of a television production company increases, the firm may derive economies of scale on fixed overheads by, for example, making better use of capital equipment (cameras, post-production facilities, etc.) or salaried personnel. So horizontal expansion may be motivated by the desire to increase the use of under-utilized resources. Media companies that expand horizontally and increase their output may also enjoy productivity gains because of the opportunity for specialization of tasks as the firm grows larger. The realization of scale economies may, arguably, facilitate higher levels of gross investment and speedier adoption of new technologies on the part of large media firms. And faster growing media firms may be able to attract better-quality personnel.

When a firm expands horizontally, an important potential efficiency gain is the opportunity to spread the use of specialized resources or

expertise across more than one product. Any savings made in this way represent economies of scope. Efficiency gains will arise if specialist content gathered for one media product can be re-used in another.

So economies of scope as well as economies of scale may co-exist for television broadcasters who operate more than one programme service, and the more homogeneity possible between both services, the greater the economies of scope. To the extent that the owner of two regional broadcasting services or two local cable franchises is able to share the same programming, or common elements of programming, a cost advantage can be achieved. Broadcasting 'networks', which are discussed in Chapter 4, are based on the logic of exploiting such advantages. As a broadcaster expands horizontally and increases the number of services it is delivering, opportunities arise to combine back-office activities (e.g. finance and administration) as well as specialist support functions such as airtime sales or secondary programme sales.

The prevalence of economies of scope in the media explains the widespread tendency towards expansion and the high number of multi-product firms. For example, EMAP plc currently owns some 19 separate local radio stations throughout the UK. News Corporation owns four major national newspaper titles.

For newspaper proprietors that publish more than one title, various economies of scope may arise. Large publishers may achieve better collective terms on input prices or support services (e.g. printing or distribution). Publishers of several titles may be able to combine and rationalize back-office functions or other shared activities such as advertising sales. However, there is disagreement about the extent to which economies of scope can be gained within the editorial process. Perspectives offered by experienced managers in the UK newspaper industry indicate a divergence in opinions about how far the process of sharing costs between different newspaper titles can go.

At one extreme, some newspaper executives believe that the most cost-effective way to produce a given range of titles is to draw, as appropriate to each newspaper's individual character, on what is regarded as a completely flexible internal pool of shared journalistic expertise:

> [Title X] . . . has a whole machinery for covering television soap operas and the Royal Family, so why would it be duplicated by . . . [Title Y]?
>
> Why doesn't . . . [Title Y] simply *leverage* the resource brought in by its partner newspaper, and customise it, so that it's all in the editing process rather than the gathering process?[4]

4. Citation from interview carried out in April 1997 with the CEO of a major UK newspaper publishing firm.

However, many publishers are sceptical about the benefits available from trying to integrate as many cost functions as possible for competing titles. Combining the journalistic functions of different titles may yield cost savings but a majority of UK publishers seem to feel that this would jeopardize the individual tone of each product:

> We've looked at all this and it is not any easy one . . . Sharing journalists across different titles would be extreme. It is *very* hard to do . . . You risk losing the independence of your title . . .[5]

The presence of economies of scale and scope in the media implies a natural gravitation towards oligopoly market structures and large scale multi-product firms. Provided that product quality does not suffer as a result of sharing or spreading costs amongst more consumers or over a greater number of media products, then strategies of horizontal expansion will yield efficiency gains which, in theory, ought to add to societal welfare. However, if cost-savings are achieved at the expense of viewers' or readers' utility then we cannot say that expansion leads to improved efficiency.

Aside from efficiency, another important advantage of having a large market presence in any sector of the media (or of cross-owning media products in several sectors) is that it gives the firm greater 'critical mass'. Large firms have greater negotiating leverage in deals with suppliers and with buyers. For example, large newspaper and magazine publishers will tend to get a better deal on paper and newsprint prices. A dominant firm has greater ability to exercise some control over the prices it charges its customers. Large media firms who control access to mass audiences may well be able to command premium prices for advertising (i.e. a higher cost per thousand – CPT – rate than smaller firms).

The greater market power which large media firms command will enhance their profitability, but it may also harm consumer interests (e.g. if prices charged are too high) and it may pose a threat to the operation of markets. To the extent that the exercise of market power by large media groups serves to impede competition, then the strategic advantage it confers upon the individual firm is simultaneously an obstacle to market efficiency and a disadvantage for consumers. In summary then, strategies of horizontal expansion can deliver a range of efficiency gains that contribute positively to societal welfare but they will pose a threat when individual firms are allowed to acquire excessive market power.

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5. Citation from interview carried out in April 1997 with the Finance Director of a major UK newspaper publisher and television broadcaster.

ADVANTAGES OF DIAGONAL EXPANSION

Diagonal expansion refers to developing the business sideways or 'diagonally' into what may be perceived as complementary activities (e.g. newspapers plus magazines, or television plus radio). Many strategies of diagonal cross-media expansion result in positive synergies and efficiency gains. A very important potential advantage is the opportunity to spread the use of specialized resources or expertise across more than one sort of media product. This will, of course, give rise to economies of scale and of scope.

The combinations of cross-media ownership that yield the most significant economic efficiencies tend to be those which enable the firm to share either common specialized forms of content or a common distribution infrastructure. When a media firm's output is characterized by a particular theme or subject matter, then expanding operations into several different sectors will usually create important synergies. For example, Pearson's specialization in providing one particular form of media content – management information – enables it to exploit economies of scale and scope across several different products (e.g. the *Financial Times* newspaper, FT business magazines, FT newsletters, FT newscasts, etc.) and modes of delivery (e.g. print, broadcast) for that content.

A focus on one particular type of content may enable the firm to build very strong brands that are more likely to be successful in crossing over from one platform to another. So specialization and the development of recognizable brands (e.g. the *Financial Times*) make it easier for firms to exploit new vehicles for delivery of media content, such as the Internet. In addition, diversified media companies such as Pearson or Time Warner are able to reduce costs by exploiting overlaps in the production process for some of their products. Cross-ownership between, for example, newspaper publishing, magazine publishing and book publishing creates potential economies in any processes and inputs which are common to all of these activities, such as printing and purchasing paper.

Most significantly, however, the availability of economies of scale and scope depends on the extent to which specialist inputs – i.e. elements of media content – or other important resources can be re-used or exploited more fully as the firm expands diagonally. This, in turn, may depend on how homogeneous the content of each media product is and how readily such content can be repackaged into different formats (i.e. the relationship between the marginal costs of reformatting content and the marginal revenues likely to be raised by selling it again in extra product markets).

Digitization makes it possible to reduce all sorts of images, sounds and text to a common format and to transport these via a common distribution infrastructure. Media content, when reduced to digital 'metadata',

can be stored, retrieved, manipulated, reformatted and repackaged with much greater ease than before. So the spread of digital technologies across different sectors of the media and communications industries has significant implications for the savings and efficiency gains that are potentially available via strategies of diagonal cross-media expansion.

The benefits and advantages of diagonal expansion involving media and telecommunications companies have been analysed by Albarran and Dimmick, who use the term 'economies of multiformity' to describe the benefits of diagonal concentrations of ownership (1996: 43). Economies of multiformity refer to any and all advantages that firms derive from cross-owning activities in more than one sector of the media or communications industry. Such economies will be gained by a telephone company moving into the cable television industry and using its existing distribution infrastructure to sell two services instead of just one – i.e. economies of scale in distribution. Or economies of multiformity arise when the same media content is repackaged or repurposed into different media products – i.e. economies of scope. Thus, the term 'economies of multiformity' embraces all benefits that come about through diagonal cross-ownership in the media and communications industries.

