

**ECONOMIC ANALYSIS OF SELECTED DMA AMENDMENTS:
TARGETED ONLINE ADVERTISING**



INESS, Bratislava, 2022

INESS acknowledges support for this research paper from Google

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Introduction

Last year, the European Commission came up with two proposals to regulate digital services in the form of the Digital Markets Act (DMA) and the Digital Services Act (DSA)¹. We have published a general economic analysis of the first regulation in the form of a policy study entitled: *Economic analysis of the Digital Markets Act*. These two Acts are currently going through the legislative process in the European Parliament. As part of this process, the European Commission is amending and making additions to the original proposal. This analysis will look at one aspect of the plethora of changes proposed by MEPs - namely changes to the operation of targeted online advertising.

There is currently (winter, 2021/2022) an intense debate between EU policy makers and MEPs on the final shape of the regulations on targeted online ads under the DMA and DSA. Part of the policy makers prefer a complete ban on targeted online ads, another part prefers to significantly regulate them and limit their use (e.g. by exaggerated requirements to disclose campaign details or by introducing an opt-in mode)³. This study will therefore focus on analysing the importance of targeted online ads in different areas of the economy and social life. And furthermore, the resulting negative impacts of limiting or abolishing them altogether.

Effectiveness of targeted online ads

Online advertising has several advantages over offline advertising. First of all, it is a significantly lower cost for reaching potential customers. The advertising parameter CPM (cost per mille) measures the cost of reaching 1,000 people and is 80-90% lower for online advertising than for traditional offline advertising, such as TV broadcasting or newspapers⁴.

In addition, online ads can be significantly better targeted to the desired target group thanks to personalisation. This targeting takes place on the basis of two types of information about the individual. The first is their online activity (what sites they have visited, what they have searched for, etc.) and the second is their demographic characteristics (gender, age, etc.).

This type of targeted online advertising, which is shown to a specific market segment, creates value, and this matter is the subject of academic research. Experimental research comes to a consensus that non-personalised advertising brings a 50-70% loss compared to personalised advertising. In particular, three experimental studies have come up with loss results of 65%, 52% and 70%⁵.

The effectiveness of targeted online advertising is also reflected in market prices, where advertisers are willing to pay up to more than twice as much for targeted advertising compared to contextual advertising.

Sharing privacy to pay for efficiency

The effectiveness of targeted online advertising described above is made possible by the lower level of privacy of internet users. This fact is also criticised by the aforementioned Members of the European Parliament who want to ban targeted advertising and by European Commission officials who want to regulate it. However, their criticism of this 'trade-off' between effectiveness and privacy has several problems.

The first is that there is no such thing as an objectively correct level of privacy that we can define and enforce through regulation. The value of privacy, like the value of any good or service, is determined by the subjective valuation of particular individuals in particular situations. **Thus, Internet users can maximise their utility by exchanging their privacy in some area** (e.g. searching for products and services on the internet) for free services offered by various internet platforms or media. Thus, it would be a net loss for them if this 'exchange' were made impossible by regulation.

Several surveys and studies suggest that the current state of the internet, where much content and services are free and financed by targeted online advertising, reflects the preferences of internet users. In the study: *Is the market for digital privacy a failure?* the author first tested the hypothesis that Google users know that the search engine collects personal data about their online activity. He was able to confirm this hypothesis because up to 90% of users knew that they were giving up their privacy when using Google's services, and this is the basis of the company's business model. The second hypothesis was to test users' willingness to pay for using services. **Here it was confirmed that almost 82% of users were not willing to pay anything for Google services if it would increase their privacy.** The median result of how much the remaining 18% were willing to pay for the services was only \$15 per year.

This reluctance of users to pay for the internet in exchange for more privacy is confirmed by a recent **IAB Europe survey showing that 75% of Europeans prefer the current internet model based on free services and targeted online advertising**⁶. This model of financing content on the internet thus represents a 'public good' from the perspective of consumers, where no one is excluded from consumption. However, its functionality would be compromised if an internet user from Europe had to 'buy' more privacy than he or she prefers today.

On the other hand, for users who prefer more privacy on the internet, there is a wide range of tools, settings and options to achieve it already today. From the user-friendly simple ones, such as joining the Apple ecosystem or disabling tracking and showing targeted ads within browser settings or Google services, to the more complex ones, such as using encrypted apps, VPN services or even entering the world of anonymous cryptocurrencies.

