



The impact of counterfeit-purchase penalties on anti-counterfeiting under deceptive counterfeiting



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ABSTRACT

This paper examines the price and welfare implications of demand-side penalties in the context of deceptive counterfeiting. I show that imposing such penalties reduces demand and hence profit of the legitimate producer under some situations. When the deviation of consumer estimation errors becomes sufficiently larger, the legitimate firm has incentives to raise its product's price. Various anti-counterfeiting policies have different impacts on the firm's pricing strategy. Under uniform distribution in product quality estimation, social welfare is reduced. Consequently, counterfeit-purchase penalties employed in some countries are not recommended.

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1. Introduction

Counterfeiting is a rapidly growing phenomenon in the real world, with numerous producers attracted to the business of counterfeiting due to its low costs. According to a report by the OECD in 2009, international trade of counterfeit and illegally copied goods could total up to US\$250 billion,

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not including in-country activities, Internet infringement, and indirect economic activity and costs. Together, the estimated global impact of these activities could add up to a staggering \$1.7 trillion annually by 2015.¹ In order to curb this situation, most countries enact codes to punish those counterfeiting firms that are caught. This is one way of combating counterfeiting from the supply side.

In Italy the purchase of counterfeit products is viewed as committing a crime. Purchasers of counterfeit goods are given on-the-spot fines of up to 10,000 Euros. The decree against illegal street trading argues that both the buyer and the seller of counterfeit or pirated goods should be fined. The buyer is fined on the grounds that he or she is an accomplice to a crime. Civil law in France under the French Customs Act permits airport inspections and the seizure of counterfeit items possessed by travelers. Authorities have the right to confiscate the counterfeit items when found, and a traveler in the possession of a counterfeit good can be subject to a fine or criminal prosecution. The way to combat counterfeiting in these two countries is to cut down the demand for fake items. This is one way of combating counterfeiting from the demand side.

Most studies in the literature investigating counterfeiting issues come from the supply-side consideration and assume non-deceptive counterfeiting. Grossman and Shapiro (1988a, 1988b) divide counterfeiting into two catalogs: deceptive versus non-deceptive counterfeiting. Deceptive counterfeiting occurs where consumers *believe* they are buying a particular brand of product (or service) that is produced by a particular manufacturer, but in fact it is the product of counterfeiters. Non-deceptive counterfeiting is when consumers *know* (or strongly suspect) that they are purchasing a counterfeit product after close inspection or by inferring it from the place of distribution channels.

Yao (2005a, 2005b), following Grossman and Shapiro (1988b), studies the non-deceptive counterfeiting issue by considering the enforcement of a pegged-fine penalty law. Other studies in the literature of intellectual property rights (hereafter, IPRs), such as Johnson (1985), Liebowitz (1985), Novos and Waldman (1984), and Besen and Kirby (1989), focus on “photocopying”. Conner and Rumelt (1991), Takeyama (1994), and Shy and Thisse (1999) conclude that when the product has positive network externalities, the emergence of counterfeits can have positive effects on both the profits of the original product firm and consumer surplus.

The aforementioned literature, however, overlooks the counterfeiting issue from the demand side and confines the analysis mostly to the supply side. We know that in the real world some countries such as Italy and France engaging in combating counterfeiting are doing so from the demand side, whereby purchasers of counterfeit goods when caught are given large fines in order to cut down the demand for fake items. This observation implies that the topic of demand-side anti-counterfeiting should be studied, especially under the case of deceptive counterfeiting.

In recent years the Internet has changed the way counterfeit goods are sold and purchased, making it much easier for firms to engage in the activities of deceptive counterfeiting. Counterfeit operations frequently set up numerous websites that appear very similar to those of the authentic designer. A simple Google search for a reputable product can lead an Internet user to these deceptive websites. Moreover, the anonymity of the Internet nowadays presents a hurdle, making it harder to find and identify counterfeiters. Thus, with the proliferation of online shopping, auction sites, and even social media and search engines, the events of deceptive counterfeiting are expected to increase in the future.

A good example of deceptive counterfeiting is art forgery. In the art market fakes can take many forms, with the most common being unauthorized reproductions that violate an artist’s copyright or trademark. Other times the reproduction has been authorized, but someone adds the artist’s signature—either forged or copied—to transform a cheap poster into an expensive ‘signed’ limited edition.² One can thus view forgery as a limiting case of deceptive counterfeiting, whereby forgery deals with a small number of high-priced items that are difficult to differentiate from a ‘true’ item. On the other hand, markets for automotive parts, pharmaceuticals, and medical devices are often

¹ See the full BASCAP Report ‘Estimating the global economic and social impacts of counterfeiting and Piracy,’ February 2011 at <http://www.iccwbo.org/Data/Documents/Bascap/Global-Impacts-Study-Full-Report/>

² According to the *New York Times* (2012), the growth in the online art market is bringing about more fraud. This report addresses that “a recent study by statisticians ... estimated that as many as 91 percent of the drawings and small sculptures sold online through eBay as the work of the artist Henry Moore were fake.”

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