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Policy Brief

Who Should Bear the TRIPS Enforcement Cost?

I. Introduction

The TRIPS Agreement adopted in 1995 provides an array of trade-related rules on the protection and enforcement of intellectual property rights. It is fair to say that many of those TRIPS rules have been reflected in the national legislations of the WTO Members, but the fact remains that developing countries are under increasing pressures from the developed countries to do more to improve the enforcement of their IPRs and to build up the institutions of IP enforcement. Some felt that such demands from the IP holders or western governments have gone beyond what the TRIPS Agreement requires, and therefore constitute TRIPS-plus requirements. So we have witnessed the phenomenon that some developing countries are forced to spend more and more resources on efforts related to enhancing the enforcement of intellectual property rights. This malady has come into light when the level of compliance, primarily through enforcement of private property rights, is governed by certain binding international obligations without formal understanding of compliance costs and the need for creating a balance featuring optimal level of compliance.

Executive Summary

Establishing and strengthening the enforcement of intellectual property rights is a costly exercise both in terms of budgetary outlays and the employment of skilled personnel. It is particularly expensive for many developing countries, as economic benefits will go largely to foreign firms over the intermediate term. One critical question is posed that "Who should bear the cost of enforcing TRIPS"? By analyzing from both economic and legal perspectives, this policy brief concludes that the enforcement cost shall be borne by private parties as IPR is private right in nature, and enforcement activities ought to be planned on a cost-benefit basis from a socially optimal perspective. It is advisable that developing countries should deny bearing undue costs in respect of providing these measures beyond TRIPS requirements, such as border measures beyond the requirements of Article 51, criminal actions, the creation of special policy units or tribunals to combat piracy and counterfeiting and ex-officio measures.

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The objective of this policy brief is to analyze the question who should bear the enforcement cost, the flexibilities under the TRIPS and to recommend the way forward. Following the introduction, the second section discusses the main elements of the enforcement costs. The third section analyzes what is the optimal level of IP enforcement and who should bear the enforcement cost from economic and legal perspectives. The fourth section presents the flexibilities on enforcement cost under TRIPS. The fifth section highlights that enforcement cost can be minimized by applying cost-benefit approach. The last section presents some conclusions

II. What is the TRIPS Enforcement Cost?

Identifying the type of costs that TRIPS Agreement imposes is important for advocating measures for finding a balance and to provide policy guidance. The costs of IP enforcement which TRIPS mandates can be essentially divided into two categories:

One is the direct cost of enforcement of specific rights (in terms of costs arising out of providing administrative remedies, judicial costs, establishing special infrastructure, etc.).[1] Increasingly, it is seen that governments of developing countries are voluntarily engaged in providing strong Sate apparatus and compliance mechanisms for fighting piracy and counterfeiting.[2] This direct cost of TRIPS enforcement includes: (a) Judicial cost; (b) Administrative cost; (c) Litigation cost; and (d) Cost of litigation error.

The second category of costs is indirect cost, which may have deeper implications than the first category of costs, although not the focus of the instant policy brief. These costs are duly associated with static losses which developing countries have to face due to TRIPS or TRIPS-plus compliance and the ensuing static consumer welfare losses, impediments to informal and formal modes of anti-competitive effects, etc. Such costs arise out of intrinsic nature of substantive rights granted to IP holders as such, but are borne by the technology users and consumers at large instead.

III. Who Should Bear the TRIPS Enforcement Cost?

Establishing and strengthening the enforcement of intellectual property rights is a costly exercise—both in terms of budgetary outlays and the employment of skilled personnel. It is particularly expensive for many developing countries, because economic benefits will go largely to foreign firms over the intermediate term. The principle of "no free lunch" poses the question: Who should bear the cost of enforcing TRIPS?

III.1. What is Justification of IPRs?

