

**Meeting on Competition, Trade & Development
Intellectual Property, Competition & Trade Policy Implications of Parallel
Import Restrictions**

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INTRODUCTION

Many countries restrict parallel imports of intellectual property. In an era of trade liberalisation and globalisation it is relevant to ask why such restrictions are in place. This paper examines that question from an economic perspective with a particular focus on copyright laws. It starts by looking at the moral and economic issues underlying copyright laws and examines the economic arguments for extending intellectual rights beyond the sphere of production into the sphere of distribution, which may include the right to control importation. The paper then provides an overview of the current international policy debates about whether parallel imports should be allowed. That overview encompasses copyright, trademark and patent products. The paper concludes with a closer examination of recent Australian experience with parallel importation.

COPYRIGHT: MORAL & ECONOMIC ISSUES

Copyright has long been characterised by two alternative rationales; moral rights versus economic rights. The two positions are most sharply distinguished in the approach and legislation of continental countries such as France, Switzerland and Germany which historically have emphasised the moral rights of authors and the approach of the United States which has concentrated exclusively on economic rights. Although the moral rights of authors, their just rewards and their contribution to society are often invoked as the reasons behind copyright legislation in Australia, its origins in British legislation clearly lie in the protection of the publishing industry.

Copyright legislation creates a property right in the product of intellectual labour by providing its owner with a series of rights over the use of that work. From a moral perspective this is viewed as the authors' right to do as they wish with the product of their labour and to control its use by others. These rights may be counter-balanced from a moral perspective by obligations. For example, protection from importation may involve a responsibility to make the work available to the public in that country. Resolving the moral question of where to draw the legal lines on rights and obligations, however, is a very difficult one; authors proclaim their 'absolute and inalienable' right to control the use of their intellectual product, while consumers proclaim their right to access the latest developments in cultural and scientific thought. Similar issues of rights and obligations occur with other forms of property rights, eg. the rights of land owners to use their land as they wish versus their obligation not to visually or chemically pollute their neighbours and the rights of

patent owners to the exclusive use of their invention versus the right of society to benefit from that invention.

One of the most useful contributions of the economic approach to the study of law is that it provides a framework that helps to enable the resolution of conflict in moral rights and obligations. Thus, the economic analysis of copyright cuts across the moral dilemmas above and examines the costs and benefits of copyright of various degrees and forms of copyright protection. This is a specific application of the economic theory of property rights. The optimal nature and extent of any particular property right will be that which in a utilitarian sense maximises the economic welfare of society as a whole. While a legal approach to property rights based on moral issues might suggest an identical balance of rights and obligations for all types of property, this does not follow from an economic approach. Thus the optimal balance of rights for land owners differs from those for patent owners or copyright owners.

A free competitive market tends to equate the cost of producing a good with the price an individual consumer is prepared to pay, which also tends to maximise the utility derived from society's resources. Intellectual products are, however, an example of what economists term 'market failure', where a free competitive market does not produce this optimal allocation of resources.

Every additional consumer who copies, say, a book adds to his or her utility and that of society without there being any additional cost to society. However, if everyone was allowed to copy freely, maximising society's utility from existing books, there would most probably be very few books ever produced, since authors and publishers would have no financial incentive to invest. This suggests there is a trade-off between consumers' interest in wide availability at low, or zero, marginal cost and the need for incentives to create the intellectual products. Two alternative solutions to this trade-off suggest themselves.

The first solution is for the state to fund directly the production of literary and artistic works and for consumers to pay only the marginal costs of physical reproduction (the cost of copying). This has largely been the solution adopted by Eastern Bloc countries in the past. The obvious problems here are how to determine the optimal level and pattern of public funding. The state may not be very responsive to either individual or community preferences for one particular product. Furthermore it may deliberately distort those preferences.

The second solution, adopted by Western countries, is copyright legislation. This addresses the free-rider problem by granting the copyright owner the exclusive right to control the reproduction of their product, it prevents copying; all demand for the product results in financial reward to the copyright owner. However, this solution does little to address the public good problem or problems associated with cultural externalities and merit goods, and will therefore tend to overly limit access to literature and scientific texts. This problem is addressed in part by public subsidies to the arts and the funding of public libraries for which authors are compensated through public lending rights legislation.

The granting of copyright protection provides the owner with a monopoly over the production (and distribution) of that good. This is not necessarily inconsistent with

competitive markets, but it creates that possibility, which in turn tends to produce inefficiencies in the allocation of resources and the cost of production (and distribution).