Different combinations of diagonal cross-ownership will, of course, yield different sorts of efficiency gains. Expansion from print to electronic publishing offers plentiful opportunity to share or repurpose specialist content between these two different text-based activities. Likewise, diagonal mergers between magazine and newspaper publishers can offer operational synergies. Efficiency gains are also possible, to some extent, through sharing of production and transmission resources between radio and television (as exemplified by the 'bi-media' approach introduced at the BBC in the 1990s).

However, combinations of text-based plus audio products, or text-based plus audiovisual products will not necessarily give rise to economies of scale or scope or to any other economic advantages. Where a newspaper and a television service share a strong common focus or theme (e.g. a focus on business news or on a specific locality) then clearly opportunities will arise to share or repurpose intellectual property. But when no such overlap in content exists then relatively few other potential efficiency gains seem to be available. Some opportunities may arise to combine back-office activities or, perhaps, to introduce improvements in managerial efficiency but no more than in any merger involving other (loosely related) sectors of activity. As one senior UK media executive points out:

> [t]here are actually a lot of successful groups who have operated both [television broadcasting and newspaper publishing], always operating each *distinctly* – with the exception of, occasionally, slavishly cross-promoting [e.g. using an established newspaper title to promote a new TV service] . . .

I do not think that television and newspapers are a ‘natural’ diversification from each other.

Notwithstanding the spread of digital technologies, the skills, techniques and equipment involved in newspaper production and distribution are, in fact, generally still quite *different* from those required in the television industry, and vice versa. So, combining these activities under common ownership will not necessarily create any special efficiency gains or opportunities to rationalize resources. Unless each service has a strong shared focus there is little economic incentive for seeking to combine these activities. Consequently, diversified media conglomerates such as News Corporation will often allow broadcasting and newspaper subsidiaries to operate in almost complete isolation from each other.

If ‘natural’ economies of scope between broadcasting and newspaper publishing activities are non-existent, it follows that few economic benefits can be directly or solely attributed to diagonal expansion from television to newspapers or vice versa. Why then, are strategies of diagonal cross-media ownership so common?

One very important special feature of cross-owning television and newspapers is the opportunity it creates to cross-promote the firm’s products. Whether this feature is economically beneficial or damaging depends on how it is used. When cross-promotion is used to facilitate *de novo* expansion (the introduction of new products which increase choice) then welfare and competition should be enhanced (Moschandreas, 1994: 349). For example, if a media conglomerate uses the pages of its newspapers to attract attention to and promote the launch of a new television service that adds to competition and viewer choice then, arguably, cross-promotion is economically beneficial. On the other hand, if the conglomerate uses cross-promotion to build cross-sectoral dominance for its existing media products then this will have a negative impact on competition and on pluralism.

Risk-reduction is another potential benefit associated with diagonal expansion. Firms diversify in order to spread their risks and so that they are not too dependent on any one product market. A media firm whose income is derived wholly from advertising (e.g. a commercial radio broadcaster) may expand operations into another media sector where revenues come directly from consumers in order to protect or cushion itself against cyclical downturns in advertising expenditure. A firm operating in a declining industry may wish to diversify into a perceived growth area. The UK national newspaper industry provides a clear example of a sector which is in slow decline while subscription television and electronic media are perceived as growth areas. So newspaper publishers might well seek to diversify in order to secure growth in future earnings.

Another motivation underlying strategies of cross-media expansion is the desire to exploit anticipated synergies and 'economies of multiformity' between newspaper publishing and television broadcasting which may develop over the long term. The expectation that growth in electronic communications will stimulate demand for new products based on both audiovisual images and text has been cited as one factor encouraging diagonal mergers between UK television broadcasters and newspaper publishing companies.

Motives other than profit maximization – i.e. managerial motives – may also play a role in cross-media mergers. A television company may decide to join forces with a newspaper publishing firm as 'a defensive move' against hostile takeover, i.e. in order to make the enlarged company less attractive to potential predators. Alternatively, the managers of a media firm may pursue a strategy of diagonal expansion because, irrespective of efficiency implications, their own prestige (and, perhaps, political influence) will increase as their 'empire' grows.

So in analysing the gains that arise from any strategy of diagonal expansion, it is worth distinguishing between different sorts of advantage – efficiency gains versus risk-spreading, etc. – and between different potential beneficiaries – the firm's shareholders, or its managers or society at large. The achievement of efficiency gains (e.g. economies of scale and scope) will not only serve the interests of the firm but should also contribute to the wider good of the economy by engendering an improved use of resources. However, strategies of cross-media expansion that yield no efficiency gains and are predicated solely on the strategic interests of the firm's shareholders or managers will not give rise to any general economic gains.

On the contrary, the accumulation of greater size, more market power and dominant market positions can lead to behaviour and practices which run contrary to the public interest (Moshandreas, 1994: 483–4). Once a firm achieves a dominant position, the removal of competitive pressures may give rise to various inefficiencies, including excessive expenditure of resources aimed simply at maintaining dominance. Hence, competition policy – which applies to media as well other firms – strives to promote sufficient competition to induce firms to operate efficiently. Public policy issues surrounding concentrated media ownership are dealt with in fuller detail in Chapter 9.

ADVANTAGES OF VERTICAL EXPANSION

The vertical supply chain outlined in Figure 2.1 indicates how it is possible to break down into stages each of the activities involved in making and then supplying a media product to the consumer. For instance, the newspaper industry can be disaggregated into news-gathering, editing, printing, distribution and retailing. The television industry can be broadly broken down into programme production, assembling the schedule and transmission to viewers. Many media firms are vertically integrated – i.e. they are involved in activities at more than one stage in the supply process. Vertical expansion is a strategy which is increasingly common, for example, amongst the main US television broadcasting networks and their suppliers and rivals (Owen and Wildman, 1992: 202–4).

Why is vertical integration an attractive strategy? Broadly speaking, it makes sense to control both content production and distribution because the greater the distribution of your output the lower your per-unit production costs will be. In television, per-viewer production costs can be reduced by 'selling' the same output to as many different audiences or segments of the audience as possible. As a distributor, vertical expansion upstream into production means that you have an assured supply of appropriate content to disseminate through your distribution infrastructure. As a content producer, vertical integration with a distributor means assured access to audiences.

Vertical expansion is not only about maximizing revenues and gaining more security or control over the market. Another advantage is that it can reduce 'transaction costs'. Broadcasters who internalize the programme production process rather than purchasing programme rights in the open market may face fewer complications, delays and so on in securing exactly the sort of content they require.

So, as with other forms of expansion, the two main incentives associated with vertical growth are improved efficiency and the accumulation of market power. In any example of vertical expansion, both motives may be present and, indeed, 'the two are not unrelated' (George et al., 1992: 65). Vertical integration may be motivated by the desire to minimize costs or by the desire for greater security (e.g. access to essential raw materials such as, for a broadcaster, attractive television programming) but then the latter – the desire to gain some control over the market environment – may itself result in market dominance.

Looking more closely at how vertical integration can help minimize costs, an important consideration is the difference between the expenses involved in buying from or selling to other firms – obtaining information, negotiating contracts, etc. – and the expenses involved in carrying out the functions performed by these other firms within one's own organization.

