False Advertising

KEYWORDS: Misleading Advertising; Product Quality; Pass-through; Self-Regulation

BACKGROUND

- Economics has traditionally contributed more to understanding competition policy rather than the inter-related area of consumer protection policy.
- However, we consider the latter in regard to the regulation of false advertising, whereby firms make incorrect or exaggerated claims about their products.
- This is an important policy issue with several prominent cases in recent years, including Volkswagen, Dannon, Skechers, and Kellogg's.

METHODOLOGY

- A theoretical model of false advertising is developed where a monopolist sells to a set of fully rational consumers.
- Consumers cannot evaluate the quality of the firm's product or the validity of its claims.
- However, a policymaker can punish the firm if it uses false advertising.
- The effects of such a punishment are then analysed in regard to a variety of different welfare objectives.

KEY FINDINGS

- A novel equilibrium is demonstrated where false advertising can actively influence rational consumers.
- Industry profits are always maximised by strict punishments with a zero level of false advertising.
- Consumer surplus and total welfare are also often maximised by strict punishments. However, under some conditions, it is optimal to use softer punishments to induce a positive level of false advertising.
- Here, despite the resulting mis-information, consumers may benefit from an associated reduction in prices.
- These results are shown to be robust to several issues, including the introduction of competition.

POLICY ISSUES

- The instinctive policy use of strict penalties or blanket bans on false advertising may not always be optimal.
- Firms' incentives for regulation often coincide with consumers' and society's incentives. This gives some support for the role of self-regulation that is popular in Europe. However, in other situations, self-regulation is not optimal.
- It is hoped that this paper will prompt much more work on the economics of advertising regulation at both the theoretical and empirical level in order to give better policy advice in this important area.

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FOR MORE INFORMATION

The full working paper 15-13 and more information about CCP and its research is available from our website: www.competitionpolicy.ac.uk

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