IPRs are State granted monopolies. What is the justification for State to grant IPRs? According to *utilitarianism*, the prevailing school of thought in intellectual property jurisprudence, the justification of IPRs is to grant appropriate incentives for the production and subsequent dissemination of the kind of knowledge desired. In other words, the justification for the provision of intellectual property rights is to use them as a *tool* to promote innovation and development. Utilitarianism posits that a lawmaker should strive to select a set of entitlements that (a) induces people to behave in ways that produce socially valuable goods and services and (b) distributes those goods and services in a fashion that maximizes the net rewards people reap from them.[3] As applied to the world of intellectual property, utilitarianism is conventionally used to justify assigning to inventors and authors entitlements sufficient to induce them to develop, and make available to the public, inventions and works of art that they otherwise would not produce.[4]

Traditional economic justifications assert that some type of government intervention is necessary to prevent market failures in socially desirable knowledge provision. However, State granted IPRs is just one form of intervention, the other being-subsidies, prize funds, open collaborations, etc. *Utilitarianism* implies that **whether or not, and to whom, to grant rights is decided on the basis of what needs to be furthered in the interest of society**. According to this theory, private property rights in information bear both benefits and costs, suggesting that they may be designed with incentives and trade-offs in mind. It makes it very clear that government intervention in the form of IPRs to

prevent market failures must be designed optimally purely to prevent possible market failures.

III.2. Economic Perspective: What is Optimal Level of IP Enforcement?

The optimal IP enforcement is one that balances the marginal cost of achieving compliance with the marginal benefit that derives from doing so. It should create appropriate incentives that maximize the discounted net present value of the difference between the social benefits and the social costs of information creation, including the costs of administering the system.[5] A balance between cost and benefit should be ensured: (Table 1)

However, IPRs are statutory grants, in the absence of which innovators cannot claim any rights on their creations. The absence of a common law right to IPRs is also clear from history. Further, the fact that TRIPS agreement mandates WTO member countries to undertake obligations and bring in mechanisms through conferring of positive rights makes it clear that they are State granted rights and not inherent. Moreover, the fact that many countries, in the yesteryears have timely withdrawn/ introduced IPRs based on contextual economic/technology transfer concerns rightly corroborates an understanding that IPRs remain as State granted rights.

Table 1: Optimal Level of IP Enforcement

Cost	Static loss	Consumer welfare loss	
		Deadweight loss	
		Enforcement cost	Judicial cost
			Administrative cost
			Litigation cost
			Cost of Litigation error
	Dynamic loss	Anti-competitive effect to follow-on innovation	
Benefit	Dynamic gain	Additional provision of innovative product	

"**Cost-effective approach**" is a fundamental principle to determine optimal level of IP regime and enforcement in a country. As IPRs create some static losses in the form of dead weight loss or consumer welfare losses, and hence must be regulated in the way to increase the dynamic gains achieved by grant of IPRs- basically creation of new products and process through constant innovation. It is also evident the static loss involves rent seeking activities by right holders which leads to monopoly rents and transfer of welfare gains from consumers to producers (right-holders).

III.3. Legal Perspective: Who should Bear the IP Enforcement Cost?

Notice the fundamental fact that IPRs are private rights, although, State granted. There are arguments that IPRs are inherent, as they are private rights, based on the property concepts propounded by John Locke, Hegel and Blackstone. It constructs that IPRs are private rights and right holders should be fully responsible for any legal actions and bear their enforcement costs.

IV. Enforcement Cost Obligations Under TRIPS

To strengthen the international legal framework on the enforcement of intellectual property rights is one of the priorities of the agenda of the G8, as expressed at its recent summit in June 2007. Japan, European Union and the United States announced in October 2007 their plans to negotiate an Anti-Counterfeiting Trade Agreement. Currently, we note that a number of developing nations are spending more and more their limited resources on endeavours related to the enforcement of IPRs while more efforts should be made in realizing the objectives of poverty reduction, hunger elimination, health and

educational causes under the Millennium Development Goals. However, it should be highlighted that there are inherent flexibility in the nature of cost effective principle as endorsed by the TRIPS Agreement. This section is to analyze the obligations related to enforcement cost under TRIPS.

IV.1. What Obligation does TRIPS Impose?