Ronald Coase (1937) first introduced the idea that 'the market' and 'the firm' represent alternative modes for allocating resources. For Coase, firms exist because the co-ordination of economic activity through the firm (by hierarchies of managers) is less costly than through the market (by the pricing system). Integration of activities within the structure of a firm will occur because it creates 'transaction cost' savings and these act as an incentive to integrate vertically.

The potential for cost reduction within a firm may stem from improved information – about price or product specifications or, more generally, about the market. In the television industry, for example, the costs (created by uncertainty, weaker informational flows, etc.) involved in inter-firm trade between programme producers and broadcasters may well be higher than when both activities are carried out in house. It may save time and hassle to be able to source the programmes that are needed directly from an in-house production division rather than having to shop around, negotiate and make deals with external programme-makers.

But, for media firms, a more important factor encouraging vertical expansion stems from the interdependent relation of different phases in the supply chain. Media content is no good without access to audiences, and vice versa. So, the main driving force for firms to diversify into additional upstream or downstream phases is the desire to gain more security and control over the market environment. Integrated media firms can avoid the market power of dominant suppliers or buyers. Vertical expansion gives secure access to essential inputs or essential distribution outlets for output. This is a key advantage in the media, since firms depend on getting access both to content and to avenues for distribution of content.

A broadcaster that has to rely on external producers to supply all the 'hit' programmes in its schedule will find itself vulnerable to the possibility of post-contractual opportunistic behaviour on the part of these suppliers. If the supplier of a key programme series in a broadcaster's schedule threatens to withdraw that series or sell it at a higher price to a rival broadcaster, then high costs may have to be incurred to retain that programme. Vertical integration is a way of avoiding the higher costs associated with such behaviour (Martin, 1993: 274).

If monopoly power is present in the programme production stage (say, because a supplier has control over a specific programme for which no perceived substitutes are available) then, even without vertical integration, the firm with upstream monopoly power may be able to appropriate some of any monopoly profits available at the broadcasting stage (Moschandreas, 1994: 417). It is rarely the situation that no substitutes are available for a particular product but, in television programming specificity of inputs (particular actors, writers or presenters) is a factor in their popularity and

success. So, to avoid being held to ransom by important suppliers, broadcasters and other media distributors may have no choice other than to expand vertically into production.

From a content-producer's point of view there are also numerous attractions in vertical integration. Ownership of, say, a broadcaster or a video distributor ensures that the firm's output will find its way to audiences. Vertical integration may lead to a more predictable and reliable stream of orders. According to the Finance Director of a major television company which is part of the ITV network in the UK, a production company that is vertically integrated with a broadcaster will gain informational advantages over its independent rivals which help it to secure more 'commissions' or orders for programmes:

> Everyone likes to pretend that there's a level playing field in terms of access [for independent and vertically integrated producers] to the ITV network – I don't think anyone actually *does* believe that because it's perfectly obvious that if you've got the same people working in production as broadcasting then you're not going to have 'Chinese Walls'. There's going to be occasions when someone from broadcasting says to someone from production – 'I'll tell you what we really want: a cracking entertainment programme for Wednesday nights'. There is absolutely no doubt that being part of ITV [broadcasting] gets the intelligence to you faster. It would be daft to pretend otherwise, because it's self-evident, really . . .

A steady and predictable production slate is an important advantage for programme-makers. This, in turn, allows the vertically integrated production company to plan more effectively and to use its production resources, equipment, technicians and personnel more efficiently. The assured distribution enjoyed by a vertically integrated production firm also helps to build that producer's reputation, or brand name, as a supplier of programmes.

An example of another sort of vertical/diagonal merger in the media industry was provided recently by Time Warner and America Online (AOL). Time Warner, a major producer of news and entertainment, owns a huge library of media content and also runs the second-largest US cable network. America Online is the largest Internet Service Provider (ISP) in the US with some 26 million subscribers. The potential gains for Time Warner/AOL from bringing together strengths both in content creation and in online distribution are clearly very promising. The dangers posed to rivals by allowing such a powerful vertically integrated entity to take shape were summed up in a *Financial Times* editorial as follows: 'The combined group could harm other content providers by restricting access to AOL subscribers and damage other ISPs by denying them access to Time Warner content' (2001: 22).

It is sometimes difficult to disentangle the pursuit of greater efficiency and greater security from the pursuit of monopoly power (George et al., 1992: 72). A media firm might well expand vertically in order to gain greater security, but the more control it acquires over all stages in the vertical supply chain, the more danger there is that it will start to dominate the market, with detrimental consequences for rivals and consumers. Vertical integration may protect the market power of incumbent firms by raising barriers to entry. For example, if all the best programme-producers are cross-owned by broadcasters then, in order to secure its own supply of attractive programming, a new market entrant in the broadcasting arena would also be forced to adopt a vertically integrated structure (thus pushing up the costs of market entry). So, vertical expansion can be seen, in one way (i.e. that of Coase), as a response to market failures and imperfections and, in another sense, as a source of such market imperfections.

three

ECONOMICS OF ADVERTISING

One of the main sources of revenue for many media organizations is advertising. Consequently, patterns of advertising activity exert a very significant influence on the fortunes of the media industry as a whole. This chapter is concerned with the key arguments surrounding the economic role played by advertising, and with its impact on market structures and on consumer decision-making. It introduces you to the economic forces and factors which determine the extent of advertising activity in an economy, examining why levels of advertising vary from one country to another, and over time. It also considers the impact of new media technologies on patterns of advertising.

After studying this chapter, you should be able to:

- Understand why advertising takes place
- Identify and explain the factors which influence the amount of advertising activity taking place in an economy, and understand why it is cyclical
- Assess whether advertising is a beneficial or a harmful economic force
- Explain the problems firms face in deciding how much of their resources to devote to advertising

THE ADVERTISING INDUSTRY

Advertising is ubiquitous. Its roots can be traced back to the cave but, in the twenty-first century, its reach and influence have become virtually

inescapable. Over the last 50 years an increased willingness on the part of firms to invest in building awareness of themselves and of their wares has given rise to the rapid development of the advertising, marketing and public relations sectors. Advertising agencies have generated catchphrases, jingles and images to make brands familiar to audiences both across the globe and across generations.

Advertising is big business, and the industry it has spawned has grown quickly and diversified to keep pace with ongoing market changes and with the development of newer forms of media. Alongside the basic function of creating advertising messages, many agencies offer an array of specialist communication services, including provision of sophisticated market research information or consultancy related to sponsorship deals. The major advertising agencies in the world – of which WPP, Omnicom and Interpublic are currently the largest – are diversified multinational corporations with networks of operating subsidiaries and strategic alliances that provide clients with global audience reach as well as creative advertising ideas.

As advertising expenditure has grown in response to rising economic prosperity in the developed world, the advertising industry has flourished. According to estimates from Zenith Media (cited in Tomkins, 2000), global expenditure on advertising reached some $330 billion in the year 2000 – a sizeable slice of our collective resources. But even this understates the extent of advertising, because industry projections tend to focus on conventional media only – i.e. television, radio, press, cinema and 'outdoor' or billboard sites. This excludes some significant investment in other forms of advertising and marketing including, of growing importance since the late 1990s, expenditure on Internet advertising. It is suggested that around $7.5 billion was spent globally on Net advertising in 1999 (Zenith Media, 2001: 115) and expenditure on it is continuing to expand rapidly, particularly in the USA.

