COMPETING FOR CONSUMERS ONLINE: THE ADVERTISING STRATEGIES OF VERTICALLY DIFFERENTIATED FIRMS

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ABSTRACT

This paper studies the strategic decisions of vertically differentiated firms that promote their products online utilizing display or search engine advertising. Our findings indicate that firms' advertising strategies in equilibrium critically depend on the type of advertising used and the degree of quality differentiation. Firms' decisions may lead to informational disparity in the marketplace that softens price competition and thus increases both firms' profits. Specifically, a low-quality firm may choose not to run a display advertising campaign, even when administering such a campaign is costless, if the degree of vertical differentiation between the goods is small. Moreover, as the degree of advertising effectiveness goes up, resulting in more customers that only consider the high-quality good, we show that the low-quality firm can be better off (despite not advertising). In the case of search engine advertising, the high-quality firm acquires the top sponsored link over a large range of the parameter space, as the value of advertising is typically greater for it. However, if advertising effectiveness is moderate and vertical differentiation is small, the low-quality firm will win the auction for the top link.

References available upon request.