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# Comparative Advertising and Competition Policy

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## **Abstract:**

Only recently, competition authorities tend to see comparative advertising as helpful in promoting competition. They now encourage firms to use it. They reason that comparative advertising, if fair and not misleading, increases consumers' information about alternative brands. For this to work, comparative claims must be credible. Competition policy and legal practice are essential in making comparative advertising (directly and indirectly) informative.

In this paper, first we provide a legal background of comparative advertising in Europe and the US. Second, we provide an analysis of some recent legal cases in Europe and the US. Third, we provide an economic analysis of comparative advertising. Here, we discuss the ways comparative advertising can affect market outcomes. In our analysis we put emphasis on the scope of information transmission through comparative advertising and on the way antitrust laws affect it. We uncover two important effects: in the case of search goods, comparative advertising can relax price competition by differentiating products; however, in the case of experience and credence goods, it can intensify competition by signaling the sponsoring brand's quality.

**Keywords:** advertising ban, advertising, marketing, antitrust, signaling

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## 1. Introduction

Until very recently several continental European countries completely had banned any form of comparative advertising whereas, in the US, the use of comparative advertising has actually been encouraged by the Federal Trade Commission since the 1970's. While in the past the European and American approach towards this type of advertising was markedly different, today competition authorities agree in considering comparative advertising an important tool in promoting competition, such that firms and retailers are stimulated to use comparative ads. The reason is that comparative advertising, if fair and not misleading, is claimed to increase consumers' information about alternative brands, products and services and to positively affect competition among (domestic and cross-border) firms. In particular, the argument goes that direct comparison ads would encourage consumers to make more informed purchasing decisions - moreover, comparison ads would ease the consumer's task of evaluating the performance of particular brands against other brands.

A particular understanding of this idea is the following (we elaborate on this in section 4). Compared to generic advertising, comparative claims provide information which is easily converted in operational knowledge by consumers. Often, content-based advertising which does not make comparisons is of little meaning to consumers. When this is the case, the consumers' ability in processing comparative claims should be higher because these claims allow consumers to make inferences from experiences made from past consumption of other products. More generally, the named competing brand serves as a reference point.<sup>1</sup>

For information transmission to work, consumers must not be deceived. Here, laws and legal practice are essential for comparative advertising claims to be truthful. In particular, competition policy must be designed such that the consumers' and the competitors' interest in truthful information transmission can be assured.

Our main point is that comparative advertising has two possible effects on competition: in the case of experience and credence goods characteristics, it can intensify competition by signaling the sponsoring brand's quality, whereas in the case of search goods characteristics, it can relax price competition by differentiating products.

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<sup>1</sup> Examples are telecommunication or financial intermediation services where often the terms of proposed contracts are compared with those previously offered by competitors.



## 4. Economic Perspectives on Comparative Advertising

### 4.1 Views on Comparative Advertising

It is useful to distinguish between different types of advertising: persuasive advertising, advertising as a complement, directly informative advertising, and indirectly informative advertising (see also Bagwell, 2003). Comparative advertising may be of any of these types.

According to the classic view on advertising, advertising is *persuasive*, i.e. by modifying tastes and creating brand loyalty, advertising changes the preferences of consumers. Since consumers' willingness to pay for the good increases, the demand for the sponsoring brand increases as well and becomes less elastic. According to this approach, advertising is an anti-competitive phenomenon. Dixit and Norman (1978) offer a formal investigation of the welfare effects of persuasive advertising. The interpretation of advertising as persuasive has been criticized because it assumes that demand is positively affected by advertising, while consumers' utility is not. In the case of *advertising as a complement* this problem is solved since it is assumed that consumers hold a stable set of preferences into which advertising enters as one argument. Becker and Murphy (1989) propose this alternative view on advertising: advertising affects demand by exerting a complementary influence in the consumer's utility function with the consumption of the advertised product.<sup>32</sup> Since the advertising firm does not internalize the full increase in consumer surplus that its advertising engenders, with this approach there is generally a social under-provision of advertising.