The growth of the advertising sector has brought about the establishment of various industry bodies including, in the UK, the Advertising Association (AA). Founded in 1924, the AA represents all branches of the industry and its functions include promoting the benefits of advertising, lobbying on behalf of its members and gathering information about all aspects of advertising (Meech, 1999: 29). Annual statistics compiled by the Association provide a clear picture of the extent of advertising activity both within individual sectors, such as television or radio, and across the media as a whole. The breakdown provided in Table 3.1 reveals a healthy pattern of growth in UK expenditure on advertising in all the major media in recent years.

TABLE 3.1 Breakdown of total advertising expenditure in the UK (£bn)

	1995	1996	1997	1998	1999
Press	5.98	6.41	6.97	7.53	7.83
Television	3.14	3.39	3.70	4.03	4.32
Outdoor & Transport	0.41	0.47	0.55	0.61	0.65
Radio	0.30	0.34	0.39	0.46	0.52
Cinema	0.07	0.07	0.09	0.10	0.12
Total	9.89	10.68	11.70	12.73	13.44

Source: Advertising Association (2000: 33)

WHY DOES ADVERTISING TAKE PLACE?

Why does all this advertising take place? Firms spend money on advertising in the hope of persuading consumers to buy their products. The general aim behind advertising expenditure is to try to increase sales and to reinforce consumers' loyalty to particular brands.[1] So, advertising is a form of competitive behaviour: it is one of the main tools that firms can use to compete to entice consumers to switch to their own product rather than that of a rival. Other tactics a firm might use to try to gain advantage over its competitors include making changes to the quality of the product so as to increase its attractiveness, or simply making adjustments to its price so as to undercut rivals.

According to the economic theory of firms, whether or not an organization is likely to engage in competitive behaviour depends on which kind of market structure it is operating within. As discussed earlier, the term 'competitive market structure' describes the kind of market situation a firm can find itself in, and is primarily to do with how many rivals it has, whether the market is open to new entrants, how similar the goods on offer are, and how much power each firm has in relation to market demand and over prices. Advertising generally takes place in market situations where firms have an incentive to engage in some form of competitive behaviour (Chiplin and Sturgess, 1981; Lipsey and Chrystal, 1995: 259).

Broadly speaking, the more competition that is present in a market, the greater the need to advertise. Thanks to globalization, most sectors of industry are now operating in a much more competitive environment than at any time in the past. In addition, deregulation and the wider

1. When advertising is successful, it may cause the demand curve to shift outwards (reflecting an increased market share) and also to become steeper (as price elasticity is reduced). The concept of elasticity is discussed in further detail in Chapter 7.

availability of inexpensive technological know-how have served to intensify competitive pressures in many areas of industry. Consequently, there is an ever-increasing trend for firms to regard advertising as the best means of differentiating and drawing attention to their own brands, and this is reflected by growth in overall levels of advertising in recent years. As demonstrated in Table 3.1 , total expenditure on advertising across the major media in the UK grew from £9.9 billion in 1995 to £13.4 billion in 1999.

Nonetheless, the decision by specific firms about whether or not to engage in advertising or other sorts of competitive behaviour is determined, to a large extent, by which kind of market structure the company is operating within. Perhaps surprisingly, firms that operate in 'perfectly' competitive markets do not need to compete actively to stoke up demand for their own product because, in theory, none has any influence over the market. It is assumed that in the rather utopian circumstances of perfect competition, there is no point in any individual firm spending money to advertise its wares because each firm's goods are exactly the same as everyone else's and consumers are perfectly well aware of this.

At the other end of the scale, in very uncompetitive market circumstances such as a monopoly or a monopolistic market structure – where there are no close substitutes for an organization's products – the firm has no rivals to worry about. So, monopolists also have relatively little to gain from expending resources on advertising.

On the other hand, firms operating in an oligopoly market structure are strongly motivated to advertise. Oligopolists do, indeed, have a degree of market power but they are aware that their rivals also have some power to influence the market. So competitive behaviour – e.g. advertising or price competition – is a particular feature of oligopolistic market structures. In the real world, a very great and increasing number of industries operate in imperfectly competitive or oligopoly situations. So, at the most basic level, it is the competitive behaviour of firms operating in oligopoly market structures that fuels advertising activity. And as global competition continues to intensify, patterns of advertising expenditure will reflect this trend.

ARE FIRMS IN CONTROL OF THEIR OWN MARKETS?

US economist J.K. Galbraith has put forward an interesting theory about the role of advertising. He suggests that firms use advertising to control their own markets (Lipsey and Chrystal, 1995: 321). Galbraith points out that firms have to make sizeable investments in developing and launching

new products but, despite market research, they cannot be entirely certain how well these new products will be appreciated by consumers and how profitable they will turn out to be. Firms are exposed to and threatened by the unpredictability of future events, especially changes in patterns of demand or fashions or technology. So, to make the future less unpredictable, firms invest vast sums of money in advertising.

According to Galbraith, expenditure on advertising is intended to manipulate market demand and to guard against sudden unexpected shifts in public tastes. Advertising expenditure enables companies to sell what they themselves want to produce rather than what consumers would want to buy. At the same time, firms decide not to produce some new products that consumers might actually like to buy. This allows them to cut the risks and expenses involved in launching untried products which, even if they are successful, might well simply undermine the market for existing products.

So, from Galbraith's point of view, consumers appear to be the hapless victims of corporations. We are forced, by the manipulative power of advertising, to buy things we do not necessarily want and we are deprived of those products we might like to have. Can this really be true?

Even though the purpose underlying firms' expenditure on advertising is to try to increase demand for particular products, wholly unexpected shifts in consumer demand sometimes occur. At times, the demand for new categories of products or services cannot just be explained by manipulative advertising; it has to do with more basic changes, or with some technological innovation. For example, the general success of the motor car or of the washing machine can hardly be put down to brainwashing by advertisers, even if advertising may persuade us to opt for one brand of these products rather than another. Likewise, the explanation for escalating interest in Internet services in recent years seems to owe more to technology, consumer convenience and fashion than to the efforts of advertisers. So, although advertising plays an important part in shaping demand, the view that firms can effectively control their own markets is not entirely a convincing one.

Where advertising seems to be most effective is in shifting and determining the pattern of demand among existing products which are similar to each other. In other words, advertising is likely to have more of a bearing on which *brands* rather than which *products* consumers will want to buy. It undoubtedly helps to create and sustain loyalty to particular brands but it is unable to dictate overall trends in consumer demand, nor can it hope to overcome the influence of technology, fashion or the media on the sorts of products people express a wish for.

INFORMATIVE VERSUS PERSUASIVE ADVERTISING

Advertising has two related aspects: it sets out to inform consumers of the characteristics of the various products available, and it tries to influence consumers by altering their tastes or preferences and, hence, their purchasing decisions. Informative advertising – giving consumers more information about what is available to them – can be seen as playing a useful role in making the market system work more effectively. It fulfils a valuable function in facilitating the interaction of consumers and producers. The second function – persuasion – is more questionable in terms of its impact on consumer welfare.

The distinction between information and persuasion has been a major preoccupation in historic texts devoted to the economics of advertising. To summarize briefly, those who see advertising as being informative in nature tend to view it as a necessary expenditure that keeps markets competitive in a world where imperfect knowledge is a fact of life. They argue that, if we didn't have advertising, then the transaction costs (i.e. all of the costs involved in negotiating and completing a deal) of any sale or purchase – especially those to do with the search for goods and for knowledge about their attributes – would be higher and, as a result, buyers would be worse off. Not only would they have to pay more for their goods and services, but the probability of their making a wrong choice would be increased. The greater the variety of goods and services offered for sale, the more difficult it is for the consumer to judge the capacity of the good to satisfy a particular want before he or she buys it and the more the consumer will value objective information to help him or her to make the right choice.