TRIPS Art 41 states: "*Ensure that enforcement procedures…are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement*." In accordance with the rules on enforcement, WTO Members should make available the legal procedures for right holders.

IV.2. What Obligation does TRIPS Not Impose?

Recognizing the institutional limitations existing in many developing countries, Article 41.5 of the TRIPS Agreement states:

> *"…this Part (Part III Enforcement of Intellectual Property Rights) does not create any obligation to put in place a judicial system for the enforcement of intellectual property rights distinct from that for the enforcement of law in general, nor does it affect the capacity of Members to enforce their law in general.*

Therefore, it is clear that members are not required to create a parallel judicial mechanism for enforcement of IPRs. The relevant national authorities can exercise discretion in applying the mandated rules.

Article 41.5 of the TRIPS Agreement also states:

> *"Nothing in this Part (Part III Enforcement of Intellectual Property Rights) creates any obligation with respect to the distribution of resources as between enforcement of intellectual property rights and the enforcement of law in general."*

It implies that no obligation is established for Member states to prioritize allocating scarce resource for the enforcement of intellectual property rights before enforcing other laws in general. IPR enforcement could be least prioritized based on constraints that affect member's capacity to enforce their law in general, e.g. specific resource allocation for IPR enforcement that may affect enforcement of member countries' general laws.

Measures that put an undue burden on developing countries beyond TRIPS obligation should be denied. On the one hand, border measures and criminal actions beyond the requirements of Article 51 to 61 are not obligatory. It is also evident that criminal actions are provided for in most developed countries themselves. On the other hand, one should note that not all the procedures are mandatory vis-à-vis some kinds of intellectual property rights. To be specific, the relevance of the procedures for border measures and criminal sanctions under Articles 51 to 61 relates only to "counterfeit trademark or pirated copyright goods" as explicitly defined in footnote 14 to Article 51. Here what is absent in the definition of counterfeit or piracy is TRIPS-consistent parallel importation of goods. It is worth noting that patent infringement does not fall within the definition.[6] While applicability of border measures and criminal sanctions defined in Article 51 to 61 are limited and measures beyond those requirements are not obligatory, developing countries shall make clear not undertake associated enforcement costs of these measures.

V. Case Study: United States - Section 110(5) of the US Copyright Act

This section analyzes WTO case law of *United States- Section 110(5) of the US Copyright Act, Recourse to Arbitration under Art. 25 of the DSU.*[7] It seems logical for any Member to try to impose its own methodology as long as it is justifiable since there are no general rules on the matter. The logic applied that the case highlights is of great significance in the light of cost-effective principle (in the light of flexibilities of WTO member countries to use one's own methodology in calculating costs) and that rights under TRIPS (via Bern Convention) are not self enforcing. The case law also implies that enforcement of private rights under TRIPS Agreement needs positive assertion.

V.1. Facts of the Case

The case reveals a glaring example of the enforcement dynamics and its underlying policy among two WTO Members, i.e. the United States and the European Communities (EC).[8] The dispute arose out of certain amendment done to the United States in Subparagraph (A) of Section 110 (5) of Copyright Act (1976) in 1998[9], which provided substantially exemptions from undertaking copyright licenses, generally to small business establishments, which thus allowed them to communicate copyrighted works to the public without payment of royalties.[10] Before the WTO panel, the EU contented that such an amendment to the United States Copyright law nullified and impaired certain benefits promised to the European Communities under the TRIPS Agreement. The panel partly upheld the EC argument and held certain parts of the US amendments to be TRIPS incompatible.[11]

V.2. The Parties' Positions

The crux of the argument that is relevant to our present discussion arose during the WTO arbitration proceedings.[12] In the instant case both the parties agreed to take recourses to the WTO arbitration forum to resolve the issue over size of the compensation to be paid by the United States to the EU.

On the one hand, the EC contended that US ought to pay the compensation calculated on the basis of full amount of royalties to be payable had all of the earlier exempted establishments (which were held to be in violation of TRIPS) been duly licensed to communicate the copyrighted music to the public. The figure arrived at by the EC was USD 25,486,974.

