

Intellectual Property Protection as Economic Policy: Will China Ever Enforce its IP Laws?

Monday, May 16, from 2:00 – 3:30 PM

Dirksen Senate Office Building, Room 192

Statement of Professor Daniel C.K. Chow

COUNTERFEITING IN CHINA

I. Introduction

In terms of size, scope, and magnitude, counterfeiting in China is considered by many to be the most serious counterfeiting problem in world history. (As used here, counterfeiting refers to the unauthorized use of trademarks owned by another on identical or similar goods.) A recent study by the PRC State Council Research and Development Center reported that in 2001 the PRC economy was flooded with between \$19-\$24 billion worth of counterfeit goods. Brand owners in China estimate that 15 to 20% of all well-known brands in China are counterfeit and estimate their losses to be in the tens of billions of dollars. Counterfeiting is estimated to now account for approximately 8% of China's gross domestic product.

China is also a leading exporter of counterfeit products to other countries in Asia, Europe, and the United States. In 2003, China accounted for 66% or over \$62 million of the \$94 million of all counterfeit and infringing goods seized by the US Customs Service at ports of entry into the United States. Mid-year figures in 2004 indicate that seizures are sharply higher with \$64 million seized in the first half of 2004 alone. An ominous development is that beginning in 2004, exports of counterfeits from China to the United States and other parts of the world may begin to increase significantly for the foreseeable future.

II. Origins and Causes of Counterfeiting

There are several explanations for the unprecedented size and scope of counterfeiting in China:

(1) *Foreign Direct Investment and Advanced Technology.* China's economic growth through the decade of the 1990s has been fueled in large part by foreign direct investment (FDI) from multi-national enterprises (MNEs). In the 1990s, China emerged as the world's second largest recipient of foreign direct investment behind only the United States and in 2002, China surpassed the United States to become the world's largest recipient of foreign direct investment with \$50 billion of foreign capital inflows. FDI is the best means in the world today for the transfer of advanced technology, intellectual property, and other forms of valuable information. In many cases today the intellectual property component of a FDI in the form of patents, copyrights, and trademarks is the most important component of the foreign investment. For example, the value of the Coca-Cola trademark in China is worth many more times to that company than the millions of dollars in capital that it has invested in China. The same is true for the patents and copyrights owned by pharmaceutical companies and software companies doing business in

China today. However, while MNEs are creating a transfer of technology through FDI that is being absorbed into China's legitimate economy through joint ventures and wholly foreign owned enterprises some of this intellectual property is also being diverted into China's illegitimate economy as pirates steal this technology to engage in counterfeiting and other forms of commercial piracy. It is no coincidence that China, the world's largest recipient of FDI, advanced technology, and intellectual property also has the world's most serious commercial piracy problem.

(2) *State Support of Counterfeiting and Local Protectionism.* No problem of this size and scope could exist without the direct or indirect involvement of the state. In China, the national government in Beijing appears to be sincere in its recognition of the importance of protecting intellectual property rights, but national level authorities are policy and law-making bodies whereas enforcement occurs on the ground at the local level. At this level, local governments are either directly or indirectly involved in supporting the trade in counterfeit goods and are often reluctant to punish counterfeiters.

(3) *Ineffective Legal Enforcement and Lack of Deterrence.* China has a developing legal system that is weak in many respects by comparison to legal systems in advanced industrialized countries such as the United States. While China's intellectual property laws are now considered by most observers to be in compliance with the standards set by TRIPS, enforcement of these laws remains inadequate and fails to create sufficient deterrence of counterfeiting.

The combination of these factors – the world's largest influx of foreign direct investment and widespread access to advanced technology, direct or indirect government involvement and support of the counterfeit trade, and a weak legal system that does not create sufficient deterrence for counterfeiters in a very lucrative trade – has resulted in a counterfeiting and commercial piracy problem that is unprecedented in world history.

III. Overview of Counterfeiting in China

The illegal trade in counterfeit goods in China can be divided into two components: manufacture and distribution:

(1) *Manufacture:* The manufacture of counterfeit products tends to be concentrated in China's southeast region in coastal areas near Taiwan and Hong Kong. Criminal organizations in Hong Kong and Taiwan involved in smuggling, prostitution, and narcotics have now branched out into counterfeiting because of its lucrative nature. These criminal organizations supply the capital and start up costs and use the borders between China and their headquarters in Taiwan and Hong Kong to frustrate and elude law enforcement.

(2) *Distribution:* Distribution of counterfeit products occurs through a series of large open air or partially enclosed wholesale markets. These wholesale markets are found in strategic locations around the country and are positioned to serve large densely populated urban areas. These wholesale markets are established and regulated by the local Administration of Industry and Commerce (AIC), a branch of the local government responsible for promoting, regulating, and policing commercial activity. Based on the experience of the author, every wholesale market in China traffics in counterfeit goods. As AICs are also one of the primary government entities in China charged with enforcement against counterfeiting, AICs

are faced with a conflict of interest as they are charged with policing and enforcing the very markets in which AICs and the local government have a substantial investment and financial interest. Shutting down these wholesale markets would not only result in a direct loss of revenue to the AIC but would also have many repercussions as many retail businesses, hotels, restaurants, and nightclubs are all supported by the trade in counterfeit goods.