Not surprisingly, many who work in the advertising industry take the view that advertising helps people to make choices in an over-supplied world. But if the information provided by advertising is not objective, then the choices it engenders may not be good ones and the effect of advertising will be to diminish rather than to enhance the overall welfare or utility of consumers. Those who view advertising as being primarily persuasive regard it as leading to excessive differentiation of products, resulting in prices and profits higher than those arising in an ideal competitive world (Chiplin and Sturgess, 1981: 74–7). Think, for example, of the amount Coca-Cola and Pepsi spend on advertising when, arguably, there is relatively little difference between their products. Those who argue that too many resources are being allocated to advertising are, to some extent, saying that consumers are being bombarded with rather too much information and that it pays firms to advertise beyond the point at which the advertising messages provide any benefit to consumers. They are also suggesting that the persuasive spin put upon product information by

advertisers results in incomplete, misleading or distorted messages rather than a useful resource for consumers.

Is advertising generally harmful or beneficial to the operation of markets? On the one hand, consumers have to pay a higher price for products to cover the cost of advertising but, on the other, they benefit from widespread information about the range and availability of competing goods and services, and this facilitates their decision-making. In its role as a source of information for consumers, advertising can be a pro-competitive force leading to an improved allocation of resources. Counteracting such a force, however, is a possible anti-competitive effect caused by the use of advertising as a means of preventing potential rivals from gaining entry to markets.

ADVERTISING AS A BARRIER TO MARKET ENTRY

An important criticism of advertising relates to its effect on competitive market structures. It is suggested that firms use advertising to put up barriers to market entry which prevent other firms from competing with them (Chiplin and Sturgess, 1981: 112). The basic argument here is that the millions of pounds invested every year in building up recognition for their brands by, for example, Procter & Gamble, Kellogg's or Elida Fabergé make it difficult or impossible for potential new entrants to encroach on their product markets unless they also have the scale of resources and the will to match this expenditure. In other words, heavy advertising is a means of imposing high set-up costs on new entrants and this, in turn, serves to deter would-be rivals.

Advertising is a feature of oligopoly market structures. Oligopolists not only have to worry about competing with their existing rivals to build and defend market share, they also have to worry about potential competition from firms that might be tempted to enter their industry. If there are no natural barriers to entry, oligopolist firms will earn pure profits just in the short run and until such time as other firms enter their industry. Oligopolists can protect their profitability in the long run only if they can find ways of creating barriers that prevent entry.

One method of keeping out potential new entrants is called 'brand proliferation' (Lipsey and Chrystal, 1995: 269). Differentiated products – i.e. products that are similar but with some discernible differences in their attributes – usually have several characteristics that can be varied over a wide range. Thus, there is room in the market for a large number of similar products each with a somewhat different range of features or characteristics. Consider, for example, the current range of breakfast

cereals or cars. Although the multiplicity of brands that manufacturers make available is, undoubtedly, at least partly a response to consumers' tastes, it may also be partly the result of a deliberate attempt by existing players to discourage the entry of new firms. When existing suppliers sell a wide array of differentiated products this makes it difficult for a new firm to gain entry on a small scale. Brand proliferation means that, in effect, all the potential niches are already occupied. The larger the number of differentiated products already being sold by existing oligopolists, the smaller the market available to a new firm entering with a single new product.

Alternatively, existing firms can create barriers to entry by imposing on new entrants significant fixed costs associated with setting up operations in that market. This is an important tactic if there are no economies of large-scale production to provide 'natural' barriers to entry. Advertising is one means by which existing firms can impose heavy set-up costs on new entrants (Griffiths and Wall, 1999: 127). Advertising, of course, has effects other than creating barriers to entry. As discussed above, it may perform the useful function of informing buyers of their alternatives. Indeed, a new firm may find it necessary to advertise even if existing firms don't bother, simply to call attention to its entry into an industry.

Nonetheless, advertising can operate as a potent entry barrier. Effective brand-image advertising means that a new firm will have to advertise in order to catch the public's attention. If the firm's sales are small then advertising costs per unit sold will be large (Lipsey and Chrystal, 1995: 270). Unit costs will only be reduced sufficiently to make a new entrant profitable when sales volumes are large, so that the fixed advertising costs needed to break into the market are spread over a large number of units.

The combined use of brand proliferation and of heavy advertising sometimes acts as a formidable entry barrier. This explains why some of the biggest advertisers often sell multiple brands of the same product. For example, amongst the top 20 advertisers in the UK in 1999 were washing powder manufacturers Procter & Gamble and Lever Brothers; shampoo manufacturers L'Oréal Golden, Van den Bergh and Elida Fabergé; car manufacturers Renault, Vauxhall, Ford, Volkswagen and Peugeot; and breakfast cereal manufacturers Kellogg's and Nestlé Rowntree (Advertising Association, 2000: 227).

To some extent, the debate about advertising and market structures is not really about the effects of advertising *per se* since both sides agree that it can work as a powerful barrier to entry. Instead, it is about whether or not barriers to market entry are a good thing or not and whether one market structure is better than another. Competition is normally considered a prerequisite for efficiency and, therefore, open and more competitive markets seem preferable to monopolised ones. If however, by keeping

rivals out of the market, advertising enables firms to increase their output and to achieve economies of large-scale production, then arguably this might serve to benefit consumers. The economies of scale created by concentration of ownership in the washing powder industry, for example, means that (provided there is sufficient competition to prevent monopoly pricing) consumers should enjoy lower product prices than would be possible under a more fragmented and competitive market structure. So, provided that firms do not become so large that they can extract monopoly profits, consumers might occasionally benefit from the anti-competitive effects of advertising (Parkin et al., 1997: 424–5).

ADVERTISING AND THE PERFORMANCE OF THE ECONOMY

In recent years a great deal of detailed analysis of advertising and economic data has been undertaken by commercial agencies for the purpose of forecasting future advertising trends. In the UK, extensive historic data is compiled and analysed by the Advertising Association each year and it provides compelling evidence of a link between levels of economic wealth and of advertising activity.

Examined over a long period of time, expenditure on advertising has tended to grow as a proportion of the national economy. Advertising expenditure can be defined in various ways, for example including or excluding production costs, new media and alternative promotional expenditures. Likewise, the performance of the economy can be defined and calculated in different ways, including by Gross Domestic Product. GDP measures the total value of all productive output in the whole economy, usually over a one year period and is probably the most widely used benchmark of general economic performance. When expenditure on advertising is calculated as a percentage of GDP, the pattern that emerges indicates that as the national economy has grown over time in real terms, advertising has not just grown in parallel, but it has grown even faster. So the amount of advertising activity in an economy is related to the size and growth rates of the economy itself, and advertising has tended to account for a progressively more significant proportion of GDP as time goes on.

