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Parallel Importation: Economic and social welfare dimensions

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Table of Contents

1. The Concept and Law of Parallel Importation

"Parallel imports" involve fundamental issues of trade and intellectual property policy. This briefing paper starts with an introduction to the concept of parallel importation, and proceeds to discuss the complex economic and developmental issues raised by it.

a. Intellectual Property and Exhaustion of Rights

Each country protects intellectual property (IP) according to its own legislation, within a framework established by international rules. Based on the widely-adopted Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement) of the World Trade Organization (WTO), most countries have implemented common basic standards of IP protection.

IP generally permits right-holders to exclude others from the market. The owner of a patent may exclude others from making or selling an invention. A copyright entitles the author or artist to prevent others from reproducing or distributing his or her expressive work. A trademark allows the business owner to prevent others from using his or her distinctive sign in commerce. These "negative rights" effectively allow their owners to make the "first sale" of protected goods or services on the market, to the exclusion of others.

The IP right to exclude is limited by the doctrine of "exhaustion of rights". This doctrine is common to all legal systems. It provides that the IP-holder's control over goods or services ends (or is "exhausted") once the particular good or service embodying the IP has been placed on the market (or "first sold").

To illustrate operation of the doctrine: consider the well-known "Mercedes" trademark for automobiles. No company other than Daimler can sell a new car with "Mercedes" displayed on its body. But, once a consumer buys a Mercedes automobile from an authorized dealer, the consumer can re-sell that same automobile to someone else.[1] Once Daimler first sells a particular automobile, it no longer controls its further disposition. Its right in the Mercedes trademark with respect to the particular automobile is "exhausted" when the car is sold to the consumer.

b. Geography of Parallel Importation

The doctrine of exhaustion of rights provides the legal basis for "parallel importation". For all countries, IP rights are exhausted when goods or services are first sold within the national territory. When a Mercedes automobile is first sold to a consumer in Bern, the consumer can resell that automobile in Basel without interference from Daimler (the trademark owner in Switzerland).

But countries need not limit their exhaustion policies to the national territory. They may provide that exhaustion also occurs when a good or service is lawfully placed on the market

[1] Under trademark "fair use" doctrine, the consumer can even place an advertisement in the local newspaper stating "used Mercedes for sale."

outside the national territory. So, for example, Swiss law may provide that when a automobile is lawfully first sold under the Mercedes trademark in Germany (or in the United States), the trademark right of Daimler to first sell the automobile is exhausted under the corresponding or "parallel" Swiss Mercedes trademark. A consumer who purchases a new Mercedes in Germany is free to import and resell that automobile in Switzerland. The term "parallel import" refers to a good or service that is first sold under a corresponding or "parallel" IPR in another country, and then imported into the national territory.

There are three distinct geographic concepts of exhaustion and parallel importation: national, regional and international. Under a "national" exhaustion policy, the IP holder's right to exclude is only extinguished when the good or service is put onto the market in the national territory. There are no "parallel imports" permitted. Under a "regional" exhaustion policy, the IP holder's right is extinguished when a good or service is put onto the market within any country of a defined region, such as the European Union. "Parallel imports" are permitted, but only with respect to goods first placed on the market within the regional territory. Under an "international" exhaustion policy, the IPR holder's right is extinguished when a good or service is put onto the market anywhere in the world. "Parallel imports" are permitted with respect to goods or services lawfully first placed on the market anywhere in the world.

A country may adopt different exhaustion and parallel imports policies for different forms of IP. In principle, a country may adopt an international exhaustion policy for patents, a regional exhaustion policy for trademarks, and a national exhaustion policy for copyrights. In fact, governments do "mix" exhaustion policies based on different policy considerations.

c. Legal Discretion

The discretion accorded to countries to adopt their own policies and rules with respect to exhaustion of rights is recognized in the WTO TRIPS Agreement. This discretion was reaffirmed with respect to patents in the Doha Declaration on the TRIPS Agreement and Public Health, and it was acknowledged in the WIPO Copyright Treaty and WIPO Performances and Phonograms Treaty (adopted subsequent to the WTO TRIPS Agreement). From the standpoint of international intellectual property rules, each country is permitted to adopt its own policies and rules with respect to exhaustion of rights and parallel importation.

2. Economic and Social Dimensions of Parallel Importation

a. Restricting Parallel Importation Segments Markets

Laws restricting parallel importation permit producers to segment the international market for their goods or services. A producer that places its product on the market in one country can prevent that product from being imported into another country by invoking a "parallel" IP right. This market segmentation permits producers to charge (and enforce) different prices for the same product in different markets. Producers need not be concerned that products they place on one national market at low prices will be imported into other national markets where they are charging higher prices.

b. Positive Consumer Welfare Effects for Ordinary Goods

Consumers benefit from parallel importation. Products are made available to them by retailers at the lowest price producers can profitably charge for them. If a retail seller can obtain the same merchandise at a lower price in France than in Switzerland, that retail seller will purchase and import the product from a distributor in France. This allows the retailer to charge a lower price to the consumer, and to better compete with other retailers.[2] Opening national markets to parallel importation should have a positive consumer welfare effect by making products available at low prices.

