

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

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Dirksen Senate Office Building, Room 192

Statement of Eric H. Smith

Mr. Chairman, Members of the Commission and Commission Staff, IIPA and its members thank you for the opportunity to appear today to review China's record on enforcement of its copyright law against widespread piracy and China's compliance with its WTO-TRIPS obligations. IIPA represents the U.S. copyright industries. Its six member trade associations consist of over 1,300 U.S. companies, accounting for millions of U.S. jobs. The copyright industries, in 2002, contributed over \$625 billion to the GDP, or 6% of the U.S. economy and almost 5.5 million jobs or 4% of U.S. employment. These companies and the individual creators that work with them are critically dependent on having strong copyright laws in place around the world and having those laws effectively enforced. On average, the copyright industries generate over 50% of their revenue from outside the U.S., contributing over \$89 billion in exports and foreign sales to the U.S. economy. Given the overwhelming global demand for the products of America's creative industries, all these numbers would be significantly higher if those trading partners, including China, that continue to allow piracy to flourish in their own economies were to significantly reduce piracy rates by enforcing their copyright law vigorously.

> Before turning to the important topic of this Roundtable, I want to provide you with a brief update to IIPA's comprehensive February 2005 Special 301 submission on China to the U.S. Trade Representative. In that submission we called for entering into a new, multilateral dialogue in the WTO with the Chinese government as a way to persuade it to take aggressive action – as promised in the Joint Commission on Commerce and Trade Meetings over one year ago – to significantly reduce the rate of piracy in all IPR sectors including the copyright sector. We then provided a summary review of what had happened in China over the last year to redeem that commitment. Our conclusion: China has failed to comply with its commitment made over one year ago in the JCCT to significantly reduce piracy rates. While some modest reductions have occurred in some sectors, by no measure have piracy rates been significantly reduced. In fact little has changed in the marketplace for our members and their companies, despite reports of increased raiding activity and seizures of many pirate products. For the record, I am submitting a copy of that Special 301 submission which tells the story of the failure of an enforcement system to deter rampant piracy in the potentially largest market in the world.

> On April 29, 2005, USTR issued its decision resulting from the out-of-cycle review of China's enforcement practices announced on May 3, 2004. USTR reflected in this decision its deep concern over China's lack of progress in the enforcement area by elevating China to the Priority Watch List. It also announced a number of other initiatives, one of which was to work closely with our industries with an eye on utilizing WTO procedures to bring China into compliance with its WTO obligations. Since that time we have met with USTR to begin this process and will work intensively with USTR toward the mutual goal of bringing China into compliance with its WTO TRIPS obligations, its bilateral obligations to the U.S. in the 1995 and 1996 IPR agreement and action plan, and its commitments made to our government in the JCCT process.

This process has now commenced in earnest. USTR will also be seeking information from the Chinese

government under the transparency provisions of the TRIPS agreement, and is committed to using the JCCT process to encourage the Chinese government to implement key reforms on both the enforcement and the all-important market access front.

Mr. Chairman, our industries are deeply frustrated by the lack of real progress by China in taking effective action to deter piracy and to open up its market to legitimate cultural and high technology copyright products. China remains one of the most closed markets in the world for the U.S. copyright industries. Onerous market access restrictions affect all our industries. Notwithstanding Premier Wen's pledge to address the \$162 billion trade imbalance between the U.S. and China by increasing China's imports from the U.S., China is retaining – and, in some sectors, augmenting – market access restrictions for creative and high-tech products that represent America's comparative advantage.

Copyright piracy represents perhaps the largest barrier to effective market access in China. An average (and truly staggering) 90% piracy rate has persisted for years despite repeated “strike hard” enforcement campaigns, steamroller campaigns, and public statements from many high level government officials supporting stronger enforcement. While our Special 301 submission highlights the current situation in China, I wanted to give you a brief flavor of what copyright companies confront in trying to do business in China in face of these trade barriers and these inexcusably high piracy levels.

> Taking the business software industry first – one of our nation's most productive and important creative sectors: The software industry faces piracy rates in China of 90%, one of the highest in the world for that industry. China leads the world in the production and export of counterfeit software – software packages that are purposely designed to replicate the original legitimate product. Losses to U.S. software publishers were estimated by the Business Software Alliance (BSA) at \$1.47 billion in 2004. China was the 6th largest market in the world for personal computers and ranked 26th in legitimate software sales. This increasing disparity not only damages the U.S. industry but hurts Chinese software developers as well.

China has failed to criminalize the most damaging type of piracy to the business software industry – the unauthorized use of software within businesses and government institutions. This is a violation of the TRIPS Agreement. Combined with the total absence of a criminal remedy is the absence of all but a few *administrative* actions against this type of piracy with woefully low and non-deterrent fines. As a consequence, piracy rates continue to remain at staggering levels.

