Institute For Policy Innovation
IPI Ideas
Innovative Insights on Today's Policy Debates

NO. 23 FROM THE IPI CENTER FOR TECHNOLOGY FREEDOM JULY 2003

# PARALLEL IMPORTATION AS A PERVERSION OF FREE TRADE

*By Richard A. Epstein*

The advantages of free trade are easy to summarize and hard to undermine. Ordinary voluntary exchange produces mutual gains from trade. The greater the velocity and quantity of the exchanges, the larger the gains. In both domestic and international context, the principle of free trade speaks in favor of the removal of tariffs and subsidies alike, but it does not stand for the proposition that any and all sales should necessarily stand. For instance, fraud in the marketplace is inconsistent with the principle of mutual advantage. Also, the sale or importation of dangerous goods poses threats to third parties that are not fully internalized by the trading partners.

As a matter of first principle, we should be deeply suspicious of any efforts by one competitor to portray himself as the victim of predatory pricing or, in the international arena, of the "dumping" of cheap imports in domestic markets. The right remedy in all cases is to buy as much as the cheap good that you can use.

Against this backdrop, it becomes instructive to examine the regime that typically applies to pharmaceutical products, whereby domestic statutes impose a prohibition against "parallel importation." This importation consists of the resale in the United States, typically at below domestic prices, of drugs that were originally sold exclusively for sale and consumption in foreign markets. The lower prices are a function of the lower demand overseas which dominates any increase in the direct cost of sales. If competition is served, so the argument goes, by allowing goods of foreign origin to freely compete with domestic goods, why treat the reimportation of domestic goods any differently?

**Parallel importation counts as perversion of the basic free trade principle.** That conclusion depends on two key insights. The first relates to the structure of the domestic patent monopoly, the lower demands in many foreign nations, and the complex web of maximum price regulations imposed on the sale of patented drugs overseas. The second relates to the critical distinction between restrictions imposed *by contract* with the initial sale of the drug and the restrictions imposed *by law* upon the resale of goods. Quite simply, if restrictions on parallel importations were statutory devices designed to stop the operation of international competition, they obviously should be rejected. But these restrictions are neither designed to provide unfair subsidies to domestic producer nor to hamper foreign competition.

First, *patented goods are subject to a lawful monopoly created by the state in order to induce the production of the good in the first place.* No one thinks that private firms who cannot receive a rate of return sufficient to meet their large costs will invent new pharmaceutical drugs. These costs not only include the basic supply costs of fabricating and selling each pill, but also the huge front-end costs that reach under anyone's estimate in the hundreds of millions of dollars (when dead ends are taken into account) for each new product that reaches the market. The legal monopoly granted is the only thing that allows the producer to recover those fixed costs, for without it, new competitors could produce the same generic compound at a fraction of the price, driving the first drug out of the marketplace. Knowing of this credible threat, the original would shut down operations. Better to receive no profits than sustain a large loss.

Once the patent monopoly is regarded as legitimate, *how should patented products be priced?* In the name of fairness, the state could insist that the patentee charge the same price for all parties. Under that regime, higher demanders of the goods would receive a nice consumer surplus, while low demanders might not be able to pur-

chase the good at all. Thus, allowing a system of price discrimination has the advantage of allowing the low demanders to participate in the market, at the cost of reducing the net surplus to the high demanders. In the international context, this discrimination allows American firms to sell high quality, cheap AIDS drugs to struggling African nations, but *only if* those nations can't engage in arbitrage by buying these goods inexpensively at home and reselling them for a nifty profit in the United States or some other nation that supports a higher price level. The net effect of allowing price discrimination (and banning resale by contract) is to increase the size of the potential gains from the patent, which in turn should result in greater efforts at patentability. As long as free entry governs the market to acquire patents, the overall level of return to pharmaceutical firms from patenting activity should approach competitive levels, which in turn suggests that any legal rules that reduces the net ex post return to patents will reduce the overall level of innovation.

It is not only differential demand that creates the risk of market arbitrage. Rather, government regulation in foreign nations that set *maximum* prices that they will pay for imported products also creates this risk. These governments are canny enough to set those prices a bit above marginal cost so that the company will get positive returns and still decide to send the drugs there. However, the price is set below what the drug company could charge in an unregulated market. There are three bad effects to this regulation. First, the use of this form of monopsony power reduces the global return to innovation, and, thus, the levels of innovation in the domestic market. It also casts a greater burden on the domestic American market to cover a larger fraction of the fixed costs of innovation. Thus, it fuels resentments at home because of the massive premium in domestic price, with the American market subsidizing these foreign markets. Finally, it creates a second chance for arbitrage if quantities of these goods can be resold in the United States.

**American companies, in order to see positive long-run returns, must preserve their ability to price discriminate in American markets**, and toward that end when they sell goods overseas they seek by contract to limit the resale of the goods in the United States. Government does not impose this restraint on alienation. It is not antithetical to free trade. It is part and parcel of free trade. If it were possible to enforce contract provisions that required foreign buyers to pay in damages an amount equal to the difference between the United States and the local price of a given drug, the profit would be taken from the arbitrage game.

All too often, these contractual restrictions are worthless because of the difficulty of proving the breach for drugs that quickly pass through the hands of multiple parties. However, imposing statutory restrictions on reimportation is an effective substitute for a valid, if ineffective, contractual restraint on alienation that makes sense in light of the basic domestic decision to grant the full patent monopoly.

**To eliminate the ban on parallel imports will have, at the very least, two undesirable consequences.** First, *it will restrict needed sales overseas.* If fewer drugs are exported to Africa, fewer will be reimported to take the higher American returns. The consequence could be shortages overseas. Second, *it will sap the incentive to innovate at home,* for the reimportation is just a costly way (two shipments, not one) to avoid a price discrimination regime that is legal and proper under domestic law. It will not do for American law to let foreign pricing practices dictate our own pricing strategies. Banning parallel imports, alas, does not supply any remedy to the persistent problem of foreign free riding on American innovation, when foreign governments use their sovereign power to limit price freedom in their own countries. The only way to counter that misguided effort is through tough trade negotiations in which the American government (which shamelessly sponsors export cartels for goods that can be competitively priced at home) should use some of its political power for more sensible ends. It would be most unwise to imitate the practices of foreign nations in order to undo the grant of the domestic patent monopoly, which has spurred a level of investment that makes this nation the dominant, if unloved, force in pharmaceutical innovation.

---

Richard A. Epstein is James Parker Hall Distinguished Service Professor of Law, The University of Chicago; Peter and Kirstin Bedford Senior Fellow, The Hoover Institution.

Copyright © 2003 Institute for Policy Innovation

Nothing from this document may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without permission in writing from the publisher, unless such reproduction is properly attributed clearly and legibly on every page, screen or file. IPI requests that organizations post links to this and all other IPI publications on their websites, rather than posting this document in electronic format on their websites.

**The views expressed in this publication do not necessarily reflect the views of the Institute for Policy Innovation, or its directors, nor is anything written here an attempt to aid or hinder the passage of any legislation before Congress**. The Institute for Policy Innovation (IPI) does not necessarily endorse the contents of websites referenced in this or any other IPI publication.

Direct all inquiries to:

**Institute for Policy Innovation**
1660 South Stemmons, Suite 475
Lewisville, TX 75067

(972)874-5139 [voice]
(972)874-5144 [fax]

Email: **ipi@ipi.org**
Website**: www.ipi.org**