The relationship between wealth and levels of advertising does not simply apply to the UK. It is also clearly observable in other developed economies and can be demonstrated by a bivariate analysis of GDP per capita (i.e. the productive output of the country divided by the number of inhabitants) and advertising expenditure per capita. As demonstrated in Figure 3.1, the pattern which emerges from international comparisons

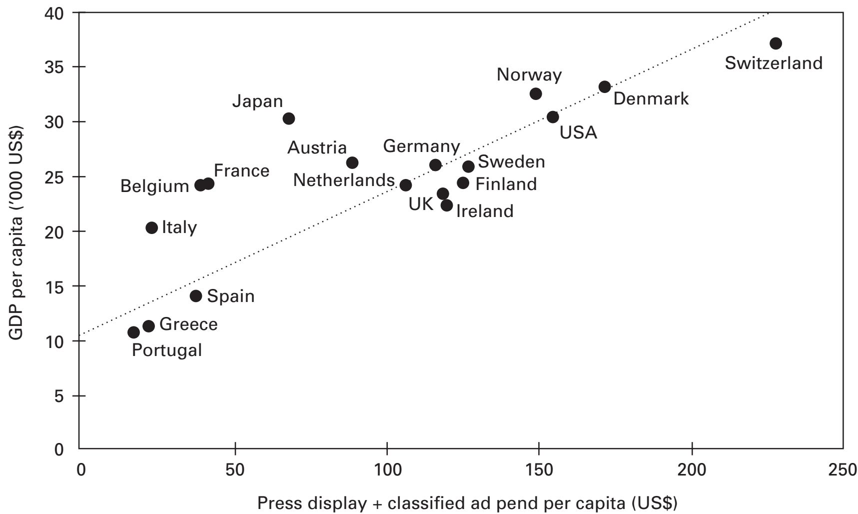

FIGURE 3.1 National advertising expenditure vs GDP, 1998
(NTC Research, Advertising Association, 2000: 22)

shows a strong and positive association between economic wealth in any country and the level of advertising expenditure it enjoys. This correlation is disturbed only occasionally when, for example, government restrictions on advertising hold back levels of expenditure on commercial airtime. Generally speaking, richer countries such as Switzerland enjoy a much higher level of advertising expenditure than poorer countries such as Greece and Portugal (Advertising Association, 2000: 22).

Why is this? There have been two arguments about the relationship between advertising and living standards. One is that advertising stimulates the levels of consumption that are found in countries with high per capita incomes. This perspective implies a causal connection between high levels of advertising, high consumption and, in turn, higher levels of economic activity and growth. The other viewpoint is that advertising is a 'waste of resources' that can only be afforded by rich countries (Chiplin and Sturgess, 1981: 7).

Historic UK data shows that the growth in advertising as a proportion of GDP is not exactly steady and continuous. Advertising growth is cyclical and it reflects, in an exaggerated way, the ups and downs of the economy at large. In periods of economic expansion the proportion of GDP spent on advertising increases; the converse is true in recession. Figure 3.2 shows advertising as a proportion of GDP over 44 years. It demonstrates how advertising, when expressed as a percentage of GDP, peaks at the top of economic boom periods such as in 1973 and 1989. By the same token, expenditure on advertising bottoms out at the lowest point in the economic

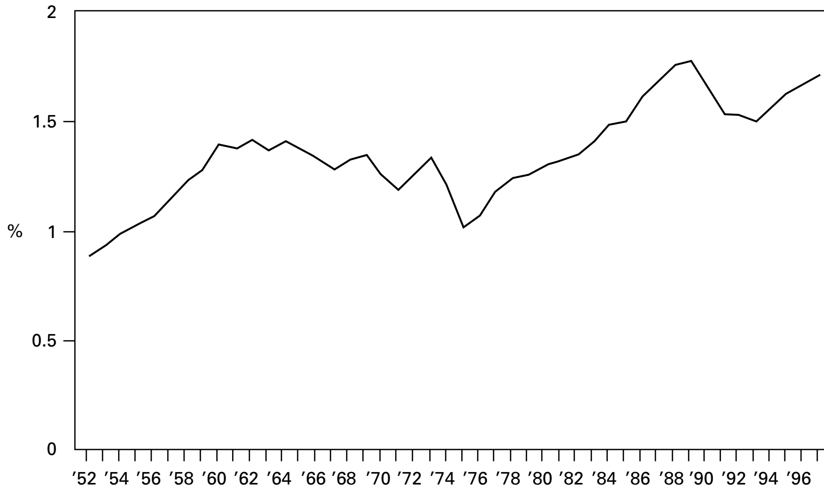

FIGURE 3.2 UK advertising as a percentage of GDP, 1952–97 (NTC Research, Advertising Association, 1998: 21)

cycle, such as in 1975 at the height of oil crisis or in the more recent recession in 1993. Advertising tends to gallop ahead more quickly than the economy in boom periods, but then slumps more quickly in recession.

To understand why advertising is cyclical, it is helpful to carry out more detailed analysis of advertising expenditure data. Advertising is sometimes broken down into 'display' and 'classified'. Display advertising (the bulk of advertising expenditure) is total advertising minus financial notices, classified and advertising in trade or technical journals. Classified is recruitment, housing, personal advertisements, etc. Different sets of factors will affect the performance of each of these two categories.

The two primary forces which appear to determine the growth or decline of display advertising expenditure are consumers' expenditure and company profits (Advertising Association, 2000: 20). The close correlation between company profits and display advertising expenditure suggests that, perhaps not surprisingly, companies can afford to and *do* spend more on advertising when times are good. Likewise, the correlation between consumers' expenditure and display advertising expenditure suggests that companies are willing to spend more when consumer spending and confidence are buoyant, i.e. when advertising expenditure is more likely to translate into increased sales. In short, advertising expenditure expands along with consumer expenditure, but is reined back when company profits are under pressure.

Classified advertising expenditure is dependent on a variety of factors, such as the state of the housing market, the second-hand car market and

employment levels. Statistics published annually by the Advertising Association suggest that the level of unfilled job vacancies is a key determinant of recruitment classified expenditure (2000: 23). It is mainly recruitment advertising which pushes up classified and, thus, total advertising expenditure during economic booms.

The strength of the relationship between advertising cycles and the state of the economy has been questioned and some would argue that advertising expenditure should continue to grow, irrespective of the performance of the economy. Patrick Barwise of London Business School, for example (cited in Tomkins, 2000), suggests that advertising by firms with established brands is essentially a defensive activity, carried out in order to protect their market share rather than in the hope of boosting sales. Likewise, according to Andrew Ehrenberg of South Bank University, '[m]ost advertising is not trying to sell. It's just maintaining your position in a competitive market' (cited in Tomkins, 1999a). Be that as it may, historic trends in advertising clearly demonstrate the prevalent tendency for firms to cut back on advertising expenditure as soon as an economic downturn looms into view. As John Hegarty, Creative Director of advertising agency Bartle Bogle Hegarty, has explained: '[r]ecession is always a problem for the advertising industry, in the sense that clients feel that advertising is the first thing they can switch off' (cited in Smith, 1998: 1).

The apportionment of advertising between different sectors of the economy is not static, but varies in response to alterations in the market structure of particular industry sectors. These alterations may reflect policy changes that are designed to promote or limit competition in a particular market. For example, advertising expenditure data by product sector in the UK in the 1980s shows how the deregulation of the UK financial services industry in the mid-1980s and the accompanying increase in competitive behaviour on the part of banks and building societies was reflected in an immediate and sharp increase in advertising expenditure by banks and building societies. In the 1990s, international deregulation of telecommunications brought about a great upsurge in advertising expenditure within this sector as new rivals emerged to compete with long-standing incumbents in the UK, across Europe and elsewhere.