If copyright legislation is the preferred solution, the question then arises as to where the limits of copyright protection should lie. Should copyright protection extend to ideas or only to the expression of ideas? Should it cover derivative works or only the original work? Should it include rights to control the public performance and broadcasting of works? What is the appropriate period of protection? At what point are rights 'exhausted'? Moral theories are not very helpful in resolving these issues. Economic theory can be useful in helping to provide answers and in practice the law often resolves issues in ways consistent with economic theory.

PARALLEL IMPORTS & THE QUESTION OF EXHAUSTION

One of the key issues associated with copyright and other forms of intellectual property protection is when should rights be 'exhausted'. Correspondingly, the question of the exhaustion of rights is the one which underlies the issue of parallel imports. Having sanctioned the reproduction of, say, a book in one country, should the author's rights over the further distribution of that book be exhausted or should he or she be able to prevent those reproductions from being imported into another country? As the first section of the paper has shown, there is a clear problem of market failure associated with the production of intellectual products in an unregulated market; they will be copied and the rewards to the original author and publisher will be appropriated by the copier, giving rise to underproduction. However, once the product has been validly reproduced, is there any need for legal restrictions to be imposed on its distribution, in particular on international competition in its distribution (by restricting sales of a product which has been legitimately reproduced in one country in another country)? To justify restrictions on the distribution of this kind, one would have to identify some area of market failure in the area of distribution; that is an area other than one associated with copying, a failure overcome by intellectual property protection in the original country of production.

THE ECONOMICS OF IMPORTATION PROVISIONS

Restrictions on parallel imports clearly benefit the owners of intellectual property rights but do they also maximise the total welfare of society? As Adam Smith pointed out, the pursuit of self-interest results in the maximisation of society's economic welfare provided it is tempered by a competitive market. Smith was highly critical of 'mercantilist' economic policies which sought to restrict free international trade and protect domestic suppliers from import competition. The importation provisions (as they relate to parallel imports) restrict import competition and are not necessary to address the free-rider problem.

Although copyright protection provides the owner or assignee of the copyright with exclusive rights over production and reproduction, this is not necessarily inconsistent with a competitive market outcome. This will depend on the extent of the availability of close substitutes for the intellectual product. In this context, it is significant that copyright does not protect ideas but only the expression of ideas. Hence there may be competitive texts expounding the same economic theories or legal doctrines. If one

publisher charges a monopoly price, others can enter the market with a competitive text and offer it at a lower price.

The importation provisions extend copyright protection from control in the sphere of production into control over the sphere of distribution. Economic analysis clearly identifies a market failure associated with copyright products, namely piracy, but it is a market failure associated with production not distribution. The problem is fully overcome by copyright laws which prohibit piracy. Once the copyright product has been produced validly, questions arise about its distribution. The presumption is that the market should be allowed to distribute the product without legal restrictions on trade or competition, unless a specific failure in that sphere can be identified.

In essence, those in favour of retaining the importation right argue that it is necessary to ensure the effective exercise of exclusive rights granted to intellectual property rights holders. The arguments in favour of retaining an importation right vary from product to product but generally relate to concerns about piracy, product safety and censorship, free riding on investments in sales and promotions and protection of local industry.

The alternative view is that parallel importation restrictions impact detrimentally on competition by granting a monopoly to import to intellectual property owners. By preventing international arbitrage, these monopolies can be used to support international price discrimination by firms with market power. Such discrimination transfers consumer gains to producer profits, some of which may be to foreign rights holders. The overall effect on a country's welfare depends on the size of the net transfer. For net importers of intellectual property, such as Australia, consumer losses from higher prices and restricted availability are not offset by rises in producer profits. Therefore, removing restrictions on parallel imports will enable a net importer such as Australia to benefit from more competition, lower prices and better availability as a result of its exposure to far larger international markets.

There is general agreement that restrictions on importation of pirate copies of intellectual products should be prohibited. However, restrictions on parallel imports are a blunt means of clamping down on piracy and come with the high costs associated with restrictions on competition. Rather, piracy should be tackled directly through specific sanctions.

THE INTERNATIONAL DEBATE ABOUT PARALLEL IMPORTS

Exhaustion is a controversial aspect of international trade. Under national exhaustion, rights end upon the first sale within a nation, but the intellectual property right (IPR) holder may prevent parallel trade with other countries. Under a regime of international exhaustion, rights are exhausted upon first sale anywhere and parallel imports are permitted. A third option, and one adopted by the EU, is regional exhaustion which permits parallel trade among a group of countries but not from outside the region.

