

Product variety and counterfeiting in primary markets

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Summary

This paper analyzes counterfeiting by applying the entrepreneur formulation of monopolistic competition. It departs from existing analyses in two ways. The first is on the market of counterfeiting. While previous studies on counterfeiting focused on the secondary markets of snob or status goods, this paper focuses on the primary market in which deceptive counterfeiting is conducted. This is motivated by the OECD's reporting on the growing concern of people unwillingly purchasing goods of substandard quality, through formal, legitimate distribution channels. The second departure is on the type of analysis. In contrast to previous studies based on partial equilibrium, this paper attempts to consider counterfeiting in general equilibrium. It is motivated by the observation that counterfeiting is no longer confined to a particular sector but it has spread into a large variety of goods that are consumed daily. Its aim is to complement the existing studies by studying the primary market of counterfeits and to clarify in what way such counterfeiting harms societies.

It first shows that counterfeiting occurs when the elasticity of substitution between existing brands is sufficiently large and/or IPR law enforcement is lax (Result 1). By studying the counterfeiting equilibrium in which all brands are counterfeited by 'shadow' entrepreneurs, it is shown that all 'legitimate' people lose (Result 2a), while the counterfeiters can gain if the outputs of the brands they counterfeit are sufficiently large (Result 2b). Otherwise, nobody gains in the counterfeiting equilibrium (Result 3). There are two sources of welfare loss. One is, of course, the possibility of purchasing counterfeits that offer no utility. The other is the reduction in the mass of varieties available, as a result of people turning to the counterfeiting business. Regardless of whether counterfeiters gain, the counterfeiting equilibrium is found to be stable, implying that once counterfeiting spreads, it prevails (Result 4). This is because, in relative terms, the expected utilities of the counterfeiters always exceed those of the legitimate people. Finally, it is shown that incremental strengthening of IPR law enforcement may not work to eliminate counterfeiting (Result 5).

The analysis helps to describe the basic economic situation of a society damaged by deceptive counterfeiting, and explains persistent counterfeiting as reported by OECD as well as the difficulty of eliminating counterfeiting.