PRINCIPAL-AGENT PROBLEMS AND STRUCTURAL CHANGE IN THE ADVERTISING INDUSTRY

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Over the past decade the advertising business has been going through structural upheavals rather similar to those that have been seen in the financial services industry, with the emergence of both giant multiservice global agencies and specialist boutique suppliers of specialised services. These changes, along with growing centralisation of media ownership, have compounded principal-agent problems that had long complicated the operations of the industry. But they have also brought new means for the advertisers to get round them. The paper explores scope for opportunistic exploitation of information advantages in this industry and the checks and balances that may serve to counter such behaviour.

Keywords: Advertising, agency theory, contestable markets, opportunism.

INTRODUCTION

Debates about the welfare implications of expenditure on advertising are frequent. In economics, they were kindled particularly by the classic anti-advertising works of Galbraith and Packard.[1] In marketing, scholars have until recently taken the view that, whatever theoretical scope there might be for misleading and manipulative advertising, in the long-run it would make sense to uncover consumers' latent wants and work out effective ways of meeting them. But, even here, heretical views are being put forward[2] and texts are starting to include discussions of marketing ethics. As the debates have continued, new dimensions have been introduced: for example, perceptive motoring journalists have pointed out that decisions by local car makers to spend money on advertising may not merely serve to boost local sales but may also be more convenient routes than expenditure on local components manufacture as a means towards generating acceptable levels of local content.

This paper explores another side to this area of controversy, which has been the subject of much attention in the business press recently but which seems to have attracted little attention in more academic circles. Marketing texts characteristically portray advertising agencies as competing keenly with one another. However, with the rise of mega-agencies and media conglomerates in the merger mania of the 1980s,

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questions arise about whether the advertising market is becoming less hotly contested than in the past, particularly if the emerging giants are tending to gobble up the smaller players. Hence, instead of considering directly the extent to which we should pity the consumer, I focus on the issue of whether the companies that spend money on advertising are likely to be getting a fair deal in their own terms. This is relevant to the normal discussions about advertising's effects on consumer welfare. If it is a bad thing that consumers may unwittingly end up paying, via inflated prices, for the advertising that encourages them to buy things, then it is even worse if the advertisers are unwittingly being milked by the advertising agencies and media companies with whom they are dealing; for if advertisers could get their campaigns conducted more cheaply, they might offer consumers lower prices or, by ploughing higher current profits back into R&D, better products in years to come.

The theoretical perspective adopted in the paper is essentially that of the recent literatures that analyse economic institutions in terms of transaction costs[3] and agency theory.[4] Inspiration is also drawn from the literature on product bundling as a means for price discrimination.[5] In using this perspective to explore relationships between advertisers and the various firms with whom they might make contracts in the advertising industry, my central concern is the scope for 'opportunistic' behaviour, that is, actions involving the guileful use of an information advantage by a party to a transaction, whether in the market or inside an organistion, and whether prior to the deal being struck or in subsequent disagreements about whether what was promised was actually delivered. The guileful exploitation of information asymmetries may result in one party enjoying a surplus in excess of his/her opportunity costs, at the expense of another. However, the distribution of payoffs to a transaction may also be shaped by factors which deter would-be opportunists from engaging in such forms of behaviour.

EFFECTS OF THE IDIOSYNCRATIC NATURE OF ADVERTISING ON THE SCOPE FOR OPPORTUNISTIC BEHAVIOUR

There are two main risks that may act as deterrents to would-be opportunists. One is that the victim will discover what has been going on and in future turn elsewhere: the short-run gain may not seem worth the long-run loss of future business. The other risk may be present even with one-off transactions: the potential victim might be alerted by one means or another to possible dangers and ways of avoiding them by dealing with alternative suppliers. Implicit or explicit collusion by suppliers may reduce the scope both for being found out and for the suspicious customer to turn elsewhere. But collusion by incumbents is likely to be of no avail if entry is easy: potential players waiting on the sidelines may 'keep the bastards honest'. Hotly contested industries are best characterised as ones where the scale of new investment in plant and know-how needed for entry is small — as indeed it will be if existing producers of other products have spare capacity which can be adapted to the activity in question, or if exit is easy (in other words, if sunk costs are small)[6] — and where uncertainties related to product idiosyncrasy (in terms of standards of quality, reliability and so on) do not pose a barrier to customers' acceptance.[7]

The advertising business at first sight seems ill-suited for such a characterisation, even though entry is possible without major investment in capital equipment. An advertising campaign is an idiosyncratic product par excellence, particularly if it is commissioned as a bundle involving the design and production of advertisements, the planning of media usage and the buying of media slots. Though an intending advertiser may invite a number of agencies to pitch for the right to conduct its campaign, what actually gets supplied will vary according to which agency gets the contract; it is not something that will be pre-specified in a highly detailed contract. The campaign will only be designed in any detail after the contract has been awarded: the situation is very unlike that in, say, the business of subcontracting to supply automotive components to a particular specification, where the incentive to deliver to the required standards and on time is considerable because a breach of contract can be easily identified.