Retail sellers seeking to provide consumers with goods at low prices favour open parallel importation because this enables them to purchase supplies at the lowest prices available on the world market.

Basic international trade theory encourages the location of production in low cost regions because this efficiently allocates resources and ultimately maximizes global consumer welfare. International exhaustion and open parallel importation are consistent with the fundamental premise underlying liberalization of trade: that is, to encourage the efficient production of goods and services for the benefit of consumers.

c. Developmental Effects for Ordinary Goods

Production of goods in developing countries tends to be possible at lower cost than in developed countries. There are various reasons for this, including generally lower wage rates and expenses associated with social welfare benefits. The lower cost base in developing countries is a principal reason why multinational corporations tend to locate production facilities in these countries. From the standpoint of international trade theory, the availability of low-cost labour inputs is the "comparative advantage" of many developing countries. The ability of developing countries to attract foreign direct investment on the basis of that comparative advantage is important to their economic development.

If wholesalers and distributors in developing countries are able to export lower-priced locally produced goods to developed country markets, this should increase consumer demand for the products in the developed countries. This should stimulate production increases (*i.e.*, supply) in the developing countries. Rules restricting parallel importation may limit the benefits of developing country cost advantages. Market segmentation allows developed country producers to prevent imports of lower-priced goods into higher-priced markets. If market demand in the developed countries is artificially limited by laws restricting parallel importation, this should have a generally negative effect on production in developing countries.

Parallel import limitations may have particularly adverse effects on authorized licensees of IP rights in developing countries because such licensees are prevented from exporting their production (directly or through distributors) to more affluent developed country markets.

[2] In theory, the retailer could parallel import, maintain a high price and earn more profit, but in a competitive market (where other retailers have access to the same low-cost distributors), this should not be the case.

d. Producers Favour Limiting Parallel Importation for Ordinary Goods

Producers tend to disfavour opening markets to parallel importation because this limits their capacity to charge different prices in different markets; that is, to engage in geographic price discrimination. Producers in different product sectors offer different explanations of why price discrimination is beneficial.

Producers selling consumer goods such as clothing, televisions, cameras and computers, often rely on trademarks as the means for establishing consumer preferences. They promote their "brands", either directly or through local distributors, by means such as advertising and by establishing branded "shops". Producers that rely on trademarks argue that market segmentation allows them to invest in advertising and "customer support" in specific markets without concern over cheaper parallel imports from markets where similar investments are not made. So, for example, the owner of the "Chanel" trademark for clothing and cosmetics may invest in a branded shop in a high rent area—and charge high prices—without concern that consumers will purchase genuine Chanel products parallel imported by and sold in department stores.

Segmenting markets by restricting parallel importation should increase prices for producers, generating "producer surplus". But, this means reducing consumer welfare by causing consumers to pay higher prices for the same goods. As a general proposition, consumers tend to prefer lower-priced genuine goods over higher priced identical goods accompanied by promises of better service.

e. Pharmaceutical Products and Parallel Importation

There are different policy arguments made with respect to parallel importation of certain public welfare-sensitive products, especially pharmaceuticals. Newer medicines are typically covered by patents. Patents as a form of IP may be used to block parallel imports of medicines when a country limits the geographic scope of its exhaustion policy (*e.g.*, by adopting national exhaustion).

i) Consumer Price and Access Benefits

There are wide differences in the prices charged for the same patented medicines (made by the same companies) in different national markets around the world. A policy of open parallel importation with respect to patented pharmaceutical products gives consumers access to the lowest-priced versions of the same authorized products available on the world market. This generates consumer surplus and public welfare benefit by: (a) providing consumers with lower prices for the same products; (b) making patented pharmaceutical products more accessible to lower-income individuals, and; (c) reducing strain on public health budgets, including with respect to publicly-funded public health programs.

It must be emphasized that parallel import medicines are "genuine" products regardless of where they are initially placed on the world market (although sometimes labelling must be translated and adapted for different markets). Parallel import medicines are *not* counterfeit medicines; that is, they are not unlawfully produced medicines of potentially sub-standard quality.

ii) Producer Arguments Against Parallel Importation

There are several arguments made by patent owning "originator" pharmaceutical companies against allowing parallel importation of their products.