A policy of national exhaustion is a government provided international restriction on vertical distribution. Each country that adopts this approach gives rights owners full rights to distribute goods themselves or through authorised dealers including the right

to exclude imports. Countries allowing parallel imports leave it to the market to determine commercial distribution channels. In many countries, however, commercial arrangements that result in vertical restrictions may be subject to competition laws to ensure that they do not result in anti-competitive outcomes. In fact, strong competition laws may be a prerequisite to ensure competitive market outcomes from parallel trade are realised. This issue is addressed in more detail later in the paper.

Traditionally, each country has been able to set its own policy on parallel imports. In particular the TRIPS agreement is silent on the question of exhaustion. Article 6 merely states:

..nothing in this Agreement shall be used to address the issue of the exhaustion of intellectual property rights.

This approach was a compromise necessary to ensure adherence to TRIPS by several developing nations. There is still debate about whether TRIPS should be amended to achieve a consistent global approach, be it national or international exhaustion. The need to ban parallel imports is argued most strongly by the copyright industries and the pharmaceutical/biotechnology industries.

The new WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty (which are nearing the required number of accessions to come into force) do not include a right to prevent parallel importation.

Given the lack of global consensus, exhaustion policies vary widely across countries. Different types of intellectual property may also be treated differently within a given country. The European Union applies community, or regional, exhaustion to trademark, patented and copyright products. The US generally applies a policy of national exhaustion. There is a 'common-control' exception for trademarks, however, which permits parallel imports if the foreign and US trademarks are owned by the same entity or if the foreign and US owners are in a parent-subsidiary relationship. Furthermore, parallel imports of trademark products can only be prevented if the parallel product is likely to cause confusion among consumers because it is not of the same quality as the original product. Parallel imports are generally permitted in Japan, except for motion pictures. Australia applies international exhaustion to trade mark products but national exhaustion to patents. Australia allows parallel imports of sound recordings and limited parallel imports of books. Legislation is currently before the Australian government to allow full parallel importation of books and computer software. However, parallel trade in other copyright products would continue to be restricted. New Zealand, Singapore and Thailand all permit parallel imports of copyright products. Few developing countries restrict parallel imports of any type of intellectual product.

The international situation is far from fixed, however, with several debates ongoing around the world. The issue of trademark exhaustion was discussed for nearly two years in the Internal Market of the EU amidst claims that trademarks holders were using the Community exhaustion regime to charge higher prices in the EU than elsewhere. This type of concern over relatively high domestic prices is often a catalyst for debate. In May 2000, however, the Commission announced that it had decided not to propose a change to the current Community wide exhaustion regime. Only 4

member states supported this position, 8 regretted the decision and the remaining members did not express an opinion. Given the lack of unanimous support for the status quo it is unlikely that the debate will end there.

Furthermore, some European courts have opened the doors to parallel imports a little by indicating that the restrictions on such imports do not apply unless there are very explicit indications from the owners of the IPRs that parallel imports are restricted. The European Court of Justice has been asked to rule on two cases; Davidoff and Levi Strauss. These cases deal with questions of consent and concern goods imported into the EU from outside. The European Court of Justice has joined these cases and a preliminary ruling was delivered on 5 April 2001.

Even in the United States there is debate about parallel import restrictions. In October 2000, US law was enacted to permit the reimportation of US brand-name pharmaceuticals. US prices for popular pharmaceuticals are often 30 to 50 per cent higher than in other nations. However, in December 2000 the US Secretary of Health and Human Services refused to implement the bill, effectively cancelling it. The Bush Administration has not to date announced its plans for the cancelled bill.

AUSTRALIAN EXPERIENCE

In Australia, the Copyright Act 1968 grants certain automatic rights to holders of copyright in literary, dramatic, musical and artistic works and in subject matter other than works, such as sound recordings, cinematographic film, broadcasts and published editions of works. The Act originally granted an importation right and hence prohibited parallel imports except for personal use. There has, however, been considerable debate over nearly two decades about whether international exhaustion should apply in Australia. As a result, Australia now permits parallel imports of sound recordings. Further significant amendments have recently been announced that will move Australia closer to a system of international exhaustion. In addition, Australia has amended the Copyright Act to stop suppliers from using copyright in packaging and labelling to prevent parallel imports of products that copyright was never intended to protect.

The Intellectual Property and Competition Review Committee (IPCRC) conducted the most recent inquiry into parallel imports of copyright products and released its final report on 30 June 2000. The IPCRC was established under the Competition Principles Agreement to inquire into and report on the effects on competition of Australia's intellectual property laws, including the Copyright Act.

A majority of the Committee recommended that the parallel importation provisions of the Copyright Act be repealed with a 12 month transitional period being allowed for books. A decision to remove the ban on parallel imports would mean that Australia would have fully applied the international exhaustion principle to its copyright products. To date, reform has been on a case-by-case basis.