During the construction of an advertising campaign representatives of the agency will normally keep the client informed of progress and seek approval for their plans. But prior to such meetings one may expect debates within the agency about the strategy to be selected. In both situations the scope for opportunistic behaviour is considerable. Consider, for example, the difficulties in assessing proposals by creative staff. Nowadays, many 60-second advertisements involve production outlays many times greater than entire programmes between or within which they are sandwiched. It is possible that the business of making them gives great satisfation to artworkers or video makers, even though something far less lavish could have had an equal or better effect. If the creators try to justify their works with reference to their supposed basis in semiotics or their psychological workings, it may be difficult for other members of the agency to refute these claims because they lack the specialist knowledge required to do so: account management and media buying skills are very different from those involved on the creative side. Disputes may also arise over the wisdom of paying big bucks to get a famous movie star to appear in an advertisement. For example, was Foster's advertising agency BMP DDB Needham justified in paying actor Burt Lancaster £500,000 for ten days' filming in Scotland and director Bill Forsyth about £10,000 a day in order to recreate the mood of the film *Local Hero* as a means of selling Australian beer? On the one hand, such kinds of expenditure may be argued to guarantee far more attention than a larger number of screenings of advertisements that were much cheaper to construct. On the other hand, more time spent on creative thinking might be able to produce attentiongrabbing advertisements for a fraction of the cost — as with the award-winning advertisement 'Ode to a pea', starring a solitary Batchelor's tinned pea and made by Park Village Productions in less than half a day for a mere £2,000.[8]

Just as differences in expertise may make it difficult for members of an agency to discover the extent of each others' self-serving behaviour, so differences between an agency and its clients in terms of know-how and access to information may enable the former to get away with conduct that would be precluded if clients had inside information. But sometimes this may work to the client's benefit. For instance, an agency's staff may have a genuine hunch about the creative potential of a particular campaign design and yet need to engage in downright deceit in order to get the go-ahead from a sceptical client. An example here concerns the well-known Silk Cut cigarette advertisements, whose deeper undertones have recently been analysed by satirical novelist David Lodge as part of a layman's illustration of the nature of semiotics.[9]

These advertisements were originally written by one of the Saatchi brothers when he was working at Collett Dickenson Pearce in the late 1960s.[10] On that occasion the client rejected them. He then proposed the same advertisement years later when Saatchi and Saatchi won the account. This time, the sceptical client insisted that the agency should try the advertisements out on the public. The test results did not square with Saatchi's intuition:

> 'It was awful. Most of our sample had no idea what the hell it was. The few that did said it was a split lung, a ripped coffin lining or something even more disgusting', recalls an ex-Saatchis man. To his colleague's horror, Saatchi straightfacedly told the client the research results were the best they'd ever had.[11]

Things might have been very different had the client engaged a third party to run the test.

Such considerations suggest that purchasers of advertising services might be wise to specify their contracts not in terms of what is to be supplied, but in terms of the results, with penalty clauses for failures to reach particular standards and bonuses for higher attainments. Such contracts are indeed starting to emerge and, as the *Economist*[12] has argued, econometric modelling and the information output from supermarket checkout scanners are helping to make advertising more accountable. Likewise, the use of 'people meters' to audit more accurately audiences of the electronic media are making it easier to assess the quality of media planning and buying services.[13] However, it is by no means obvious how success might be measured, given the difficulties of isolating the impact of advertising from other factors that might be affecting sales, including slackness (for example in terms of quality control) on the part of the advertiser or its distributors. Most easily measurable are recall rates and coupon responses. But there is a danger that the agency will concentrate its efforts on producing the outcomes that are agreed on because they are measurable even if members of the agency themselves harbour doubts as to their effects on sales — for example, an anti-Aids campaign might enjoy high recall rates and yet have little impact on sexual behaviour.

Results-based fees come into their own if a campaign is as conspicuous a flop as that which Hill Holliday ran for most of 1989 as a build-up to the launch of Nissan's Infiniti luxury car brand in the United States. The advertisements talked about the car but did not show it or even parts of it, in an attempt to ensure that the product did not get in the way of the message about the brand's new philosophy of Japanese luxury.[14] But the results of the campaign that 'dwelt on rocks, streams and trees, but not cars'[15] were dismal brand recognition and sales — at around a third of those achieved by Toyota's less cryptically advertised Lexus — that were barely half what the company had been expecting. However, outcomes are usually much more debatable and costs of measuring results may discourage advertisers from insisting on results-based fees. If the market research resources required for assessing the campaign are subcontracted, it would obviously be unwise to award the contract to a subsidiary of the agency whose work is being examined. The market research arm of a rival agency could barely be said to be preferable in terms of conflict of interest. A specialist research agency has attractions as a supplier of an independent audit.

Where a client does feel that the agency has delivered a defective campaign, the scope for obtaining redress is likely to be limited, even if the contract is so detailed as to specify such things as image recall rates: it may well be possible for the agency to commission an audit which reveals much more favourable impacts of its campaign. Although the campaign may have turned out a flop due not to opportunism but to incompetence, poor judgment (probably the case with the Infiniti advertisements), or the relative creative ingenuity of rivals, one would well expect opportunistic behaviour in the face of complaints. (Of course, one could imagine the setting up of a judicial tribunal to resolve such disputes, whose own audit team's assessment would be definitive. However, the longer the dispute dragged on, the harder it would be to assess what the actual impact of the campaign had been). In most cases a suspect agency will simply be fired.

Clients would not normally find it in their competitive interests to tell other firms about their experiences with advertising agencies that appeared to have indulged in slack behaviour and sharp practice. This is rather different from the consequences of the discovery of opportunistic behaviour in consumer markets, where, unless the embarrassment is too great, people tend to spread the word amongst their social networks; one act of opportunism thus results in the loss of many sales. However, in this industry an alternative restraining factor is the fact that major changes of advertising agency clienteles are usually given media coverage by trade journals such as *Marketing*. The fact that only about ten per cent of accounts change hands each year [16] might be construed as implying that most of the time agencies are seen as striving vigorously and competently to do the best thing for their clients. But there is another way of viewing this situation.