IV. Barriers to Effective Enforcement Against Counterfeiting

(1) *Local Protectionism*: While it appears that central level leaders understand the importance of protecting intellectual property for promoting China's long-term economic development, central level authorities are legislative and policy-making bodies. Actual implementation and enforcement of the law occurs at the local level where there continue to be questionable commitments to suppressing counterfeiting, copyright piracy, and other forms of economic crimes. Local areas benefit directly and indirectly from counterfeiting. In some areas, counterfeiting provides jobs and generates revenue that are essential to support the local economy. In some cases, counterfeiters voluntarily pay substantial taxes to local authorities. In other cases, legitimate businesses such as hotels, restaurants, nightclubs, storage and transportation companies have been created to support the trade in counterfeit goods. The payment of taxes and the creation of lawful supporting businesses has integrated counterfeiting into the legitimate local economy. It is no exaggeration to say that some local areas in China are entirely supported by the trade in counterfeit goods and that local residents are ready to use any means necessary to protect their illegal trade. A crackdown on counterfeiting would result in shutdown of the local economy with all of the attendant costs of unemployment, dislocation, social turmoil, and chaos. Because the costs of a crackdown at the local level can be so severe, counterfeiting is heavily defended at local levels.

(2) *Inadequate Punishment*: Local protectionism and a weak legal system contribute to the lack of adequate enforcement against counterfeiting. The result is that the Chinese enforcement system does not create deterrence. To be sure there is no lack of enforcement activity. To the contrary, it is relatively easy to obtain an administrative action in the form of a raid and seizure action against suspected counterfeiters. The problem is that once the enforcement action is completed the level of fines and criminal prosecutions are so low that whatever sanctions are meted out do not create deterrence. For example, the average fine imposed on the counterfeiter or infringer in 2000 was \$794, a figure that is so low as to be considered a cost of doing business in a very lucrative trade. The amount of compensation awarded to brand owners in 2000 stands at \$19, a negligible amount. Damages awarded by AICs seek to award the brand owner the profits earned by the counterfeiter after deducting all expenses (as represented by the counterfeiter) and are not based upon economic losses suffered. As for criminal prosecutions, in 2000 only about 1 in 500 cases were referred to judicial authorities for criminal prosecutions. Enforcement in China does not create fear in counterfeiters or deterrence.

V. Exports from China

Recent changes indicate an ominous development: exports from China are likely to increase dramatically beginning in 2004.

(1) *Exports to the United States*: In 2003, U.S. Customs seized a total of \$94 million of counterfeit and

infringing goods in ports of entry at the United States. Of this total, products originating in China accounted for 66% of the total and \$62 million of the total. The 2003 figures for China represent a significant increase over comparable 2002 figures when China account for 49% of all counterfeiting and infringing products and \$48 million of the total \$98 million of illegal product seized by US Customs. Counterfeits from China and Hong Kong (through which many counterfeits produced in China are transshipped) accounted for \$80 million or 75% of the total. No other country accounted for more than 3% of counterfeit products. As many counterfeit products, such as auto parts, that originate in China are transshipped through other countries, such as those in South America and through Canada, before ultimately entering the United States, China likely accounts for a significantly higher percentage than the 66% set forth the 2003 US Customs statistics. It is possible that China accounts for as much as 80% or more of the counterfeits goods that enter the United States. Note that the \$94 million figure represents only the value of the products that are seized by US Customs in 2003, which can only be a tiny fraction of what enters the US market. If the total value of the products seized represents 1% of the counterfeiting and infringing product that enters the U.S. market then the total value of counterfeits that entered the US market in 2003 is approximately \$10 billion with China accounting for between \$6 and \$8 billion of that total. It is possible that the actual figures are much higher.

(2) *WTO Commitments:* There is likely to be a significant increase in the amount of counterfeit products exported from China to the United States beginning in 2004 and for the foreseeable future for several reasons. In accordance with its WTO obligations, China has amended its foreign trade laws in December 2003 to eliminate the monopoly on export rights that had been limited to state trading companies. Under prior law, only certain designated state trading companies were permitted to lawfully export products from China to other countries. This restriction meant that counterfeiters had to find a compliant state trading company that was willing to work together with the counterfeiter in exporting the illegal goods overseas. To be sure, there was no shortage of export companies willing to work with counterfeiters in exporting counterfeit and infringing products, but this requirement nevertheless created an additional obstacle and costs that have now been removed. The effect of the elimination of the monopoly on exports rights means that anyone can now lawfully export products from China. As counterfeiters are likely to take full advantage of the elimination of this restriction, exports of counterfeits from China to the United States are likely to surge for the foreseeable future. U.S. Customs mid-year seizure figures for 2004 indicate that there is a sharp increase in seizure activity: \$64 million in counterfeit goods were seized by mid-year 2004 compared to \$38 million by mid-year 2003.

(3) *Lack of Criminal Laws:* China does not appear to have any current criminal laws that specifically apply to the export of counterfeit products. As the earlier discussion indicated, China has criminal laws against commercial scale counterfeiting within China, although the effective enforcement of these laws is impeded by various obstacles. In the area of exports, however, it is arguable that there are no applicable criminal laws at all, and that counterfeiters can export with impunity from both civil and criminal liability. As pressure mounts on China to obtain better enforcement results within China, it is likely that counterfeiters will turn increasingly to exports as a source of revenue.