When comparative advertising is persuasive it may increase the willingness-to-pay for the sponsoring brand and/or it may reduce the willingness-to-pay for the compared brand. Comparative advertising may also be seen as a complement if consumers derive benefits from consuming the advertising together with the product of the sponsoring brand. Also, when the comparative advertising is consumed together with the negatively compared good, it may decrease the utility that consumers of the competitor's product get from such a product. As shown in the case of non-comparative advertising, it is a matter of interpretation whether advertising is to be seen as persuasive or as a complement because market outcomes are the same (see Bagwell, 2003). However, welfare results may differ.

Under *informative advertising*, advertising provides directly or indirectly useful information to consumers. In the real world we observe both advertising messages which are content-based credibly transmitting information to consumers about the sponsoring product, and ads which, on the contrary are content-free (or contain questionable content claims). We consider content-based ads as potentially *directly informative*. Whereas, in the case of content-free ads, the "words" of the advertising claim (if any) provide no information to consumers. Nevertheless such ads can be *indirectly informative*. In fact, when consumers are able to infer the cost of the advertising campaign, content-free ads can work as signals. In particular, the term "dissipative advertising" indicates that it is just the cost of the ad, instead of its content, which is able to transmit some information to consumers. The firm burns money in the advertising campaign and this is publicly observable; the consequence is that

<sup>32</sup> A standard example is the following: if a consumer values "social prestige," advertising may serve as an input that enables him to derive more social prestige when consuming the advertised product.



advertising expenses can indirectly communicate some information to consumers (Nelson, 1976).<sup>33</sup> Under such indirectly informative advertising, the sponsoring firm does not necessarily give truthful information. By the amount of the advertising expenditure the firm may be able to convince consumers that its claims are truthful.

Comparative advertising can be considered content-based because it makes a comparison or a “superiority claim”. In fact, implicitly or explicitly, in every comparative ad either the message “my product is better than ...” or “my product is as good as ...” is contained. Thus, *a comparison ad is always potentially directly informative*. The comparisons often serve as benchmarking to help consumers placing the product in the right category and focusing on its salient aspects. In fact, e.g. in the case of food advertising, absolute statements on nutrition often are of little information to consumers. As another example, comparative advertising offers to new firms which enter the market of telecommunication services an easy tool to explain the advantages that their contracts provide to consumers.

As we will see in this section, comparative advertising can also transmit some information indirectly. First, the cost of the advertising campaign, as in the case of generic content-free ads, can indirectly provide information to consumers. Further, *what seems to be really relevant in the case of comparative ad is a second channel to indirectly convey information which operates through the competitor’s reaction that a comparative ad potentially induces*. Note that in general all advertising claims can be challenged. However, as outlined above for puffery, certain comparative ads are more likely to be challenged than corresponding non-comparative ads. With the same reasoning, *direct* comparative ads (i.e. ads in which competitors are explicitly named) are riskier than *indirect* comparative ones for the sponsoring brand. In fact, when the target brand is explicitly mentioned, its incentives to react to a false claim are obviously higher.

Practitioners have recognized that the potential reaction by competitors is a distinguishing feature of comparative advertising. Several advertising agency publish statements on their web sites such as “Comparative advertising can be a very effective tool, but with it comes the risk of challenges by competitors, state attorneys general, and even the FTC”. Or: “Comparative advertising campaigns present greater risks - and can lead to greater rewards in the form of customer response - than traditional monadic campaigns. You should assume that any campaign you run will be seen by your competitors’ upper management, who will decide whether or not to challenge the ad” (Freeman and Nemiroff, 2001). We will focus on this aspect later on in this section when considering how comparative advertising can intensify competition by signaling the sponsoring brand's quality.

The superiority claim always contained in the comparative ad can go together with other direct information. This is the case of pricing comparative advertising where information about a verifiable characteristic of the product (and of the competitor’s one) as the price, is given. Comparative ad is usually directly informative when *easy*

<sup>33</sup> Nelson’s well known explanation of advertising as a rational phenomenon is based on the idea that its explicitly high cost works as a device to signal high quality of a brand. The signaling motive filled a gap in the understanding of a controversial economic phenomenon, namely the apparently wasteful advertising campaigns. The argument, intended to apply to generic advertising, implies that the cost, and not the content, of an ad is what really matters.