The emergence of markets for successful new products or service innovations often has reverberations in the advertising sector. In the early part of the year 2000, a boom in the number of Internet start-ups created something of a bonanza for the advertising industry as many new 'dotcom' companies launched campaigns (using conventional media, such as billboards and television) as a means of raising awareness of themselves and their online businesses. A subsequent downturn in investor confidence in dotcom start-ups has since diminished some of this rich vein of new billings for advertising agencies. Even so, it is expected that expenditure

on advertising by dot.com companies will, by itself, add around 3 per cent growth to total advertising in the USA and the UK in the year 2000 (Killgren, 2000: 7).

THE FIRM'S ADVERTISING DECISION

The decision each firm takes about how much of its resources to devote to advertising depends on what it believes this investment can achieve. What companies expect in return for their expenditure on advertising varies: whereas some simply want an effective marketing campaign, others believe that advertising agencies play a broader role in creating and managing their long-term brand strategies.

Systems of remuneration for advertising agencies have changed considerably in the UK over the last 10–15 years. Up until the late 1980s, most agencies expected to be paid a commission on 'gross billings' (i.e. the cost of all advertising space purchased on behalf of the client), usually at a rate of 15 per cent. US radio comedian Fred Allen coined the definition of an advertising agency as 85 per cent confusion and 15 per cent commission. The commission-based mode of payment not only encouraged agencies to concentrate their efforts on expensive media outlets but, more significantly, it ignored whether the advertising campaign supplied to the client was in any way effective or not. Nowadays, advertising agencies are generally paid on a flat fee basis and, in the UK, around one-third of their clients favour the concept of 'payment by results' (Hall, 2000b: 5). This approach raises a perplexing and long-standing question surrounding firms' expenditure on advertising – namely, how can the effectiveness of advertising be measured?

Many advertising clients put the 'payment by results' approach into operation by means of a sales-based model of compensation. In other words, the fee the advertising agency receives is calculated by reference to the impact of the advertising campaign on client sales. This seems fair, to the extent that the motivation behind advertising is simply to sustain or improve demand for the firm's products or services. However, some advertising clients regard this approach as too simplistic and prefer to measure their agencies' success by, for example, tracking studies that focus on perceptions of the firm and its brands.

The question of how to measure the effectiveness of advertising expenditure is important since, unless some idea can be gained about what return advertising will bring, firms will naturally find it very difficult to decide how much to spend on this activity. The two most common ways of researching the effectiveness of advertising involve either measuring the

success of advertising in communicating its message, or direct tests of the effects of advertising on sales or profits. Both of these methods, however, have serious weaknesses.

In the case of testing people's ability to recall advertising messages, the obvious weakness is that this approach doesn't yield any reliable information about the impact on sales. How often does a clever visual or punch-line in an advertisement create a lasting impression but without successfully projecting the brand or having a discernible effect on demand? Studies that look more broadly at how advertising has affected perceptions of the firm and its brands suffer from the same problem – the impact of this expenditure on the firm's financial performance is not addressed. The capability for interactive advertising (e.g. on the Net) brings another way of measuring effectiveness: the number of responses an advertisement elicits can be counted. All in all, however, proof that advertising has engaged viewers' attention, has communicated a message successfully or has improved a brand or a corporate image is not the same as demonstrating an impact on profits.

So, for many advertisers, the second method – looking directly at sales – seems more useful, since the whole point of advertising is usually to boost sales. But there are also problems with this second method, to do with establishing any direct causal link between what a firm spends on advertising and what happens to sales. One immediate problem to be taken into account with direct testing is that advertising is not, itself, a homogeneous product. The effect on sales that a given expenditure on advertising will achieve depends, to a great extent, on the quality of the advertising campaign that has been purchased. Not all advertising agencies have equal talent. In the UK, for example, those advertising campaigns which seem to most clearly demonstrate a profitable return for clients are acknowledged each year by the Institute of Practitioners in Advertising (IPA) effectiveness awards competition. The way in which a firm's sales move or fail to move as a result of a campaign devised by one particular agency may not be a reliable indicator of how sales will typically or more generally respond to investment in advertising.

Another problem is that of time lags. It may take some time before advertising starts to have the desired impact on sales. Advertising might inspire an initial trial which might then result in positive recommendations to friends and, in turn, be followed by further purchases. Advertising may communicate its message successfully but at a time when the consumer is not yet in a position to make a purchase. So it may take some time before advertising has a visible impact on sales. It is often argued that consumers need to be exposed to a certain amount of advertising before they will respond but once they do respond, not much advertising is required to retain their loyalty. Advertising gradually builds up and then

reinforces the positive perceptions of a product or brand or, in a sense, the 'goodwill' that is needed to ensure habitual purchasing of it. Indeed, the future earnings potential that investment in advertising is thought to have generated for a firm is sometimes recognized when famous brands are valued and accounted for as assets on a company balance sheet.

To deal with time lags, a regressive model is sometimes used to measure the effect of advertising. Advertising which has taken place in a previous period (say, the first quarter of 1999) is compared with current sales (in the first quarter of the following year). But a further and more insurmountable difficulty with measuring the effectiveness of a firm's expenditure on advertising is that of the behaviour of rivals. How do you disentangle the effect of advertising on demand for your product from the effect caused by whatever your rivals have been up to simultaneously in terms of advertising or not advertising their own wares, or implementing competitive price reductions, or instigating product changes or other special promotional efforts? It is virtually impossible for any firm in an oligopoly or a competitive market situation to isolate the impact of its own advertising investment from the impact on demand caused by the behaviour of its rivals.

So, the problems of measuring the effects of advertising are not simple and, in particular, it is very difficult to establish proof of some degree of causality, i.e. that x expenditure on advertising will have y given effect on sales (Carter, 1998: 6). How, then, do firms decide on their advertising budgets?

Economists who have considered this question – especially Cowling et al. (1975), Chiplin and Sturgess (1981) and Duncan (1981) – acknowledge that many firms simply use some kind of 'rule of thumb'. The decision taken about what level of resources to devote to advertising is often based on customary practice or what amounts to intuition rather than on any attempt to calculate expected returns. Sometimes advertising is regarded as discretionary rather than necessary expenditure and firms simply spend whatever they think they can afford at a given time. This approach is reflected in historic data, discussed above, which demonstrates the sensitivity of overall levels of advertising to company profits and to fluctuations in the economy at large. But the discretionary approach is often criticized on the basis of being too unscientific and unlikely to achieve great results.

Many firms set their advertising budget as a given proportion of sales or of assets. The pre-determined percentage of either previous or predicted sales is a particularly popular method – e.g. this year's advertising budget may be set at the rate of 10 per cent of last year's sales – and it offers various advantages. It is easy to calculate and it is quite manageable in financial terms, in the sense that the advertising budget will go up or down directly in accordance with the firm's fortunes.

But how does the firm decide what proportion of sales the advertising budget should represent? Analysis of historic sales and advertising figures reveals some very wide disparities between the proportions opted for by different firms. For example, according to statistics compiled by the Advertising Association (1996: 226), advertising accounted for just 5 per cent of what consumers spent on babycare products in 1994 but for a massive 44 per cent of consumer expenditure on double-glazing! Should the advertising budget be set at 5 per cent or 44 per cent of sales? Many firms examine what their competitors are spending and set their own advertising budget as a similar proportion of sales or assets. But there is no guarantee that the level set by competitors is optimal.

Some economic theorists have tried to provide a more scientific answer to this question. Dorfman and Steiner have suggested that, when it comes to deciding what proportion of sales income to devote to advertising, there are two things that firms should take into account: first, 'advertising elasticity'or how responsive sales are to changes in advertising expenditure and, second, 'price elasticity' or how responsive sales are to any change in price (Chiplin and Sturgess, 1981: 45). The reason why consumers' reactions to any price change should be taken into account in setting the advertising budget is because it would be inefficient to spend money on advertising if the same money invested in a price reduction would boost sales by a greater amount. If sales are more responsive to fluctuations in price than to changes in levels of advertising, this implies that a lower proportion of sales income should be devoted to advertising.