To make matters worse, China is on the verge of shutting down access for U.S. and other foreign companies to the largest purchaser of software in China: the Chinese government. It would accomplish this by adopting draft government procurement regulations that would expressly favor Chinese software only. In short, the situation for this critical copyright sector is truly dire in China with no significant improvement in sight.

> The U.S. motion picture industry is facing a 95% piracy rate in China (the highest in the Asia Pacific region, and among the highest in the world) which represents a worsening of the situation from the previous year. Losses to just the motion picture industry, from 1998 through 2004, are estimated at over \$1 billion (not including losses from Internet piracy, which are growing alarmingly). While raids and seizures have increased somewhat following Vice Premier Wu Yi's 2004 enforcement campaign, administrative fines remain far too low to deter pirate activity and, as I will describe later, criminal cases have been extremely rare despite Chinese promises to use this TRIPS-required remedy. According to a recent newspaper report, the legitimate home video market in China represents about 5% of the estimated total market of \$1.3 billion (which is itself a very conservative estimate). Of the 83 optical disc factories licensed by the government (and an unknown number of “underground” unlicensed plants), many continue to churn out pirate DVDs. The export of pirated home video product, which had slowed to a trickle after the U.S. Section 301 action (and threatened retaliation) in 1995-96, has resumed and is

growing. The total optical disk plant production capacity, a significant amount of which is devoted to producing pirate product, is now close to 2.7 billion units annually. Optical disks sourced in China and containing pirated films have been seized in over 25 countries around the world. The massive quantity of pirated movie product available in China is evidenced by the fact that pirate prices start around \$0.60 per unit the lowest price in Asia. As with the other copyright industries, any enforcement that occurs is conducted by administrative agencies, with overlapping jurisdiction and often little coordination, and fines imposed are a mere “cost of doing business.” A recent anecdotal study, conducted by IIPA member, the Motion Picture Association (MPA), revealed that the average fine imposed per pirate home video product (DVD, VCD) seized in raids resulting from MPA complaints is only slightly higher than the cost of purchasing a blank disk – clearly of no deterrent value. The lack of deterrent administrative penalties is a key reason, in addition to the almost complete lack of criminal enforcement that piracy rates persist at 90% of the market and above.

> Accompanying and reinforcing this piracy situation are onerous market access restrictions, including a Government-owned, monopoly importer, very limited competition in distribution, and a quota of 20 theatrical films allowed into China annually on commercial terms. The pirates capture 100% of the market for films not permitted legally in China. Even those films permitted theatrical release suffer piracy rates of 70-75%, because of the long delays before most American films are given screen time. Another consequence of the lack of competition in importation and distribution is the non-competitive pricing in the Chinese market. Cumbersome licensing requirements burdens the retail sale of legal home entertainment product, holding down revenue potential and helping keep the market in the hands of the pirates. These barriers and those to all our industries must be removed in the JCCT process.

> The entertainment software industry, one of the fastest growing copyright-based industries, faces similar high piracy rates and estimates the value of pirated videogames in the market at \$510 million in 2004. Demand for entertainment software products is growing rapidly but is being soaked up primarily by the pirates. This demand is exemplified by the exploding popularity of “massively multiplayer online roleplaying games” (MMORPGs) where literally thousands of players can compete against one another simultaneously. Demand for MMORPGs in China grew at 40-45% over expectations in 2004. This increasing demand has fueled, in part, the growth of Internet cafés in China. (It is estimated that there are close to 200,000 Internet cafes in the country, with a seating capacity of between 100-300 seats, of which 60% are involved in game play.) While U.S. game publishers, represented by IIPA member, the Entertainment Software Association (ESA), have engaged in some licensing of the cafes, the vast majority of the product used is pirated, either available at the café or downloadable from the Internet. This dire situation has been all the more exasperating since the Chinese government extensively regulates the activities of these Internet cafes and often and vigorously revokes licenses for actions the government deems inappropriate. However, as far as we know, the government has never sought to include in this extensive regulatory scheme prohibitions against the widespread and blatant piracy at these cafes in its business licenses (which are otherwise very thorough). Moreover, no copyright enforcement of any kind has occurred. The legal infrastructure governing the Internet still is not helpful to copyright enforcement. Takedown of pirate sites is negligible; penalties non-existent.

> Cartridge-based handheld games are also hard hit by the pirates with manufacturing and assembly operations throughout China with exports throughout Asia, Latin America, the Middle East and Europe. Enforcement attempts have been relatively successful in terms of raids and seizures but, like with other industries, administrative fines are non-deterrent and criminal enforcement action very rarely undertaken, even against factories generating millions of dollars in illicit profits. Entertainment software products are also subject to a protracted content review process, by two separate agencies contributing to market entry delays. Given the immediate nature of the demand and lifecycle of best selling games, this leaves the pirates virtually uncontested in the market prior to the official release of a new title. There are also Internet and investment restrictions that must be significantly eased or abolished.