The EU's goal of increasing privacy also has many unintended consequences and runs counter to other objectives of the EU itself. **For example, trying to increase privacy for all users inevitably leads to lower levels of security on the internet.** An example of this 'trade-off' was when, in 2020, the European privacy regulator EDPR banned internet platforms from monitoring their users' communications. In doing so, however, it restricted the operation of a system that internet platforms had been developing for years to track images of abused children. At the same time, the fight against child abuse is also an important EU policy. So last year, the European Commission had to resolve this last-minute internal contradiction in the form of a clash of its own objectives.⁷

It should also be taken into account that the EU has already had a comprehensive regulatory framework in place since 2018 in the form of the GDPR, which is precisely aimed at ensuring a higher level of privacy for internet users. Experience with the short period of operation of this regulation points to many of its negative and unintended consequences. For example, some foreign services have become inaccessible to European consumers.⁸ GDPR regulation has favoured large players and established platforms at the expense of smaller ones.⁹ And the architects of GDPR regulation are already calling for it to be updated, as advances in digital services are dynamic, as opposed to static regulations.¹⁰

In addition, **targeted online advertising is already regulated by a number of regulations:** the Consumer Rights Directive (CRD), the ePrivacy Directive, the Directive on Misleading and Comparative Advertising (MCAD), and the Unfair Commercial Practices Directive (UCPD). The creation of two more broad regulatory packages in the form of the DMA and DSA, which will add another layer of regulation on targeted online advertising, introduces additional complexity to an already massive regulatory burden.

In the next section, we look at the anticipated unintended consequences of restricting or banning targeted online advertising.

Unintended negative consequences of restricting targeted online advertising

A company Adex estimates that total online ad revenues in the EU will reach €70 billion in 2020.¹¹ More than half of this will come from targeted ads. **If these ads were restricted or outright banned, it would cause significant damage to several sectors of the economy and society.** In particular, we will look at I) small businesses, II) consumers, III) publishers and IV) civil society.

I. Small businesses and start-ups

Small and medium-sized enterprises form the backbone of the economy and the vast majority of businesses in the economy. These are also businesses that have relatively low profit margins¹², high failure rates and have been severely negatively affected by the COVID-19 pandemic¹³. **For many of these businesses, going online and finding new online sales has become a matter of survival.** In Slovakia alone, payments in domestic online shops increased by 80% in 2020. While in 2019, €34 out of every €100 paid online went to domestic merchants, in 2020 it was already €43¹⁴. And this increase continued in 2021 as well¹⁵. An essential part of this transition of businesses and their customers to the online space was and is the use of targeted online advertising.

Any reduction in the effectiveness of targeted advertising or its cost would disproportionately affect small businesses and start-ups, which do not have the budgetary capacity to rely on traditional advertising channels as much as their larger and more established competitors.

The latter already have established distribution channels, their brand is widely known and their survival is not dependent on actively reaching out to new customers. **Targeted advertising thus helps new small players to enter the market and thus removes barriers of entry in different sectors.** Targeted online advertising also helps to create specific niche markets that would not have been able to reach the right customers without its existence.

In addition, effective advertising has a positive impact on the overall level of competition in the economy. Effective advertising thus pushes real prices closer to equilibrium market prices and ensures that there are no unrealised mutually beneficial exchanges in the economy (deadweight loss).

Restricting targeted online advertising would also negatively affect various sub-sectors in the economy. For example, targeted online advertising plays an important role in tourism, travel and the overall HORECA sector, which is a major source of revenue for many European countries. Also, targeted online advertising is important in the early stages of start-ups when they need to get enough suitable employees quickly. A deterioration in the situation of start-ups in attracting the necessary human capital could negatively affect the competitiveness of the European economy compared to other major economies such as the US or China, where targeted advertising is not prohibited.

Several trade associations (namely eCommerce Europe, EuroCommerce and Retailers Europe) have already opposed the proposals to restrict or ban targeted online advertising.¹⁶

Expert opinion

Martin Bulák, owner of Boosters, PPC specialist:

„Targeted advertising on internet platforms is a key marketing tool, especially for small businesses. Its reduction or elimination would make sales more expensive for many businesses and cut their already relatively low margins. This would significantly undermine their ability to compete with larger players and reduce competition in the market, which is something that no customer can enjoy. It would also severely limit the ability of ad platforms to invest in the development and maintenance of tools that millions of users around the world use for free today, thanks to funding from targeted ads.“

II. Consumers

From a consumer perspective, the restriction or abolition of targeted online advertising presents two main negative impacts.

Firstly, it would be the difficulty in accessing free content on the internet. Much of the internet today is free and funded by consumers indirectly through targeted online advertising. If this advertising were banned or restricted, it would undermine the business model of a significant proportion of providers of free online content. These providers would try to compensate for the fall in advertising revenue by some form of charging their content. However, this is a business model that suits only a certain type of content on the internet. For example, services such as email clients, weather forecasts, mainstream news, maps, tabloids, video playback, social networks, sports coverage, search engines **do not offer the type of content that consumers are ready and used to paying for today** (e.g. as opposed to streaming music and movie services, gaming, specific and specialist content, etc.).

This reduction in the scope of free internet would most adversely affect relatively poorer customers in Central and Eastern Europe (CEE region). They are not used to paying for content on the internet and also have lower incomes, which limits the amount of content they can afford to pay for. However, this disproportionate effect of limiting access to paid-for content on the internet can also be expected in relatively wealthier countries. There are also relatively lower-income groups of people such as pensioners, students or the unemployed, who are somehow forgotten in policy discussions about charging for access to internet content, yet it is these groups that will be most affected by regulation or prohibition. **From this perspective, removing or restricting targeted advertising is a tool for increasing inequality in society.**

A second significant impact of restricting targeted online advertising on consumers is that they would be less informed about products and services on the market. Advertising broadens consumers' horizons and helps them to acquire knowledge they 'don't know that they don't know'. If consumers receive less relevant advertising, their information costs will increase. This will result in the non-realisation of some mutually beneficial exchanges that would have taken place in a world with more information available to consumers.

