Let’s start in Beijing and its Silk Street Market, which is, in essence, a five-floor mall. A resident of China or a tourist can find here a profusion of luxury goods. Or, to be more precise, the consumer will find a profusion of products masquerading as luxury goods. On any given day, name brands will appear to beckon you to buy quality and buy cheap; from Rolex to Armani by way of Gucci and Burberry, the pirates seem to offer the impossible: high quality and low price. On the surface this seems like a simple story: those who pirate products are stealing profits from brand names. True, but five minutes away is a store that sells real Tag Heuer watches as well as other genuine watch models. The lesson is clear but counterintuitive: piracy and legitimate brands can live side by side. Is there a new global truth emerging here?

Product piracy is a prevalent, if commercially worrying, practice. Yet, after extensive research, Julio O. De Castro, David B. Balkin and Dean A. Shepherd believe that those who pirate your products can sometimes actually be helpful to your sales.
recently have researchers begun to examine the possibility that product piracy might improve overall customer demand for legal versions of the product and thus benefit the entrepreneurial firm. Our research and thinking, while not condoning the lack of ethics that commercial pirates use, does proffer the point of view that – in some cases – piracy can actually help the firm being pirated.

Entrepreneurship involves the discovery and exploitation of opportunities to bring into existence new products and services; and, as has been seen time and again the intellectual property behind an entrepreneurial firm’s new products can be pirated by competitors impacting the effectiveness of exploitation efforts. Product piracy is not a recent phenomenon, but technology advancements that have made piracy easier and improved the quality of the pirated products have forced global examination and discussion.

Simply put, product piracy is the misappropriation of intellectual property by a party other than the rightful owner, resulting in the making of unauthorized copies of a product. And piracy is pervasive: it has been estimated that five per cent of software used in the US is illegal, while in China and Russia the rate of illegal copies approaches 90 per cent, and the losses from software piracy have been conservatively estimated at $1.5 billion a year. In one case, US officials have even complained that an entire automobile produced in China pirates a GM design. Cartier has declared that it spends more than $3 million a year protecting its intellectual property rights in over 125 countries. According to one source, Microsoft maintains a staff of 250 in its intellectual property protection department, which operates as a “worldwide police force”.

A new logic on product piracy?

As we mentioned earlier, most research on piracy has focused on its costs to entrepreneurial firms: sales losses, brand image erosion and enforcement. Yet it is worthwhile to examine the possibility that product piracy might actually improve overall customer demand for legal product versions, thus benefiting entrepreneurial firms. How so? We put forth seven propositions that will help the business world to realize that piracy is not always deleterious; together, these propositions provide a new “logic train” for thinking about product piracy.

1. The greater the overlap between the markets of customers for legal versions of the product and customers for pirated versions, the more piracy reduces sales of legal versions.

This is the best starting point. Obviously, if there were two almost-identical products existing in the same marketplace – one genuine, one a close imitation – then the sales of the original product are bound to be affected, especially if the knock-off is cheaper.

Piracy occurs in a variety of different ways, and the quality of pirated products varies. We contend that the quality of the pirated products likely also affects the amount of overlap between pirated and legal markets and should have significant implications for the entrepreneurial firm’s enforcement efforts. For example, consider the quality of a DVD made from a stolen master copy compared with one made from a recording in a theatre. Both are common practices, but the DVD made from the stolen master will have much higher quality, and thus higher overlap with the legal version, than the copy made in the theatre. This difference will affect prices paid, the likelihood of further acquisition of pirated copies, the number of public versions available and network effects.

The price of a Class A copy of a Rolex watch can be 5-to-10 times higher than that of a Class B copy, owing to the differences in quality and the lower likelihood of detection of a copy. The closer the pirated product is in quality to the original version, the closer customer markets for legal and pirated copies, and the more likely it is to detract from the entrepreneurial firm’s sales.

2. The smaller the quality gap between legal and pirated versions of the product, the greater the overlap between the markets of customers for legal versions of the product and customers for pirated versions, and the more piracy reduces sales of legal versions.

While it’s not safe to assume that the potential buyer of a product will always ferret out “a great deal” on a pirated product, it does seem verifiable that (a) if genuine and pirated products are close in quality, and (b) if there is a healthy dissemination of information about the availability of the pirated version, then (c) the more likely that the sales of the pirated products will be at the expense of genuine product inventory. This can happen not so much from any kind of promotion by the pirates...
(whose effort could attract unwanted attention from authorities) but by simple word of mouth. People stumble upon a pirated version of a product, buy it, and then others take note, quite probably asking “Where did you get that?” If a pirated product is readily available and also attractive by virtue of quality and price – and if the social communications network (the buzz) is strong, pirated sales should soar and legal sales should be reduced.