The Government has not yet responded to the Committee's recommendations, but did introduce legislation to amend the Copyright Act in February 2001. The Copyright Amendment (Parallel Importation) Bill 2001 will allow competition from parallel imports for a wide range of products. It will amend the Copyright Act to allow the

parallel importation of books, periodicals, printed music and software products including computer games, video arcade games and business software. The current anti-piracy measures covering sound recordings, which require the importer or seller to prove legitimacy of imported product in a civil action, will be extended. The amendments will be implemented 12 months after the passage of the legislation to allow time for the local publishing industry to adjust to the changes.

The Bill also includes provisions that were first included in the Copyright Amendment (Importation of Sound Recordings) Bill 1999. Those provisions will close a loophole arising from the sound recordings reforms that allowed some Australian rights holders to prevent parallel imports of sound recordings by relying on copyright in material used to 'enhance' sound recordings. These secondary materials, defined as 'accessories' include any copyright work or subject matter other than 'feature' films irrespective of how it is incorporated into the product.

AUSTRALIA'S EXPERIENCE WITH PARALLEL IMPORTS OF BOOKS

The Copyright Act was amended in 1991 to relax somewhat the restrictions on parallel imports of books. These amendments addressed the problems of availability rather than price. They allowed Australian publishers and distributors to retain exclusive import rights, and hence territorial copyright, subject to maintaining reasonable availability. Booksellers were also unrestricted in their ability to import to supply verifiable orders from individuals for a single copy of a book for their own use, or to supply multiple copies to libraries. Individuals retained the right to import non-pirated books for their own use.

There is general agreement that the 1991 reforms have improved the availability of books but the impact on price is less clear.

The Australian Competition and Consumer Commission (ACCC) was asked in early 1999 to report on the potential consumer benefits of repealing the importation provisions as they apply to books and computer software. That report combined earlier Prices Surveillance Authority findings with new research and found that Australian consumers had consistently paid more for books and computer software over the past decade or so than overseas consumers. The ACCC considered that the importation provisions of the Copyright Act contributed to those price differences by allowing copyright holders to price discriminate to the detriment of Australians.

The ACCC concluded that allowing competition from parallel imports should lead to more competitive pricing and better choice of product and service for consumers and retailers.

AUSTRALIA'S EXPERIENCE WITH PARALLEL IMPORTS OF SOUND RECORDINGS

The ACCC has been observing the local industry and prices on an informal basis since the parallel imports of sound recordings were allowed in 1998. Of particular interest are any attempts to prevent retailers, importers or wholesalers from exercising their legal right to source sound recordings from the best available supplier. As well as resorting to legal means to restrict parallel imports, it appears that some copyright

holders may also use illegal anti-competitive practices to restrict imports of sound recordings.

On 30 August 1999 the ACCC instituted legal proceedings against Universal Music Australia Pty Ltd, Sony Music Entertainment (Australia) Limited, Warner Music Australia Pty Ltd, and Music Industry Piracy Investigation Pty Ltd (MIPI) and others alleging that each record company had taken unlawful action to discourage or prevent Australian businesses from selling competitively priced parallel imports of compact discs. The ACCC began its investigation into the conduct of the major record companies after receiving reports that certain record companies threatened to withdraw significant trading benefits from retailers who stocked parallel imports. Trading benefits can include point of sale material and favourable trading terms. It was further alleged that in some cases record companies had cut off, or had threatened to cut off, supply to retailers who stocked parallel imports.

The ACCC alleges that by virtue of the action PolyGram, (which has since been taken over by Universal), Sony and Warner took to prevent retailers from stocking parallel imports they have:

- ? contravened section 47 of the Trade Practices Act 1974 (TPA), which prohibits exclusive dealing; and
- ? contravened section 46 of the TPA by taking advantage of their market power to deter retailers and wholesale suppliers from engaging in competitive conduct.

The ACCC also alleges that PolyGram, Sony and Warner each colluded or attempted to collude with record companies to try to prevent Asian wholesalers from supplying compact discs to Australian businesses. It is also alleged that Sony entered into an arrangement with Music Industry Piracy Investigations Pty Ltd to cut off these trading opportunities. These arrangements are alleged to be in contravention of section 45 of the TPA as having the purpose or likely effect of substantially lessening competition.

Despite apparent attempts by copyright holders to maintain the status quo and thereby reduce the competitive impact of the parallel imports there has been evidence that the repeal of the importation restrictions has given some competitive impetus to the industry.