(a) Benefits from Price Discrimination

The first is that price discrimination allows them to obtain high total revenues by tailoring prices to national conditions, for example, by charging consumers in more affluent countries higher prices than consumers in less affluent countries. There are two ancillary arguments made by producers regarding the benefits of this price discrimination. The first is that consumers and governments should prefer that originator companies make more money so that they can invest more in research and development (R&D), ultimately providing benefit to consumers in the form of new and better medicines. The second is that, in the absence of the ability to price discriminate among markets, originator companies will raise prices in lower income regions to avoid undermining their profitability in wealthier regions. That is, without restriction of parallel importation, originator companies will raise prices and reduce supplies of medicines to lower-income markets (rather than suffer a decline in overall profitability).

(b) Unfairness of Price Controls

The second line of argument by pharmaceutical originators is that open parallel importation is unfair to them because most countries impose some form of price control on their products. Producers are not able to charge "free market prices" for their products, except in the United States (where they charge much higher prices than everywhere else). If wholesalers and distributors are able to export price-controlled products, this will undermine the profitability of the industry in higher-priced markets, and therefore reduce the amounts of money available for investment in R&D.

(c) Protecting Public Safety

The third major argument from the originator industry is that parallel importation may represent a threat to public safety because imported pharmaceutical products are first sold to wholesalers and distributors that may not be as reliable as the originator companies themselves.

iii) Assessing the Industry Arguments

(a) Increased R&D

The general argument that consumers worldwide will be better off if originator pharmaceutical producers earn more income presents certain difficulties. This argument is based on the premise that higher levels of income will lead to increased investments in R&D, ultimately creating new products. However, the originator companies on average invest about 15% of their gross income on R&D. The industry spends a substantially higher

percentage of income on advertising, promotion and administration. Much of the advertising and promotion costs are spent on "lifestyle" drugs such as Viagra. Considerable R&D spending is directed to lifestyle products and minor variations on existing therapies (so-called "me too" drugs). If consumers are going to be "taxed" to pay for pharmaceutical-related R&D, there should be more cost-effective ways of doing this than through paying higher prices to the originator companies.

(b) Low Prices for Poorer Regions

It is difficult to assess the argument regarding the benefits of price differentiation for poor populations because evidence of significant use of preferential pricing to benefit the poor is scarce. As of the late 1990s, originator companies often sold products in less developed countries at prices as high, or higher, than those in developed countries because only a small wealthy segment of the population in developing countries could afford new medicines. While today there are programs of some originator companies to supply low-priced antiretroviral and antimalarial medicines in some developing countries, part of this is a response to low priced generic competitor drugs from India. It is not apparent that price discrimination in favour of poorer populations represents a significant part of the originator global market, or that open parallel importation would threaten that market. In any case, there is an alternative to restricting parallel imports as a means to enable price discrimination, and that is to contractually restrict re-exports of preferentially-priced products along with monitoring of supply chains. To date, there is scant evidence that medicines intended for developing country HIV-AIDS or malaria treatment programs are being diverted to developed country markets.

(c) Price Controls

Most countries control the price of patented medicines as a means to protect public health interests. It is a matter for the originator companies to decide whether they are willing to sell medicines at the prices established by governments. If originators respond to price controls by unduly restricting supplies, governments can use competition law proceedings to remedy the situation and, if necessary, issue compulsory licenses. In the "free" pharmaceuticals market of the United States, originator companies charge much higher prices than elsewhere. This makes it difficult to foresee the advantage of removing price controls; that is, by the logic of their argumentation, the originator companies would respond by raising prices everywhere but in the United States. It does not seem unreasonable for governments to use parallel importation to moderate pharmaceutical prices even if price controls are affecting prices.

(d) Product Safety

Parallel import medicines are originator products that have left the direct control of the originator. That is, the medicines have been sold to distributors or wholesalers that undertake to export and import the medicines. There is scant evidence of tampering or other interference with the quality of medicines that enter developed country markets. In most or all developed countries, medicines importation is subject to careful supervision by government authorities. It is very difficult for medicines with compromised quality to enter

the supply chain. Parallel importers of medicines can and should be subject to government supervision.

iv) Limited Alternatives

As observed earlier, there are three geographic categories of exhaustion and parallel importation: national, regional and international. As an alternative to opening up a national market to parallel imports of medicines from everywhere in the world, a government may decide to open the parallel imports market to a relatively homogeneous group of countries in terms of income level and regulatory supervision. Thus, for example, the European Union permits parallel importation of medicines from within the 27 member states, but not from outside the EU. This avoids the issue whether price discrimination in favour of poorer developing countries will be inhibited by open international parallel importation. It also largely eliminates the "quality" issue since it is assumed that regulatory supervision throughout the EU is similar. This does not eliminate issues surrounding price controls, but it does reduce them since prices in the EU are less likely to be subject to exceptionally wide variation as compared with the world market as a whole. The disadvantage of a limited parallel importation policy is that it does not take advantage of the lowest world market prices for the same medicines, but rather the lowest market prices among a more homogenous group.