This leads to two other closely related propositions.

3. The more important network externalities are to customers, the more benefits piracy can generate for the entrepreneurial firm. The less overlap between the markets of customers for legal versions of the product and customers for pirated versions, the more network externalities produced by piracy create benefits for the entrepreneurial firm.

Here, then, is the first way in which piracy can convert from a liability to an asset. It could work like this. The power of premium brands is linked to both inherent product attributes and widespread consumer confidence and enthusiasm. When a brand product is pirated, it could easily provide a consumer who has limited market knowledge a clear indication of what other consumers in the market appreciate. Thus, a male customer seeking to buy an original handbag for his partner and lacking information about which bag is “hot” would walk down the street and find that lots of people are carrying Louis Vuitton bags, both original and pirated ones, which by the way would be hard to differentiate, and decide that that is the hot one and purchase. By increasing the number of products that the consumer sees in use in everyday life, piracy would reduce uncertainty, information-gathering and processing costs, and adoption risks for prospective customers of non-pirated products. In this sense, pirates want satisfied customers as much as legal manufacturers and marketers.

For example, a customer who is shopping for upscale leather goods can easily determine which brand produces the most utility for other customers: the one most-pirated. Indeed, its utility is such that individuals pirating the product are willing to run significant legal and financial risks in order to capture some of that utility. Finally, pirated products might provide potential users with a basis for comparison and thus enhance the credibility of quality claims about the product – not to mention “snob appeal” – by highlighting the difference in price/quality between the legal and pirated product. This leads to yet another double proposition.

4. The more receptive customers are to market signals, the more benefits piracy can generate for the entrepreneurial firm. The less overlap between the markets of customers for legal versions of the product and customers for pirated versions, the more market signals produced by piracy generate benefits for the entrepreneurial firm.

To reveal our thinking here, let’s offer this possibility. A highly regarded, very expensive leather briefcase has been pirated so that its quality is strikingly similar to the original and its price an unquestionable bargain. People find and buy the pirated briefcase and then start talking about their purchase. A lot. What can easily result is a bandwagon effect.

A bandwagon grows in proportion to the extent to which the demand for any commodity is increased by the fact that others are consuming the same commodity. When there is great discussion about this, more and more people start to want the same thing. Yet this is not necessarily bad for the maker of the legal product line.

In the context of piracy, bandwagon effects would serve to inform prospective buyers of legal versions of the product about the appropriate product choice made by other consumers, even those who bought a pirated model. For example, a pirated video game may signal to a customer that the game is “cool”; indeed, by buying a different game, a customer risks being “uncool”. In time, demand for both the legal product and the pirated one grows to red-hot intensity.

5. The more receptive customers are to bandwagon effects, the more benefits piracy can generate for the entrepreneurial firm. The less overlap between the markets of customers for legal versions of the product and customers for pirated versions, the more bandwagon effects produced by piracy generate benefits for the entrepreneurial firm.

Briefly, our point here is that – to cite the briefcase...
example again – the more people flock to acquire the same briefcase, the greater the sales for both
the legal producer and the pirate producer. In short,
a lot of these briefcases are being sold in the
marketplace. What happens in such a situation is
classic herding behaviour.

In herd behaviour, individuals mirror or emulate
the choices and behaviours of others. Herding
relates to the willingness of individuals to conform
to social or group norms and an unwillingness to
depart from the herd, even in situations when it
would be advantageous to do so. Herding is actually
different from bandwagon effects, which are related
to the need to follow specific individuals or groups,
whereas herding behaviour relates to the
unwillingness to depart from the herd, that is, to
adopt a product that would be different and not
acceptable to the peer or referent group.

Consider a new digital music player that captures
the loyalty of a vast number of youthful music
lovers. When a product (digital or other) with first-
mover advantage is pirated, the herd effects can
raise barriers for other technologies or products to
enter the market, even if the pioneering technology
or product is suboptimal. The herd effects can in
turn intensify the network effects and thus the
perceived product value for prospective consumers
of the legal products. That is, young people want
the new digital player – or one that is very, very
close in design and quality.

In the case of prestige goods, piracy can provide
information to prospective buyers as to which prestige
good is more desirable and appreciated by others.

Piracy, by extending the market into segments that did not
want or could not afford to acquire legal versions of the
product, could help cement standard setting, reduce
uncertainty about orphaned products and hasten early
adoption of the product.

