

The Evolution of Advertising Agency Compensation

February 2019

Sharon Horsky *

ABSTRACT

Hundreds of billions of dollars pass annually from firms to advertising agencies in order to create and fund advertising campaigns aimed at enhancing their sales and profits. A crucial element in this relationship is the design of an effective compensation plan for the advertising agency which aligns the incentives given to the agency with the overall objectives of the advertiser. These compensation plans have undergone radical changes over time. They have evolved from a flat 15% of media billings - a commission method that has its roots in the mid 19th century, to a mostly “cost-plus” nature nowadays. A striking puzzle concerns the 15% commission rule – How and why did it appear? Why did it persist for over a century? Why did it eventually cease? Why did the cost-plus method replace it? We shed light onto these issues by examining the evolution of the compensation methods along with the structural changes that have occurred in the advertising industry over time including the changes in the functions that the advertising agency fulfilled.

Keywords: Advertising, Advertising Agencies, Compensation, Media, Principal-Agent

* School of Business Administration, The Hebrew University of Jerusalem, email: Sharon.Horsky@huji.ac.il, phone: +972-2-5880403