REPUTATION AND THE CONTESTABILITY OF THE ADVERTISING BUSINESS

The idiosyncratic nature of advertising opens up a major role for reputation to determine whose services are contracted. The costs of failure and the difficulties of proving that one has fallen victim to opportunism or incompetence may make it seem vital to choose a reputable, reliable agency in the first place. At first sight, this appears to open up scope for such agencies to command fees that generate supernormal profits. It seems that newly established agencies will experience difficulties in picking up customers even if they try to compete on price, because they will not be able to guarantee to match incumbent suppliers in the non-price terms. Prospective advertisers may find it very difficult to discern opportunism on the part of a supposedly reputable agency whose pitch seems to involve greater expenditure than that suggested by an interloper who promises a different way of meeting the client's stated goals. Clients who lack experience of doing the job themselves may feel it not unreasonable to judge the likely quality of a campaign by its estimated cost. A similar barrier may arise in respect of entry pitches that focus on the prospect of a wildly innovative campaign: decision-makers in the client organisation may be poorly equipped for assessing the chances of success.

As an example here we can note that, for all his reputation as a creative hi-flier in the Australian advertising business, even Siimon Reynolds initially found it hard going when he set up his Omon agency. In an interview Reynolds lamented the cautiousness of representatives of prospective clients, who seemed to adapt the maxim 'No one ever got fired for choosing IBM' to provide a basis for sticking with an established advertising agency.[17] No marketing manager will relish the prospect of a fiasco ensuing if a tried and trusted agency is dropped on his/her recommendation. Many may thus be in danger of ending up paying over the odds for a relatively ineffectual conservative campaign run by an agency with whom they have felt satisfied in the past. So long as they meet their aspirations, they are under no pressure to do something radical.

Matters are, in fact, less in favour of incumbent firms than they initially appear. As they decide on their pitching strategies, senior staff in incumbent agencies should be worrying about three main threats to their positions. First, major advertisers may be willing to experiment with alternative agencies by signing over small parts of their accounts. A new agency's growth can thus be based on the reputation it achieves following success at chipping off bits of the blue chip accounts[18] Secondly, entry by staff defecting from established agencies to set up their own businesses is made easier insofar as past clients recognise that the success of particular campaigns may have been due not to the fact that they were handled by particular supposedly reputable companies but due to the skills of the particular personnel that handled them. If the latter feel that they could do better by branching out on their own, they may then be able to take established clients with them and use these clients as a basis for attracting new business of their own. Thirdly, entry may come from established companies who lure well-known advertising hi-flyers (and with them, their established clients) into their organisations by paying appropriate golden hellos. These firms may include rival agencies, major users of advertising that are choosing to 'internalise' all or part of their advertising activities — the ultimate restraint on opportunism by subcontractors is to do it oneself, at the risk of being let down by members of one's organisation — or other established firms that are trying to set up agencies of their own, hoping to build on their existing skills in somewhat similar lines of business (say, travel services or video production). The internalising entrants may be adopting a taper integration strategy in which they internalise part of their advertising activities as a means of building up expertise about the value for money likely to be associated with the pitches of external suppliers of advertising services.

These scenarios seem not to have been much on the minds of those who helped finance the takeovers that led to mega-agencies such as Saatchi and Saatchi or WPP. In many cases over-inflated sums were paid for agencies based on their past earnings even though their key assets were their personnel. Subsequently, some agency partners found that the fortunes they made from selling out to the likes of Saatchi and Saatchi did not compensate them the feelings that came with being owned by someone else.[19] If they, or their more junior staff, subsequently tried to restore their morale by quitting to set up on their own accounts, the mega-agencies would be left with a smaller market share. Hence unless such agencies enjoy advantages of size that outweigh the costs of servicing the debt burdens incurred in order to stitch them together and any other disadvantages that go with larger size, their long-term positions look precarious. Having raised these question marks about the distribution of sustainable competitive advantage in this industry, I feel it is now appropriate to refocus the discussion on the economics of advertising agencies' internalisation strategies. I turn first to consider the advantages and disadvantages of greater size, and then move on to consider the question of diversification versus specialisation.

PROBLEMS WITH GLOBALISATION

The mega-agencies that Charles and Maurice Saatchi and their emulators (most notably, the Saatchi's own former finance director Martin Sorrell) put together in the 1980s were not intended to struggle under the weight of a crushing debt burden. According to Marks and Kleinman,[20] their aim was to reap the benefits of alleged trends towards the globalisation of markets that had been identified by Levitt.[21] It was expected that a global advertising agency would be able to pitch more successfully for the lucrative accounts of companies that sought to market 'world' products via unified campaigns. A London-based manufacturer that, say, allowed the London office of Saatchi and Saatchi to handle its United Kingdom advertising might use the same creative campaign in Australia and have the Australian office of Saatchi and Saatchi handle any extra work, such as media planning and buying, needed to implement that campaign in Australia.

This strategy did not come unstuck merely because global marketing proved in many cases to be concept ahead of its time owing to a lack of uniformity in buyers' tastes and needs. Those companies that do embrace global marketing philosophy will be reluctant to concentrate all their advertising business with a global agency if they are not convinced that the agency can deliver a uniformly excellent standard of service from each of its branches: as the *Economist* puts it, "A dot on the map is not enough."[22] The idiosyncratic, creative nature of advertising ensures that agencies cannot standardise their branch operations in the way that McDonald's manages with its hamburger franchises.[23] Given the difficulties of judging the performance of an agency at a great distance, and the fact the global agencies were the product of rapid growth by takeovers of companies with often opposing corporate philosophies, it is easy to understand why most multinational firms remain happy to leave to their local executives the choice of suppliers of advertising-related services.[24] Creative staff have tended to adopt a 'Not Invented Here' attitude to campaigns designed by other branches and have been reluctant to refer their valued clients to unknown staff in overseas offices who happen to be colleagues merely as a result of a recent merger.[25]

CONFLICTS OF INTEREST DUE TO CLIENT RIVALRY

Globalisation strategies have also run into a particularly acute version of a principal-agent problem that is inherent to any kind of agency growth in the advertising business. As an agency expands its market share it will eventually find itself faced with the prospect of acting on behalf of rival companies. Sensitive information about one client's product or plans could be used secretly to win a contract to implement a devastating campaign on behalf of a rival. So long as the opportunism were subtle enough not to raise the suspicions of the client, one could well imagine the agency using the success of the rival's campaign as a basis drumming up more business from the victim — this time at the expense of the rival, and so on. The recognition of this possibility led long ago to the convention that if an agency found itself handling competing clients it would drop the least profitable account. The ousted client then had to find another agency.