On the other hand, the US contented that actual benefits that had been nullified or impaired was smaller, anywhere between USD 446,000 to USD 733,000. The basis for the US contention mainly revolved around two methodologies of calculating royalties.

i) Those actual royalties to be received by EC right holders would be based on the actual licensing routinely done by the collective management organizations (CMOs), in which case, these organizations voluntarily exempted small establishes due to higher transaction costs involved when viewed from a cost benefit perspective.

ii) EU is entitled to only those payments which the EC right holders would have actually received after deducting the charges of the CMOs based in United States.

Thus, the issue revolved around the US contention of what ***would have been*** collected vis-à-vis the EC approach of what ***should have been*** collected.[13] It should be noted that the EC strongly contented that to settle for a lesser amount would tantamount to sanctioning piracy.

V.3. The Parties' Approaches: Potential Revenues vs. Legitimate Expectations

The core of the EC methodology suggests that they arrived at the estimate of the foregone licensing revenue based in the "*bottom-up*" approach which involved an estimate of establishments that qualified for under the impugned amendment (which was held TRIPS incompatible) and applied the fee schedules as routinely charged by the CMOs in United States over those works.

The US contended that lost benefits must be calculated based on legitimate expectations and not on potential revenues that the right holders would have earned. The underlying US argument was that certain transaction costs involved in collecting the revenues made the right holders to avoid licensing such establishments, which the US called the number based on legitimate expectation of revenue and not full potential revenue. In this regard, the US used the "*top down*" approach based on the methodology discussed above to arrive at a smaller figure.

How the U.S. justified its Arguments is of utmost interest to developing countries:

i) Not all of the eating and drinking establishments that might potentially be licensed actually pay royalties. CMOs do not find it profitable to license all potential users of their works in view of **transaction costs** that are involved.

ii) The **legitimate expectations** of E.C. right holders (impaired benefits of E.C.) could include only **net** payment they would receive absent the exemption for small eating and drinking establishments, **not** the **gross** payments that include a part to cover the cost of doing business for CMOs.

V.4. The Arbitrators' Award

Agreeing to the conceptual argument put forth by the United States, the arbitrators came to agree to certain aspects of the US calculation of impaired benefits. The arbitrators ruled that the level of E.C. benefits that are being nullified or impaired … is equal to the amount of royalty payments that **would have been** distributed by U.S. CMOs to E.C. right holders had offending amendment not taken effect. The arbitrators' reasoning is as follows (Chart 1):

Chart 1: The Arbitrators' Reasoning

a. Rights protected by Art 11.1 (Berne Convention) should **not** be considered to be **self-enforcing.**

b. **Enforcement imposes a cost**, as is evident from the fact that the E.C. right holders choose to rely on CMOs to assist them in collecting their royalty fees. The **actual size of these costs should not be neglected** in calculating the benefits that the right holders can expect to realize from TRIPS.

c. **Enforcement activities ought to be planned on a cost-benefit basis.** CMOs license only those establishments for which the expected revenues exceed the transaction costs.

To elaborate, arbitrators ruled that rights under TRIPS, through Berne convention, are not self enforcing. It said, since enforcement induces a cost, and the fact that right holders relied on CMOs, such costs should not be neglected in calculating the benefits that the right holders can expect to realize from the TRIPS Agreement. Very importantly, the arbitrations agreed to the fact that the rights protected under the Berne Convention (article 11.1 in this case) were not self enforcing and that right holders would consider to make a cost benefit analysis before licensing, which would in some case be determinative of whether right holder would seek to enforce rights against those violators where transaction cost of collecting royalties would exceed the net benefits of royalties. Thus, the arbitrators considered the US "top-down approach to be more relevant, but based on certain adjustments which considered a past three year revenue collected.

V.5. Lessons for Undertaking Enforcement Costs

The WTO case illustrates how US could adopt an approach which considers calculation of cost of enforcement is essential if right holders have to receive benefits from enforcement. As in case of the US, countries have the inherent flexibility to consider what type of enforcement cost does right conferred under the TRIPS agreement imposes.

