



OECD ECONOMIC SURVEY OF SWITZERLAND: THE SCOPE FOR PROTECTION FROM PARALLEL IMPORTS SHOULD BE REDUCED

This is an excerpt from Chapter 3 of the OECD Economic Survey of Switzerland, 2003.

The possibility to block parallel imports of products protected by patents is one of the reasons for price differentials.¹ A potential for arbitrage mainly exists with regard to pharmaceuticals and certain consumer durables (computers, household appliances and consumer electronics, watches and vehicles).² Shifting to the international exhaustion regime for patent law, such that patent law could no longer be invoked to block parallel imports has been the subject of a lot of controversy for several years. (**Box 4**). Recently, however, the Federal Council did reject such a change. This decision was based on the results of two studies ordered by the authorities to guide their decision (Federal Council, 2002). These studies show, *first*, that liberalising parallel imports would have positive economic effects on Switzerland. However, the empirical results suggest that the gains would not exceed 0.1 per cent of GDP, despite the prices of parallel imports falling by between 14 and 32 per cent in the case of drugs and between 4 and 8 per cent for consumer goods. According to the Government's report to Parliament, this was considered a small gain. *Second*, it is also noted that introducing international exhaustion could cause difficulties in the drugs market regarding the preservation of medical safety standards. *Third*, lifting the ban on parallel imports of patent protected products would lead to competition between different countries' regulations, thereby calling into question the choices that countries make with regard to the provision of pharmaceuticals. On the other hand, keeping a national exhaustion system makes it possible, in principle, to reduce the cost of drugs going to poor countries – as the Swiss authorities want – without harming the pharmaceuticals industry in the case of re-exports to the developed countries. *Last*, the Government's reports to Parliament argue that authorising parallel imports would mean that less attention is paid to protecting patents, which could discourage research-intensive firms from setting up in Switzerland. That said, the Federal Council advocated using the law on cartels as a corrective if the patent holder makes improper use of the right to control imports. According to the Federal Court, this is the case if there are big price differences when a product is first put in circulation between Switzerland and other countries of similar economic and legal conditions. As COMCO observes, however, this particular legal framework only allows to enforce parallel imports on a case-by-case basis. Moreover, several years may elapse between the time when a complaint is received and the entry into force of a decision, with the result that the corrective instruments contained in the law on cartels are limited by comparison with the adoption of the principle of international exhaustion of patents (COMCO, 2003).

Box 4. Advantages and drawbacks of applying the international exhaustion principle to patent law

OECD countries have adopted different policies with respect to parallel imports: the United States applies the national exhaustion rule, while the EU, as a customs union, allows parallel imports between member countries, but not from third countries ("regional exhaustion"). A few countries such as New Zealand have adopted the international exhaustion principle while countries like Japan apply still another solution ("implied licence"), with some similarities with the international exhaustion principle.³ As was observed in a recent report addressed by the Federal Council to Parliament (Federal Council, 2002), the question of the authorisation of parallel imports and the exhaustion of patent rights is complex since it affects competition and innovation policy, and also has to take account of the international context.

Economic theory is inconclusive concerning the welfare impact of bans on parallel imports, but it is admitted that, under certain assumptions, price discrimination may have positive economic effects. For instance, Malueg and Schwartz (1994) argue for a banning of parallel imports on the grounds that perfect price discrimination would result in net global output expansion and raise global welfare; it would notably ensure that low-price markets are provided with goods. This includes notably developing countries' markets, which in case of application of international exhaustion would possibly not be delivered anymore. Second, as long as producers maintain or are obliged to maintain price differentiation if parallel imports are authorised, parallel importers are exploiting the arbitrage opportunity and free-ride on the costs of research and development that patent holders incur. Third, high entry costs together with rapidly decreasing margins from parallel imports due to country size are likely to limit the number of parallel importers in a small country; the resulting oligopolistic market structure could leave little benefit for the customer.⁴ Finally, any change in the intellectual property right system on a larger scale has to take the overall regulatory framework into consideration, in particular the balance between innovation and technology diffusion. The introduction of the international exhaustion principle carries the danger of shifting the attention of producers away from competing with innovations.

This assessment does, however, prompt a number of comments. *First*, since economic theory is inconclusive concerning the macroeconomic effects of authorising parallel imports, it is important to consider pertinent empirical work. A number of empirical studies do indicate that liberalising parallel imports has a positive impact, as suggested by the recent study ordered by the Federal Council concerning Switzerland. However, this positive macroeconomic impact seems bound to be small, as is true of any measure affecting competition only in a small part of the economy. Yet to reject this type of measure on the basis of a case-by-case evaluation runs counter to an overall strategy of stepping up competition, which is what Switzerland needs. *Second*, the main factors that make Switzerland attractive for research activity (the availability of skilled labour and quality infrastructure) would not be affected by opening up to parallel imports. Moreover, the latter would have only a very limited impact on the activity of firms carrying out their research in Switzerland, the bulk of them operating in the world market.¹ *Third*, it is the drugs market regulations that appear to be responsible for most of the big drug price differentials with other countries. Ensuring competition between these regulations could prompt reforms aimed at reducing their undesirable effects in terms of economic efficiency. *Finally*, as noted in the report ordered by the Federal Council, authorising parallel imports could be compatible with low-price selling of patented drugs to poor countries thanks to the introduction of vertical agreements including, if necessary, specific labelling of drugs to prevent them being re-exported to developed countries.

All told, if it were not possible to apply the international exhaustion principle for the reasons highlighted above, an interesting alternative that has also been suggested in the Federal Council's report would be to commence negotiations with the European Union with a view to adopting the EU principle of regional exhaustion.

1. The turnover in Switzerland of the big Swiss pharmaceutical companies accounts for only about 1 per cent of their world sales.

NOTES

1. In Switzerland, patent law is subject to the national exhaustion regime, which prohibits parallel imports of patent-protected products without the approval of the holder of the protective rights, even if there are large price differentials with other countries. In contrast with patent rights, copyright and brand rights are subject to the international exhaustion principle which allows parallel imports. See Kraus (2003) for a discussion of the legal framework on parallel imports.
2. For patented drugs, the best prices found at international level are 40 per cent lower than in Switzerland, while for non-food consumer goods the average wholesale price differential is put at 30 per cent (Federal Council, 2002; Frontier Economics, Plaut and BAK, 2002).
3. For legal aspects, see (Strauss and Katzenberger, 2002).
4. This is confirmed by the case of the Swiss Trademark Law where the principle of international exhaustion applies but where the prices of many branded products are still comparatively very high.