What initially sounds a reasonable convention starts looking more problematic once one considers what the ousted client may then do. If the company judges that it has been placed in its predicament because the going rate for advertising services has increased it may conclude a more expensive deal with a different agency, a deal that is profitable enough to persuade the agency to accept even though it will have to drop its account with a rival to the firm it is taking on. In other words, we seem to have recipe for an expensive game of musical chairs. An initial disturbance, or simply a mistakenly generous client, may spark off a very tortuous adjustment process in which advertising agency fees continue to rise until (a) a displaced player stumbles upon an agency that does not deal with any of its rivals; (b) new agencies enter the advertising services market; or (c) some erstwhile clients decide to internalise the increasingly expensive services that they formerly contracted out to the agencies.

This version of musical chairs is expensive in terms of management time spent on establishing new deals. It also reduces the efficacy of reports of agency switches as indicators of client dissatisfaction. Worse still, it reopens the way for opportunism. Having ditched a client in favour of one of its rivals, the agency can hardly be expected to unlearn all that it has discovered in the course of its dealings with the former. It will serve its new client most effectively if it exploits this information.

These conflicts of interest make the formation of giant agencies via takeovers a potential generator of negative synergy, for established clients may have to be shed. The business press has been replete with examples of this, amounting to hundreds of millions of dollars of lost billings.[26] As the concentration ratio rises in the market, a brake upon the profitability of such takeovers comes into play: the musical chairs problem will drive quite major clients into the arms of smaller agencies, or towards internalisation. This problem will become all the more acute the more that the advertisers themselves are engaging in merger activity, including global takeover strategies: some potential clients may have so many interests that their lucrative accounts are simply too expensive to accept — for example, after 34 years of handling Proctor and Gamble, Young and Rubican resigned the account in 1983 because of the cost of having repeatedly to turn away new accounts.[27] An agency may find itself having to give up business even if the firms that it services are not operating as rivals in the particular markets for which the agency handles their accounts. For example, suppose Nestle is using a particular agency to promote a brand of 'infant formula' in Pakistan and then discovers that the same agency's UK office is handling a chocolate bar account for Mars in the UK. Though the agency may not handle Nestle's chocolate products in the UK, or indeed anywhere in the world, Nestle may still prefer to find an alternative agency.

Much the same kinds of conflicts of interest have been recognised in the financial services industry following the recent spate of diversifiction-oriented mergers: for example a merchant bank division of a banking conglomerate handling a share issue would face less of an underwriting prospect if the investment advice division gave a favourable picture of the issue. The regulatory response in some countries has been to insist on the creation of 'Chinese walls' between different divisions. If such directives were implemented in an honest manner, many of the imagined gains of such mergers would be threatened, so it is hard not to imagine grapevine growing over the Chinese walls.[28] In advertising, a similar solution is being tried, and clients may harbour similar suspicions. Most convincing would be an organisational situation in which, following mergers of rival agencies, an M-form structure is adopted, operating under the rule that no profit centre could handle rival accounts. The internal capital market aspect of such a structure would discourage insider exchanges of information unless — and this may be a major qualification — pairs of profit centres found two-way trades mutually profitable as a means of raising their billings against the internal rivals with whom they did not deal.

Ultimately, what matters for agencies is not the actual degree of confidentiality they can deliver, but the expectations of clients about likely performances and the prices they are prepared to pay for the benefits of a global network or expertise in advertising a particular kind of product. Advertisers in some industries, in some countries, may adopt a more relaxed stance, possibly because they accept the agencies' claim that leaks are more likely to result from defections by the clients' own senior staff. Despite running three parallel networks (Saatchi and Saatchi Compton, DFS Dorland and Ted Bates), Saatchi and Saatchi lost all Ted Bates' Colgate-Palmolive business shortly after the Bates takeover because Saatchi and Saatchi Compton were handling Colgate's rival Proctor and Gamble.[29] On the other hand, Saatchi and Saatchi still had the accounts of four car makers. Likewise, in the United Kingdom all the clearing banks were once all handled by Charles Barker and even when inter-bank competition intensified one could still find both the Trustee Savings Bank and National Westminster being handled by J. Walter Thompson.[30]

THE PRODUCT PORTFOLIO OF AN ADVERTISING AGENCY

Advertising agencies seem for many years to have taken the view that it pays to offer a variety of services that are vertically or horizontally linked. It has been standard practice for an agency to provide expertise in creative thinking and copy production, and in media planning and media buying. Holding the operation together is the account manager who liaises with clients and ensures that they pay their bills. Having accumulated such resources, many agencies are likely to be well equipped to become involved in activities employing related skills, such as direct marketing, telemarketing, market research, public relations, graphic art, design, typesetting and film production. It is perhaps no surprise, therefore, that agencies have been diversifying into such fields, or even beyond. Given that Saatchi and Saatchi had been very successful as middlemen and financial managers — collecting money from their clients early, and paying it to media companies as late as possible — one can perhaps see why they made their ill-fated bids for merchant bankers Hill Samuel and for the Midland Bank, even though they claimed that the basis for their interest was that they could use their marketing skills to revive the bank's fortunes.[31] For a time, this firm even experimented with providing computing and management consultancy services, though the Saatchis' consultancy acquisitions were put up for sale once it was discovered how little synergy they had with advertising.[32]