One of the major changes arising from the reforms is that non-specialist retail outlets are now significant suppliers of low priced Top 40 CDs. The ACCC's latest price survey suggest that the average price of Top 40 CDs available from non-specialist music stores in Australia is around \$23, or 18 per cent below prices in specialist stores. Prices in the latter stores have not yet dropped as significantly as expected following the change in legislation to allow the parallel importation of sound recordings. One reason for this is the industry's attempts to maintain the status quo and the introduction of relatively high priced 'enhanced' CDs. Another key factor is that in 1998 when the reforms were introduced there was not as large a difference between Australian and overseas CD prices as there had at times been in the past. This was primarily because the Australian currency was relatively weak compared with the currencies of countries that were likely to be sources of parallel imports. Since 1998, the Australian dollar has continued to depreciate relative to many of those currencies.

This reduces the potential for parallel imports and tends to dampen any immediate price reductions flowing from reforms. Nevertheless, the ACCC estimates that as a result of the reforms, average CD prices in Australia are as much as \$A8 less than they might otherwise have been given the depreciation of the Australian dollar and general price inflation. In other words, the competitive impetus flowing from the reforms has helped to prevent prices rising as much as they might otherwise have done.

Retailers report that advertising and promotional spending is continuing and the indent services provided by producers has improved. Very little has been heard about damage to artists' incomes from parallel imports. While the industry predicted rampant piracy, the available reports are that the incidence of piracy is low, and arises mainly from Australian sources. In fact a report published by International Federation of Phonographic Industry in September 2000, *Recording Industry in Numbers 2000*, reports that in Australia the incidence of piracy in 1999 decreased from the levels reported in 1998. The ACCC expects that the benefits will be even greater if retailers can achieve diversity in their sources of supply and a good supply of product. Interestingly, most of the imported Top 40 product to date has been sourced from South East Asia, despite predictions that the US would be the major supplier. This has been due in part to the depreciation of the Australian dollar against the US currency. When the US is back as a viable supplier, the diversity and volume of product available from US wholesalers and 'one stop' shops should magnify the competitive influences on the Australian market.

PACKAGING & LABELLING

Prior to the removal of copyright controls over packaging and labelling in 1998, the Copyright Act had been used by exclusive distributors of non-copyright products, including toys, drinks, food, clothing, footwear, soaps, perfumes, spare parts, cleaning fluids and alcohol, to prevent other suppliers from importing the product. This had been achieved by using the copyright in the packaging and labelling of the goods.

The amendments allow the importation of goods with copyright packaging or labelling without the permission of the copyright owner, if the owner of the copyright had agreed to the use of the copyright material with the goods.

ASSESSMENT OF AUSTRALIA'S EXPERIENCE WITH PARALLEL IMPORTS

Australia has taken considerable steps towards allowing parallel importation of copyright products.

Australia's reform of parallel import restrictions has been accompanied by strengthened laws to address concerns about piracy as well as implementation lags to allow affected industries time to adjust to new arrangements.

Australia's experience following the implementation of these substantial reforms has been fairly recent and limited. Attempts to undermine the intent of the legislative changes may also have dampened the competitive impact of the reforms. The early signs are, however, that the affected industries are coping fairly well with the changes and that consumers have gained from more competitive pricing and better availability.

CONCLUSIONS

Holders of IPRs often claim that such rights are 'absolute'. However, like other property rights, the law both grants these rights and places limits on them. All rights are limited because they cannot be exercised without affecting others. The question is how far should IPRs extend? Moral arguments of rights versus obligations are inherently difficult to resolve. Economic analysis provides a useful set of tools for determining these boundaries. In general a freely competitive market maximises society's total economic welfare.

The production of copyright products is characterised by market failures associated with 'public goods' and 'non-exclusivity'. Copyright protection is a means of dealing with the latter. However, it is not a justification for extending copyright controls into the sphere of distribution. Controls over free trade in goods and services, such as those contained in the importation provisions, tend to limit the 'Wealth of Nations'.

More broadly, this examination of the importation provisions raises the issue of the difficult interface between intellectual property rights and competition policy, which has received scant attention in the past. The current age of information technology and biotechnology makes this area all the more important to study.

One general outcome of the international debate about parallel imports is that a great deal of interest has developed in the economic justification for protection of intellectual property and the appropriateness of parallel import restrictions, an area previously neglected by economists and general policy makers.

Many economists have formed the view that the import provisions are a sign that intellectual property laws may have been captured to operate unduly for the benefit of producer interests at the unwarranted expense of consumer interests and that this capture operates especially strongly to the detriment of countries which are net importers of intellectual property products. If this is true, does capture extend further into other areas of intellectual property law? Certainly the closed market provisions of much intellectual property law around the world sit very uneasily with the trend to liberalise trade and investment in our global economy.