III. Publishers

One important source of revenue for publishers of online newspapers and other media is online targeted advertising. **These sources allow them to create and provide content free of charge to their readers, listeners and viewers. Or it allows them to provide relatively cheaper paid content that is cross-subsidised by online advertisements.**

The experimental studies described above examining the effectiveness of targeted ads showed that switching from targeted to non-targeted ads would decline publishers' revenues. For example, the Competition and Markets Authority (CMA) in the UK reported in an experimental **study that blocking cookies (personalised data) reduced publishers' revenues by 70%**¹⁷.

For many publishers, advertising revenue is an important independent source of income that allows them to maintain a high degree of press freedom and independence from both government and opposition politicians, entire corrupt regimes or oligarchic groups. **Targeted advertising can thus support independent journalism and news reporting.**

Despite the growing role of subscriptions as a source of revenue for publishers, consumer willingness to pay for content online is still relatively low. According to an IAB Europe survey, Europeans' willingness to pay for the online content they currently consume for free is less than €4 per month¹⁸. Consumer willingness to pay is highly likely to be even lower in the CEE region.

Expert opinion

Michal Flimel, Head of Sales, Ringier Axel Springer Media:

„For a long time we have been focusing on different forms of targeting, creating audience segments, tracking various events and interactions in order to increase the performance and effectiveness of the campaigns we run. However, we will no longer be able to offer all of this. We can expect a decline in revenue, especially for programmatic channels where third-party cookies play a significant role, but there could also be a negative impact for direct sales campaigns.“

IV. Civil Society

Targeted advertising is not only important for the commercial part of the economy (businesses, consumers, publishers), but also for the non-profit and civil society sectors. This sector also needs to reach out its potential supporters, participants in its projects and financial and non-financial backers.

Targeted advertising makes it easier to coordinate dispersed stakeholders interested in different types of civic activism, education, and public issues. This better coordination, in turn, allows even relatively smaller or more narrowly focused projects to emerge and survive that would not otherwise be able to function.

Similar negative impacts can be expected in the case of culture and artists. It is now commonplace for many bands, orchestras, painters, sculptors, and other artists to target their viewers or listeners through targeted online advertisements when promoting their works, exhibitions, openings, concerts, etc. If they lost this opportunity or it was less effective, it would reduce their ability to present themselves to their audience and therefore make a living from their art.

Expert opinion

Monika Budzák, Director of the Economic Olympiad:

„Since 2017, we have been organising the Economic Olympiad for high school students in Slovakia. Teachers register their students in the competition, who are contacted partly via school email or direct contact with the teacher. We also use social media advertising to do this, and each year dozens of teachers indicate on the registration form that they learned about us through targeted online advertising.“

Conclusion

When introducing any regulation, the costs to all affected parties need to be carefully balanced against the potential benefits. The more the regulation affects natural evolution of the economy and the more actors it affects, the more difficult it is to assess its costs and benefits. In the case of some MEPs' proposals to restrict or outright ban targeted online advertising, **this is regulation of an industry that is tens of billions of EU dollars in size, affecting millions of small and medium-sized enterprises in the EU¹⁹, tens of thousands of non-profit organisations²⁰, and hundreds of millions of internet users.**

Such regulation will inevitably have many unintended and unpredictable negative impacts. That is the price that the European Union must reckon with. Such a large cost and risk for the future should be balanced by clearly definable and sufficiently high benefits of regulation. However, these are only vaguely identified in the case of restricting or banning online targeted advertising.

Supporters of this regulation highlight the benefits in the form of increased privacy for internet users. However, users who are interested in a higher level of privacy already have a choice between different services, tools and companies that make this possible. Respectively, the major internet platforms themselves allow users to get detailed information about why they have been shown an ad, what the platform knows about them and give them the option to edit, delete or cancel ad targeting altogether.

Thus, there is already quite significant competition in providing different levels of privacy in the use of services between different platforms. Moreover, the platforms themselves have both the best knowledge and strong incentives to balance the costs and benefits of different levels of privacy for their users.

In contrast, the public regulator is significantly worse off in terms of the level of knowledge and know-how of the online advertising industry itself. Equally problematic is the set of motivations of regulators, who may be subject to pressures from various narrow interest groups. Such groups may also be comfortable with regulations that are sub-optimal from a societal perspective. There are many indications that this is also the case today, and that the restriction or banning of targeted advertising is being pushed by various companies that are in direct competition with existing internet platforms and whose business model is based on traditional or online contextual advertising, or provide services with a high level of privacy²¹. Then if the European Parliament significantly restricts or abolishes targeted advertising, it may not be a victory for the consumer, but a Pyrrhic victory in the form of securing profits and market position for a selected small number of companies.

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Published by: INESS - Institute of Economic and Social Studies

Year of issue: 2022

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