The basis for getting involved in these kinds of areas is not simply that they are linked in terms of production and research synergies to the traditional core activities. There are two other considerations, both of which relate to matters of information and opportunism and which ultimately may be classified under the heading of marketing synergy. First, there is the matter of clients being concerned with the possibility that sensitive information about their new products and marketing strategies — and, indeed, about their operations generally — may get into the hands of rivals. To deal with a full-line advertising agency rather than a set of specialised contractors may seem to reduce the risk of such information seeping out. If only one firm is responsible for one's market research, one's public relations and for one's advertising in general, it may be easier to pin down the origins of any inconvenient leaks than if several firms are involved. The conglomerate agency's leadership should recognise both this and the size of business that they might lose if leaks are discovered. Hence they might be expected to take greater steps to ensure confidentiality. Here, then, is a plus point for the advertising conglomerates, though, of course, they may be less vigilant if they expect to be able to get away with suggesting that the responsibility for any leaks actually lies not with them but inside the client firm or with another of its suppliers.

Secondly, if the agencies can win a client for one of their activities and appear to perform well in that function, they can hope to have an edge when the client is looking for other services: better the devil you know, as they say. More generally, one might expect that diversified agencies can claim to offer the advantages of 'one stop shopping' — in other words lower transaction costs — to both potential and established clients. Since it is also costly for an agency to establish a relationship, one might expect that discounts would also be offered to clients that signed up for the agency's full menu of services, but so far this does not seem to be the practice.[33]

There is again a parallel here with the recent strategies of players in the financial services industry in the UK: by diversifying into real estate agencies, banks, building societies and insurance companies have hoped to pick up bigger slices of the mortgage market; for even if they cannot sell a person the house she wants, an estate agent may at least fix her up with finance from the parent institution which she may then use to buy the house of her choice.[34] In either case, one-stop shopping may save the buyer valuable time that would otherwise have been spent on establishing fresh relationships with other potential suppliers, but it may also result in the buyer getting a poorer deal than would have been possible had she chosen to shop around more.

Consider a firm that has had a particular agency's market research division undertake a market survey on how its products are perceived. If that survey discovers that the firm's image falls far short of what it had intended, the firm may then find itself in the market for a fresh advertising campaign. Having already established a relationship with the client, the agency is in a prime position to discourage the firm from seeking alternative bids. Even if rival pitches are sought by the firm, the first-mover may have an advantage due to its greater hands-on knowledge of the firm. To be sure, this may enable it to construct a proposal which is more suited to the client's needs; yet its package may cost the client more than would have to be paid if such knowledge were also available to the rival pitchers. The key point to remember here is that the appeal of a proposal lies not just in its likely cost but also in its likely efficacy and the latter depends on how well tailored it is to the problem at hand.

When an advertising agency has a range of linked services to offer, a strong incentive may exist for top management to manipulate information acquired by one division to generate business in another. A market research finding that implies a need for advertising is obviously much more attractive to the agency than one which stresses the need for modifications to the product, and if the agency is also in the media buying business as well as in media planning, a campaign which involves major media expenditure is also better for the agency. This conflict of interest has long been present in the industry, owing to the nature of the traditional billing system. When the typical agency offered creative inputs, media planning and media buying services as a package, its income came from fees that were based on the value of media expenditure commissioned — service fees from their clients and commissions from media companies — rather than from itemised accounts.

The incentive for agencies to skimp with creativity and advertising production inputs and to try to produce an impact by sheer volume of media spending was acute with such a method of billing. But itemised billings do not remove these conflicts of interest from the multi-service agency, for the key thing is still the bottom line of the account. For example, under itemised billing, a large agency which has its own television studios is more likely to want to recommend a television campaign than one involving a similar amount of spending on space in the print media. If the client is worried by the bottom line, the managers of such an agency may be tempted to make a case for cutting the bill by spending less on air-time and taking more time in the studio to make more memorable advertisements that would not require screening so often (but whose increased cost would more than offset the agency's loss of commission as a media buyer).

The main deterrent to opportunistic intra-agency generation of business lies in the self-serving tendencies (or, better, the integrity) of managers of an agency's specialist divisions. This is also a problem for a synergy-seeking full-service agency whose cross-referrals have no opportunistic intent: as the *Economist* notes, "despite the helpful prodding of their bosses, many of the boutiques remain bolshy about cross-referring clients. For a good reason. They often have little idea how good their sister company is and are unwilling to lose a client in the process."[35] A particular division's own work will have greater credibility if it does not end with a recommendation that the client then commissions further work from another arm of the parent agency. Lack of knowledge of the standards of other arms of the business will be more acute the more distant and different these are from the operations of a specialist division. The incentive to make cross-referrals is also reduced by the effort that may be involved if the personnel from the client company that one would need to convince to take up the service (for example, those involved with public relations or quality management) are not the same as those with whom one has so far been dealing (for example, a local marketing manager). It is thus not surprising that even Saatchi and Saatchi could only win about a fifth of its new projects via cross-referrals.[36]

Unbundling is a phenomenon that we must explore in detail, but before we move on to do so it should be stressed that internalisation is not a prerequisite for obtaining rewards at the expense of clients through exploiting linkages between various advertising-related activities. Separate firms may conceivably engage in co-operative behaviour, exchanging information with one another about clients or buying and selling information for a fee if the flow is prone to go one way. Of course, there may be legal restraints on such abuses of these kinds of inside information. Alternatively, firms specialising in different niches in the advertising industry may habitually recommend each other's services, just as with international airlines and their preferred domestic carriers and rental car firms. Strategies involving mutual recommendations without commissions are unlikely to prove viable if the parties distrust each others' claims about the efforts they make to cross-refer business and if the distribution of gains is felt to be lopsided.