That there can be differences in calculation of what amounts to infringement of IPRs and what degree of enforcement is to be applied, basically based on a cost-benefit analysis. Right under TRIPS (through Berne Convention or Paris convention etc) is not self enforcing thus making it necessary for right holders to bear total costs of enforcement. That cost-benefit analysis is done while enforcing rights and transaction costs can be substantive, which may be a determining factor for right holders to selectively opt remedies.

VI. Conclusion

There are sufficiently inherent flexibilities endorsed by the TRIPS Agreement for the country to develop socially optimal guideline in terms of who should bear enforcement cost. It is advisable that governments should as a policy measure aim to strike a balance between the dynamic gains and static losses for assessing the cost of enforcement of TRIPS enforcement obligations. It is fair to say that a government should make available the legal means for IP holders to protect their private rights, but the fundamental responsibility for intellectual property rights enforcement must be born by the right holders. The WTO case of United States-Section 110(5) of the US Copyright Act demonstrates the methodology how the enforcement cost can be minimized. Developing countries should also deny bearing undue costs in respect of providing these measures beyond TRIPS requirements, such as border measures beyond the requirements of art. 51, criminal actions not required in article 61, the creation of special policy units or tribunals to combat piracy and counterfeiting, ex-officio measures, etc. Developing countries are highly recommended not to bear unnecessary enforcement cost, especially when careful and empirical studies show that the TRIPS enforcement would not lead to creation of domestic welfare.

End Notes

1. Although the TRIPS Agreement does not specify in detail the enforcement measures and mechanisms to be adopted, it does impose minimum standards that generate costs for the member countries. The devil lies in the modalities of implementation of part III as whole.
2. See, e.g., Strengthening the IP System: The Campaign Against Piracy and Counterfeiting in the Philippines (2005-2006) - *Comment of the Government of the Republic of the Philippines submitted to the United States Trade Representative's Office in relation to the 2007 Special 301: Philippines.*
3. Chayes, Abram & Fisher, William, *Economic Analysis of Intellectual Property*, Teaching Material on Legal Theory, Cyber Harvard Law School, http://cyber.law.harvard.edu/bridge/LawEconomics/ip.htm.
4. Fisher, William, *Theories of Intellectual Property*, Teaching Material on Legal Theory, Cyber Harvard Law School, http://cyber.law.harvard.edu/people/tfisher/iptheory.pdf.
5. Maskus, Keith E., (2000). *Intellectual Property Rights in the Global Economy*, Institute for International Economics, Washington, D.C., pp. 31.
6. Ermias Tekeste Biadgleng & Viviana Munoz Tellez (2008), "*The Changing Structure of Intellectual Property Enforcement,*" forthcoming South Centre Research Paper 15.
7. WTO Doc. WT/DS160/ARB25/1
8. WTO-DS 160: US Section 110(5) of the Copyright Act. Available at: http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds160_e.htm
9. Subparagraph (A) of amended Section 110 (5) of the U.S. copyright Act exempts eating, drinking, and retail establishments that transmit music on a single receiving apparatus of the kind commonly used in private homes. Subparagraph (B) exempts, on the other hand, bars and restaurants of less than 3750 square feet that transmit radio and television music as well as larger bars and restaurants that communicate audio performances by means of six or fewer loudspeakers, or audiovisual performances by means of four or fewer audiovisual devices and on the other hand establishments other than bars and restaurants.
10. The amendment was called Fairness in Music Licensing Act of 27 October 1998.
11. It should be noted that neither parties went in appeal over the substantive issues being decided in the case.
12. See WTO Doc. WT/DS160/ARB25/1.
13. Gene M. Grossman and Petros C. Mavroidis, *US-Section 110(5) of the US Copyright Act Recourse To Arbitration Under Art. 25 of the DSU (WTO Doc. WT/DS160/ARB25/1): Would 've or Should 've? Impaired Benefits due to Copyright Infringement*, in The Principles of World Trade Law, (2003).

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