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Why Some Consumers Benefit From False Advertising

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Classes of consumers frequently sue companies alleging they suffered economic damages as a result of false advertising or other deceptive promotional activities. These cases are brought under different state consumer protection statues. Some of these statues, such as California's Unfair Competition Law, allow a class of consumers to sue even if not all class members were deceived by the false advertising.

The economic logic behind these claims is that false advertising, even of a limited number of consumers, artificially raises the demand for the defendant's product, causing all consumers to pay higher prices. This article discusses why artificially raising the demand for some, or even all, buyers need not lead to higher prices for all consumers. In fact, deceiving some customers can cause prices to be lower for other consumers. This has important implications for both class certification and damages issues in these cases.

How Advertising Affects Competition and Prices

When companies in an industry sell differentiated products, competition is limited by the differences in brand preferences across consumers. When companies know that there are differences in the willingness to pay across consumers but cannot price discriminate, they face a trade-off. If they price high, they will make fewer sales but earn higher profits per unit on sales to their most loyal customers. If they price lower, they can make more sales to buyers who view their product as a closer substitute to their competitors' products. However, this reduces the profits per unit they earn on sales to the most loyal buyers. Therefore, companies will choose prices that balance the reduced profits on loyal customers with increased profits through more sales to customers with weaker brand preferences. The existence of consumers with strong brand preferences, therefore, limits competition among companies in an industry because it reduces the willingness of companies to compete for consumers with weaker brand preferences.

Advertising that targets consumers with weaker brand preferences, can increase competition among firms in an industry. To see this, suppose that a company has two types of customers: (1) nonloyal customers who view its products as a close substitute for its rival's products; and (2) loyal customers that have a high willingness to pay for its product and a low willingness to pay for its rivals' products. If a company can use advertising to raise the willingness to pay for customers with weaker brand preferences, then sales to those customers become more profitable. As a result, companies may be willing to reduce prices and forego profits on more loyal customers when less loyal customers are willing to pay more, so advertising can reduce prices for customers with stronger brand preferences and increase prices for customers with weaker brand preferences.

False and Truthful Advertising Have the Same Effect on Prices

The economic logic of the arguments above do not depend on the truthfulness of the advertising. Both false and truthful advertising can cause prices to rise for nonloyal customers and prices to fall for loyal customers. However, the effect of advertising on the welfare of individual consumers depends on whether it is false or truthful.

When advertising is truthful, nonloyal customers pay higher prices because the advertising has convinced them that the company's product is higher quality than its rivals' products. Thus, nonloyal customers who purchase a product because of the advertising will not be harmed even if they pay higher prices. However, if the advertising falsely convinces nonloyal customers that a company's product is higher quality than its rival's product, then customers who purchase the products because of false advertising are harmed because they pay higher prices but do not actually get a higher quality product.

Loyal customers, however, can benefit from false advertising even if it raises their willingness to pay. If loyal customers pay lower prices as a result of false advertising, then they are better off because they would have purchased the company's product even without the false advertising.

Surveys Cannot Be Used to Show Common Impact

In addition to relying on economic principles, plaintiffs often present survey evidence to support their claims that putative class members suffered a common economic injury. These surveys are typically designed to show that the allegedly false advertising increased the willingness to pay for a large share of consumers and to estimate the average incremental willingness to pay for a company's product due to allegedly false advertising.

However, these survey results are not sufficient to establish that false advertising caused a common economic injury. Even if the false component of the advertising raised the willingness to pay for a large share of consumers, it could still lead to lower prices for others. In addition, a large increase in the average willingness to pay does not imply that all customers paid higher prices.

Moreover, evidence that average prices paid by consumers were higher as a result of false advertising would not be sufficient to establish all class members suffered a common economic injury. If the increase in prices paid by nonloyal customers as a result of false advertising were sufficiently large relative to the decrease in prices paid by loyal customers, average prices would increase even though not all class members would be harmed by the false advertising.

Instead, to show that all or nearly all class members suffered a common economic injury from false advertising, plaintiffs would have to examine prices paid by all class members and show that they paid higher prices. In theory, this could be done by, for example, using benchmark methods to show prices were higher for all class members after a false advertising campaign began than before it began.

Conclusion

Because false advertising can induce companies to compete more aggressively for customers with low brand preferences, it need not cause prices for all customers to increase even if the advertising increases demand among class members. This means that plaintiffs seeking to certify a class of consumers that paid higher prices because of false advertising should not be able to claim that raising the willingness to pay of some, or even all, customers necessarily leads to higher prices for all customers.

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