UNBUNDLING AND THE RISE OF PROVIDERS OF SPECIALISED ADVERTISING SERVICES

Service unbundling and itemised billing based on 'head hours' spent performing particular services are options that full-service advertising agencies might have offered their clients at an earlier date had they been forced to do so by competitors who offered such choices. But a state of implicit collusion appears to have prevailed until the rise of 'boutique' operators specialising in providing particular advertising services. Prior to 'Advertising's Big Bang', the industry was dominated by the convention that an advertiser bought a bundle comprising creative inputs, and media planning and buying, with billings amounting fifteen per cent of spending on media space. Now, advertisers can, if they wish, put together for themselves a full line of advertising-related services from a variety of agencies and specialists, and then compare the cost of doing so with the cost of buying the whole bundle from a single supplier. Their task is made easier by the entry of specialist consultants who advise on which agencies should be selected to undertake each service, and how much they should be paid.[37]

In addition to encouraging shopping around and making it easier to reduce risks of falling prey to opportunistic agencies, unbundling and the itemisation of accounts may also encourage to advertisers to start internalising some advertising-related activities, for their opportunity costs become clearer. In particular, large account, regular users of media time and space are now likely to be far less inclined to use agencies as media buyers, even if they still chose to use their account planning and creative services. For example, consider an advertiser that lacks resources for engaging in the creative side of advertising and would not be able to use them on a full-time basis even if it cultivated them. Whether or not it opted to do its own media planning and buying could hinge on its ability to subcontract creative inputs, artwork, jingle and video production. (Of course, the firm might indeed consider cultivating such resources and then subcontracting out their surplus capacity, but it might fear that potential clients might be deterred by overlaps in their areas of interest). These services may become increasingly easy to purchase if creative workers in middle-ranking agencies feel they cannot work at their best in giant organisations and therefore opt to branch out on their own as their employers are gobbled up by takeover-hungry giant agencies. If the giants are not to lose market share in these areas they will need to demonstrate they can match the deals offered by the specialists.

Advertisers may be attracted to use specialist providers of particular advertising services if they believe that a focus on a particular activity may enable them to do a better job, offsetting the greater search and other transaction costs that are the downside of not dealing with a conglomerate agency. The services of specialists may also seem attractive as a result of the latter staunchly pursuing the strategy of being independent, aloof from conflicts of interest with other levels of production in the industry. An excellent example here is that of Australia's largest independent media buying company, Mitchell and Partners, which is the only non-agency-owned operation in the top five media buying companies.[38] Mitchell has around 500 clients on its books and in 1990 handled $800 million in spending on media advertisements. Until 1990 Mitchell's closest independent rival had been Merchant and Partners, who, in 1987, had won the media planning and buying business of both Ogilvy & Mather and J. Walter Thompson when these two agencies closed their media departments. One wonders what these companies made of the purchase of Merchant by Interpublic, the fourth largest advertising agency holding company in the world. Harold Mitchell's view is that the move could only be good news for operations like his own. As he puts it, "In a service industry like media buying, which relies on advertising agencies as its client base, a media buying firm cannot be owned by an agency. The conflicts are too great. I predict an uneasy period ahead for Merchant."[39]

British Telecom provides a good example of the kind of mixed strategy that may become commonplace in a world of partial internalisation and of increasingly respected specialists. As the *Economist* notes,

> British Telecom spends around £250 million each year on what it terms 'call stimulation' — split between four agencies, all chosen *a la carte* and paid performance-based fees. BT looked at the idea of running its own media-buying shop. Instead, all its television buying is handled through a new independent firm IDK Media and all its press buying is directed through a sister company of IDK. BT handles media planning itself, talking to 2,000 people each month and anonymously measuring how much 80,000 families around Britain use their phones.[40]

We should not jump to the conclusion that the appeal of the specialists will necessarily deter the conglomerates from behaving with opportunism. Not all advertisers will be aware of the conflicts of interest that face conglomerate agencies. Of those that are aware of such hazards, not all need judge that the costs of shopping around represent a sufficiently low risk premium to pay to ensure that they receive appropriate standards of service, particularly given the possibility that confidentiality may instead by lost as a result of more agents having access to their secrets. For a full-service agency that seeks to convince its potential clients that it is at least as trustworthy as independent specialists, the wisest strategy may be to structure itself so that it appears to clients as several specialised companies as well as a full-service team. Clients who prefer to make banquet-style purchases from a single company can continue to do so. Those who do not may also continue to do so, without realising it, as they purchase various services from seemingly separate organisations. Whether or not such an organisational/ownership structure leads to the attenuation of opportunism then becomes a matter of the nature of internal incentives. If the seemingly separate divisions are competing with each other for corporate resources, as in an M-form structure, then the clients may come out on top unless opportunistic negative cross-referrals are made. However, unless a mega-agency is actually organised as a set of smaller full-service agencies (each of whom is prepared to provide unbundled deals), rather than as one full-service agency plus a variety of specialists, managerial difficulties would be expected due to lopsidedness biasing the focus of top management's attention.

ADVERTISING AGENCIES VERSUS THE MEDIA BARONS

In October 1988 Saatchi and Saatchi attracted much attention when they announced that they were forming the Zenith media buying house by merging the media buying arms of their three British agencies (Saatchi and Saatchi Advertising, BSB Dorland and KHBB) with their newly acquired media buyer, Ray Morgan and Partners. Henceforth their agencies would concentrate on creative and media planning work. The creation of Zenith would be to the advantage of customers, it was suggested, since Zenith would be better placed to counteract the selling power of media barons such as Rupert Murdoch and Robert Maxwell.