Sales of legal goods drive up the rate of piracy,
which also drives up sales of legal products through
herding, creating a “virtuous circle” between legal
and pirated copies of the products. This effect helps
explain phenomena such as markets in Hong Kong,
where vast numbers of sellers of pirated copies
coexist with a great number of stores selling legal
copies of the same consumer products, such as
Gucci handbags or Rolex watches.

But piracy really pays off for a legal manufacturer
when two conditions occur simultaneously.

6. The more receptive customers are to herding, the
more benefits piracy can generate for the
entrepreneurial firm. The less overlap between the
markets of customers for legal versions of the
product and customers for pirated versions, the
more herding effects produced by piracy generate
benefits for the entrepreneurial firm.

If there is a herd movement to obtain a product, but
that product has a limited arc of distribution
(meaning it’s hard to find or can be acquired only in
a tight geographical area), then the creation of
pirated versions can help the legal manufacturer in
a number of ways.

Perhaps the easiest one to mention is the
relationship between a hot new product and barriers
to entry. Reconsider the highly desired new digital
music player. If, in fact, it is not so exotic that any
other legal manufacturer could come close to it,
then having pirated copies could lessen the
inclination of legal competitors to enter the same
marketplace with a similar product.

Piracy can create barriers to entry for potential
competing legal products through standard setting
and market size. Some research has shown that the
presence of technology standards within an industry
not only commits producers to compete on price or
service but also protects adopters from being
orphaned by a losing technology. This allows potential
consumers to reduce uncertainty and information-
gathering costs and thus encourages them to buy
earlier. In this sense, pirates are helping to
standardize the look, feel, and performance of a
new product; they can do so, perhaps, in ways that
regulation by governments cannot.

And it makes sense that the more consumers who
buy pirated versions of a product, especially if these
sales are taking place in a part of the world where
the legal versions aren’t readily available, then the
net effect is a disincentive to other legal producers
to compete while also helping to create a worldwide
standard for the original manufacturer. This helps
consumers by helping them to be able to keep using
the product they just bought (before some “new and
improved” model unsettles their minds and forces
them to buy anew). This also helps the original
manufacturer by allowing it to “keep rolling” with
the manufacture and sale of its new product, which
is highly sought in its legal channels of distribution
and in the pirated channels of distribution.

Business Strategy Review Spring 2007
Piracy, by extending the market into segments that did not want or could not afford to acquire legal versions of the product, could help cement standard setting, reduce uncertainty about orphaned products and hasten early adoption of the product. Ergo,

7. The more the environment rewards standard setting and barriers to entry that protect market share, the more piracy can generate benefits for the entrepreneurial firm.

Our research led us to these seven proposition sets; via these propositions, we propose that piracy can simultaneously diminish one source of competitive advantage – inimitability – and enhance another – value. The net impact of these countervailing forces depends on the overlap between the markets for legal and pirated products: the less overlap, the less negative (and perhaps more positive) the relationship between piracy and the entrepreneurial firm’s performance. This contingent trade-off may explain mixed empirical results on the effects of piracy. While we have concentrated here on the possible benefits of piracy, it is important to remember that its costs to the entrepreneurial firm include direct sales losses, costs to the brand of product image erosion and costs of enforcement, among other negative effects. Yet, given our research and conclusions, it might behoove a manufacturer to make future decisions on piracy policy (including intellectual property protection) after re-examining both its total costs and its benefits.

The characteristics of the pirated product and its market are also important. Mature markets, for example, might create a different set of trade-offs than growing markets. We propose that the legal product loses more sales when the market is more mature. In the early days of software, the market for legal products was highly independent of the market for pirated products, although as the technology has matured there has been an increasing overlap between the two markets. If we assume that there is considerable overlap between the markets of legal and pirated products, when in fact there is little such overlap, we will likely overestimate the negative impact of product piracy on entrepreneurial firms’ performances. On the other hand, the network effects found in the software industry may be stronger than in other industries; and, if we generalize from these effects, we may overstate the benefits of piracy to entrepreneurial firms.

Make no mistake: when an entrepreneur or a manufacturer produces a product with vast market appeal, the last thing anyone wishes upon them is the affliction of pirated versions. What we wish to point out is that, yes, piracy is bad news. But maybe it’s not necessarily all bad.

Resources

Julio O. De Castro (Julio.Castro@ie.edu) is a professor at Instituto de Empresa in Madrid, Spain; David B. Balkin (David.Balkin@colorado.edu) is a professor at Leeds School of Business in Denver, Colorado and Dean A. Shepherd (shepherd@indiana.edu) is a professor at the Kelley School of Business at Indiana University in Bloomington, Indiana.