The Dorfman Steiner approach may have merit in theory but it is by no means easy to put into operation. Price elasticity refers to the responsiveness or sensitivity of demand to upward or downward movements in the price of a product. Likewise, the concept of advertising elasticity refers to the responsiveness of demand to changes in levels of advertising expenditure on that product. The problem is that it is virtually impossible to calculate advertising elasticity in 'real world' circumstances because of constant changes and the unpredictable behaviour of competitors.

ADVERTISING AND NEW MEDIA

The growth of new media such as the Internet and digital television has provided advertisers with a range of new communication channels through which they can address messages to their target audience groups. At first glance, the arrival of additional supplies of audience access seems to be a positive development, allowing for more specialist targeting and, potentially, lower advertising costs. However, the growing popularity of new

media inevitably erodes mass audiences which, from the point of view of many advertisers, makes consumers more difficult to reach.

Just as newspaper proprietors were concerned about the development of advertising-supported broadcast media in the 1940s, so too the current generation of media players is anxious to assess the likely threat to commercial revenues posed by the development of the Internet, interactive television and other new multimedia products and services. The question they face is to what extent the rise of alternative avenues of communication with consumers may come at the expense of conventional advertising media and to what extent they may simply expand the overall advertising market. Will the growth of advertising in new media be incremental to or a substitute for traditional mass market advertising?

The capacity for interactivity facilitated by digital technology is a major concern for traditional advertising media. The Internet has already established itself, especially with younger audiences, as an important medium and interactive television is also well on its way towards gaining acceptance. Interactivity is, of course, driving the process of fragmentation of audiences into ever narrower niches and specialisms. More significantly, interactivity has the potential to provide advertisers with extensive information about the tastes, preferences and habits of particular sections of the audience. The facility for advertisers to get to know their target customer base – to learn about and speak to individual tastes amongst niche audiences – is a valuable advantage that conventional mass media cannot provide.

The Internet is now beginning to compete with traditional media for a share of some major advertisers' marketing budgets. According to the UK's Institute of Practitioners in Advertising, 'the number of companies allocating more than 5 per cent of their budgets to Internet marketing rose from 8 per cent to 14 per cent in the third quarter [of 2000]' (cited in Hall, 2000c: 6). The Internet is clearly better suited to some forms of advertising than others; for example, to provide classified rather than display advertisements, and to aim commercial messages at specific audience subgroups. Consequently, some conventional media – particularly those newspaper and magazine publishers who rely on targeted classified advertising – will find that their revenues are more threatened by the growth of the Internet than others.

New media such as the Internet, digital television and WAP[2] mobile phones offer users more choice and control over what sorts of entertainment or information services they wish to receive. On the one hand,

2. WAP or Wireless Application Protocol is a technology that allows consumers access to the Internet on their mobile phones.

personalized and interactive media consumption make it possible for advertisers to collect useful feedback and to foster closer and more effective two-way communication with relevant consumers. On the other, the cost of attracting the attention of large audiences via tailored one-to-one marketing is much more significant than via a campaign conveyed across conventional mass media. The price of advertising on the Internet, for example, currently running at around £30 per thousand ‘page impressions’ in the UK, is not far behind the price of a direct mail shot and is considerably more expensive than the cost per thousand (of around £10 and £3 respectively) for a 30-second commercial either on network television or radio (Oliver, 2000: 57). On a cost per capita basis, ‘micro’ marketing may prove expensive but, for some advertisers at least, it is also less wasteful than mass advertising in mainstream media.

Paradoxically perhaps, as audiences for traditional media have fragmented, the cost of reaching a mass of consumers has increased. The growing price and waning influence of advertising expenditure on mainstream television channels such as the four main ‘over-the-air’ networks in the US or the ITV network in the UK is a source of frustration for many advertisers, yet they are powerless to reverse the changes in lifestyle and in patterns of media consumption which make mass marketing an increasingly expensive exercise.

We live in an era in which famous brands are highly valued. So, even as audiences fragment across media catering to ever narrower sets of tastes, many advertisers continue to rely primarily on mainstream conventional media to create the mass consumer brands of the future. The greater ability of conventional media to reach mass audiences and to establish famous brands still remains a strong selling point. According to Hegarty, ‘[w]hat makes a brand is fame, and that comes from communicating with people *en masse*’ (cited in Smith, 1998: 1). So, despite the fact that, in the UK as elsewhere, newspaper circulations are declining and television audiences are beginning to fragment, ‘advertising prices are still being pushed up because the advertiser’s need to find fame is more urgent than ever’ (Hall, 2000a: 3).

So far at least, it seems that extra channels of communication and better opportunities for tailored marketing have stimulated incremental demand for advertising rather than diminishing appetites for commercial space in traditional media. For this reason, the arrival of new media is seen by many as a complement to rather than a substitute for conventional mass media. The effect of the Internet on advertising markets has been likened to ‘adding a couple of lanes to the motorway – it just means that overall traffic levels get higher’ (Gottlieb cited in Hall, 2000a: 3). ‘Micro’ marketing via new media is adding extra volumes of advertising activity rather than replacing mass marketing.

But new digital and interactive media are still in their infancy and until their full capability as marketing vehicles is understood, the future for advertiser-supported conventional media like television, radio and newspapers is uncertain. Traditional media are protected only so long as they remain the most convenient route to mass audiences. As new niche services continue to splinter audiences, the perceived level of substitutability between new and traditional advertising media will inevitably increase.

A fragmented audience is not the only problem facing advertisers. Some new media offer users the ability to bypass advertising altogether. For example, the emerging generation of digital video recorders, such as those offered by TiVo (manufactured by Royal Philips Electronics of the Netherlands) and ReplayTV (manufactured by Panasonic, a subsidiary of Matsushita of Japan), allow viewers to skip over the advertisements when they watch recorded television. Digital video recorders – also known as Personal Video Recorders (PVRs) – can record and store programmes by type in response to pre-selected choices made by the individual viewer and, at the same time, can edit out programme credits or other unwanted interruptions, including commercial breaks.

The ability for viewers to skip advertising has been heralded by some as 'the end of commercial television' (Lewis, 2000: 2). But opinions vary on how exactly PVRs will affect viewing habits. Video cassette recorders have always offered viewers the option of fast-forwarding to avoid commercial breaks in recorded material and this has not undermined advertiser-supported television broadcasting. PVRs, however, make it much easier to side-step advertising. The question is, to what extent will audiences continue to watch much of their television 'live', in spite of the greater convenience of recording thanks to PVRs?

According to Ave Butensky, President of US industry body the Television Advertising Bureau, (cited in Tomkins, 1999b: 19), viewers 'will figure out how to switch the television on and how to change the channel, but beyond that, they don't want to know. Basically, they're couch potatoes.' If, as Butensky suggests, most viewers ignore the arrival of the PVR and continue to flick passively between 'live' television channels, then audiences will not be able to skip over advertising breaks and commercial broadcasters have little to worry about. Many viewers will, however, undoubtedly be tempted by the possibility of their own customized pre-recorded programme schedule, and so PVRs will continue the process of erosion of audiences for conventional broadcast channels as well as making it progressively more difficult to entice audiences to watch television advertising.