One specific ploy of media conglomerates which a company such as Zenith claimed it would counter is block-booking, a practice whereby a firm finds it can only purchase, say, television time if it also purchases space in the same media conglomerate's newspapers.[41] We can illustrate how this works by adapting Stigler's[42] classic example of how movie producers used to profit from a block booking policy at the expense of movie exhibitors. Consider two advertisers who are trying to reach somewhat different audiences and therefore value differently the media outlets of a particular company. Assume, for simplicity, that buyers can only purchase one unit of each service. Given their assessments of the payoffs to placing their advertising dollars with rival media organisations, the two advertisers rate as follows the maximum worth to them of the media company's products: A would pay at most $8,000 for a TV slot and $2,500 for a full page in a newspaper; B would pay at most $7,000 for a TV slot and $3,000 for a full page in the newspaper.

Now, if the media company is to sell its TV and newspaper spaces separately, and if it cannot charge the buyers different prices for the same services, it must price TV slots at $7,000 and newspaper pages at $2,500. Higher prices would entail failure to sell newspaper space to A and failure to sell TV time to B. Its total revenue fom these two clients would be $19,000. If it block-booked these clients, insisting that they could only buy TV and newspaper space as a bundle, for a cost of $10,000 each, it would make an extra $1,000.

The firms dealing with such a media conglomerate could be either advertisers that were buying space on their own behalf, or their agents. Naturally, they would be keen to understate their willingnesses to pay for particular advertising slots, leaving it to the media owner to try to infer their upper limits by seeing what price would make them carry out a threat to go elsewhere. But the upper limit can only be discovered by asking a price just beyond it and then losing the business. Learning is difficult in this situation, not merely because the population of advertisers and their campaign strategies will change through time but also because a switch-inducing price only applies given the particular set of offers made by rival media companies on the occasion in question. The rivals may be pleasantly surprised to win business on this occasion and then experiment with a more demanding offer on a future occasion, just as the company that had earlier overstepped the mark starts making rather more humble bids for business. It is also possible that some buyers could be deliberately switching at prices below the maximum they are prepared to pay, as an opportunistic means towards getting better terms in future — sometimes it may pay to 'cut off one's nose to spite one's face.'

Although the Saatchis' justification for Zenith seems to be that it carries enough buying clout to produce softer quotations by media conglomerates, it is not immediately clear what might be the rationale for believing that threats to deal with other suppliers might be more troublesome if made by a large agency acting on behalf of a group of advertisers than if made separately by advertisers or small agencies, each acting on their own initiative. The situation is rather analogous to that which exists in the market for new cars: why do fleet purchasers get a better deal than individuals? Certainly, if a major buyer does switch to a rival supplier, the firm that loses the business will have a major chunk of capacity to fill by other means. Such spare capacity would not automatically be filled by buyers displaced from rivals if the latter ran into capacity constraints and raised their prices or created waiting lists. (Capacity constraints would probably be less significant in the print media than in the electronic media where advertisement/content ratios are regulated, though obviously newspaper and magazine buyers may become annoyed if they judge that too much space is being devoted to advertisements.) But it is altogether too simplistic to suggest that supplier, whether a media company or a car manufacturer, may give better deals to large buyers simply because of the possibility of having spare capacity to fill. A multitude of alternative clients might switch in the firm's favour if they were offered low prices instead. Moreover, although a company the size of Zenith clearly could cause havoc if it, say, implemented a threat to withdraw its business from News Ltd; so too, could a set of smaller buyers that simultaneously withdrew from News Ltd. a similar total value of advertising business.

Economists might normally make sense of price discrimination in terms of differences in price elasticity of demand between the various customer groups. It might cost a car manufacturer less in terms of the expected value of lost revenue to have a satisfactory chance of winning a contract with a fleet buyer, than it would cost if prices were subsequently cut to increase sales to individuals to offset the loss of the fleet order. This analysis is less obviously applicable to the context of media buying, when the parties negotiating with the media owners are merely agents for the ultimate customers. The latter can switch between media buyers to get better deals with a given media owner, whereas individual car buyers may find it difficult to pass themselves off as fleet buyers.

An alternative way of looking at the issue is in terms of transaction costs. Consider once again the car market analogy. The costs associated with fixing up a single fleet deal involving several thousand vehicles may be much less than those involved in selling the same number of vehicles to individual buyers. More finely targetted advertising media can be used, and fewer hours of staff time are likely to be involved with a fleet deal, even if greater effort is lavished on wooing an individual fleet buyer. (With this type of product we should not ignore the possiblity that fleet sales may actually serve as a marketing device in respect of sales to individual customers: for example, people who learn to drive in a particular car may then purchase one of their own. This marketing role may be worth paying for via lower prices, if this is necessary to clinch the contract). Inventory costs may also be lower, not merely because fewer demonstrators will be needed but also as a result of the fleet buyer making a forward purchase of a standardised product, rather than expecting on the spot choices of a range of specifications. By forming a buying collective, a group of individuals could in principle set about trying to reduce many of these costs for the manufacturer, but to do this would obviously involve them in other kinds of transaction costs.

It is easy to extend this line of thinking to the case of media buyers if we envisage some of them operating as intermediaries who earn commission by bringing media owners and users of media space together, and others acting as 'time brokers' that make forward bulk purchases of vacant blocks of media space which they then partition and resell to advertisers. (The former are analogous to stockbrokers in Britain prior to the 'Big Bang', the latter are like stockjobbers). Carat Espace, which handles about a third of media buying in France operates in the latter way, but the phenomenon has yet to spread elsewhere.[43] Clearly, a media conglomerate would find it far more convenient to make large, infrequent deals via a number of traditional media buyers. In addition to lower costs of dealing with media buyers, it might feel it enjoyed a stronger base of future revenue against which it could make its programming commitments. However, we should also recognise that time brokers who push their luck too far may find themselves in a very vulnerable position compared with traditional media buyers. Suppose a time broker carries out a threat to withdraw its business and make a giant advance block booking of space with a rival media conglomerate. The ditched media supplier can try to pull the rug from under the time broker's feet by incurring the transaction costs of negotiating directly with the firms that want the advertising space (or with other media buyers to whom they might turn for alternative quotations), and offering them the sort of deal that the giant media turned down. The time broker could then find itself having to resell its media slots at a discount.

Comparing differently sized media buyers that do not act as time brokers, we can note that larger operators will probably be having more occasions to arrange deals with any particular media owner. There will thus be more scope for bundling together transactions that smaller operators would have had to process separately. If there are economies of scale in gathering information about prices at which alternative media slots can be obtained, one would expect larger media buyers to make more forceful claims to media owners about the possibility of buying equally effective media slots more cheaply from rival media firms. In particular, larger media buyers may enjoy economies in respect of the use of advanced computer systems for keeping track of the availability of particular kinds of media space and matching it with clients' needs.

These advantages of size do not mean that the future necessarily lies with companies such as Zenith that are subsidiaries of giant advertising conglomerates. Major independent operators, able to attract business partly because of their perceived freedom from conflicts of interest, may also exert considerable buying clout. For example, in 1987 the independent Australian media buyers Mitchell and Partners pulled all of their clients' television spending out of the Ten Network because the network's then owner Frank Lowy was demanding an increase in advertising rates of about 50 per cent.[44] This amounted to a loss of sales of about 15 per cent of the station's advertising time and Lowy relented as the Mitchell's ploy helped push the network into the red. From this it would appear that Lowy found it easier to retreat than to set about trying to sell the network's time directly to advertisers or through other media buyers. Interestingly enough, Mitchell and Partners' independence from advertising agencies might not be sufficient to make all their clients feel happy that they were completely free of conflicts of interest. The company owns 21.4 per cent of Sonace, which in turns owns 15 per cent of Brisbane radio station 4BH and 32 per cent of Sydney's 2GB.[45]

The possibility that larger media buyers can extract better terms from media companies does not necessarily mean that advertisers will end up paying less for space in the electronic and print media. For a start, there is the question of what the media companies may do in order to make good the losses they incur by giving in to media buying giants such as Zenith. If previously they were keeping their advertising rates down to level which kept their earnings low enough to discourage entry, one might now expect them to raise the rates they charge to those who have rather less bargaining power. A number of major advertising spenders, including Nestle, were so worried by this possibility that they actually considered getting together and setting up their own media buying group.[46]

Secondly, if a giant media buyer can obtain media slots on better terms than its smaller rivals, it may then stand to capture some or all of the difference. How much it passes on in terms of reduced billings may depend on how far it believes it is safe to push its luck before it will lose future business due to clients switching to other media buyers (including other giant operators) or internalising the activity. These risks will vary among advertisers, so price discrimination is likely to be attractive to media buyers. In Australia, different advertisers do indeed pay different prices for similar media slots.[47] In the United States, by contrast, media owners are prevented by the *Robinson-Packman Act* from offering special deals to one advertiser over another.[48] In economies where price discrimination is a possibility, advertisers could try to guard against it by seeking quotations from several media buyers and then choosing the cheapest quotation but, clearly, this involves higher transaction costs.

Thirdly, we should recognise that if, in future, non-independent media buyers start seeking to get better deals by acting as time brokers, they will face a conflict of interest. If the media buying arm of an agency has committed itself to more space than clients appear to want, and if it is experiencing difficulties in attracting extra clients (for example, due to the difficulties of finding potential clients who are not rivals of existing clients), the agency is under a strong pressure to avoid embarrassment by ensuring that its media planning arm inflates its estimates of the need for space by its clients. Once again, though, advertisers may be able to avoid this conflict of interest if they use an independent media buyer, as part of an unbundling strategy.

Finally, in respect of the implications of changes in relative sizes of media companies, advertising agencies and advertisers, we may consider what happens to the distribution of trade credit. To the extent that bigger agencies are in a stronger position when it comes to delaying payments to media companies and in speeding up payments by their clients, they are in a better position to generate positive cashflows and use these to fund expansionary activities or simply to reap the benefits of scale economies associated with placing large blocks of funds on the money markets.

CONCLUSION

This is an industry replete with potential conflicts of interest but one which also has a number of checks and balances to deter opportunistic tendencies. The question is whether the latter are sufficient to overcome temptations to succumb in respect of the former. Moves towards unbundling of advertising services by full-service agencies rather suggest that the advertising industry is becoming more competitive, with less of a tendency towards implicit collusion. So, too, do moves towards internalisation by larger clients and the emergence of specialist providers of services. However, there may be informational advantages associated with dealing with integrated agencies that make the risk of agency opportunism seem worth taking, especially if a full-service agency has a good reputation. Pressures for larger agencies to trim their costs will be lessened to the extent that they are able to exert bargaining power with media suppliers and to the extent that they recognise that it does not pay to compete amongst themselves on the basis of price. Growth by merger may enhance bargaining power but also bring problems of lost goodwill due to client perceptions of conflicts of interest arising from a single agency handling accounts of rival clients. The advertising industry probably could set potential clients' minds at ease if it established an open access computer register of agency/client relationships and agency/subsidiary relationships. Such a facility would make it easy for clients to check up on potential conflicts of interest. But it is rather hard to imagine this service becoming available on such a scale as to contend with the complexity of globally organised markets.

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