> The U.S. book publishing industry, represented by IIPA member, the Association of American Publishers (AAP), faces both significant offset printing of pirated books, primarily in translated editions, and massive commercial photocopying of textbooks and reference books on and near University campuses. There are 580 licensed state-owned publishers in China, 50 of which are considered major. There are only a few privately owned publishers but they must buy publishing rights from the state-owned publishers. U.S. publishers issued 4500 translation licenses in 2004, a significant number but far below China's potential. All the best selling books are then virtually immediately pirated by outlaw "printers" and made available through independent bookstores, stalls and street vendors. To give an example, the famous self-help bestseller "Who Moved My Cheese" sold over 3 million copies in China. It is estimated, however, that the pirates sold another 6 million copies. The Harry Potter books, and other best sellers like Hilary and Bill Clinton's books "Living History" and "My Life," John Grisham's books and others all face a similar fate from the pirates. Former General Electric President, Jack Welch's biography, "Winning," has sold over 800,000 copies but with an equal number of pirate copies available in the market. English language textbooks are also heavily photocopied in their entirety and there are six known websites which make available entire copies of textbooks that are downloaded and then photocopied. Enforcement against this vast piracy is spotty and all done administratively through the local and national copyright bureaus. Any resulting administrative fines are non-deterrent. We know of no criminal enforcement. The book publishing industry also faces market access barriers – U.S. publishers are not permitted to publish, sign authors, or print their books in China.

The recording industry, represented by IIPA member, the Recording Industry Association of America (RIAA) did experience a minor reduction in the piracy rate for sound recordings, from 90% in 2003 to 85% in 2004 in "hard goods" piracy, but with significant increases in Internet piracy. Losses remain in excess of \$200 million per year from continued optical disk manufacture and distribution within the Chinese market and significant levels of audiocassette piracy (still an important format in China). The recording industry faces many of the same problems with optical disk piracy confronting the motion picture industry. Millions of pirated music CDs are readily available throughout China. Some of these pirate products have found their way into the export market. China continues to rely on its failed administrative enforcement system, which relies on numerous inspections, product seizures and, when the pirate doesn't flee, the imposition of small, non-deterrent fines.

> Internet piracy in China, as in other countries in the world, has become a huge problem for the recording industry. Thousands of active websites such as www.9sky.com and www.chinaMP3.com are giving away, or offering links to, thousands of pirated songs. (These not-for-profit acts of piracy are not criminalized in China, as they are, for example, in the U.S.). International criminal syndicates are apparently using Chinese servers to hide their illicit activity (www.boxup.com) and many Asian pirate sites are doing a thriving business in China, such as www.kuro.com from Taiwan.

Market access restrictions are severe, contributing to piracy and market losses. U.S. record companies cannot "publish" or release a recording without permission of a state owned company and cannot manufacture, distribute or engage in retailing of its products, which artificially segments the market and makes it extraordinarily difficult for this world class industry to participate in the Chinese market. Its products are subject to censorship while domestic (as well as pirate) recordings are not – a national treatment violation.

All in all, the copyright industries estimate their total losses in excess of \$2.5 billion in 2004 due to piracy in China. The simple fact remains that these losses and the 90% piracy rates will NOT be significantly reduced without subjecting major piracy to criminal enforcement accompanied by deterrent penalties and substantially increasing the administrative fines specified in the copyright law and imposing them in practice. To date, even after the JCCT commitments, this has NOT happened and there is a real question

whether the Chinese government as a whole (Vice Premier Wu Yi has been a staunch defender of better enforcement) can muster the political will to take these absolutely necessary actions – actions that have been key to significant reductions in piracy levels in other countries in which our companies operate. China cannot exempt itself from the rules – that enforcement against piracy requires deterrence and criminal remedies. The global community recognized this when it fashioned the Article 61 criminal obligation in TRIPS and it has proven to be the case in practice.

The Commission has asked the key question that has trouble everyone associated with China's IPR regime: "Will China ever enforce its IPR laws." The article in the Far Eastern Economic Review,¹ provided to us by the staff, sets out the interesting thesis that this failure has nothing to do with "stages of development" or "cultural attitudes." We completely agree. These shibboleths have regularly been argued to excuse China (and other countries) from meeting their freely bargained-for WTO obligations. In fact, other countries have similar "cultural attitudes" and are at or near China's development level and they have done a far better job bringing deterrence to their copyright enforcement system thereby reducing piracy rates. Piracy is an economic crime and responds to economic disincentives placed in the pirates' way by an effective, deterrent enforcement system. If the risk is too high, the conduct will cease or be substantially reduced. The authors also set out the view that Chinese government control over its economy and the "command" nature of the government's involvement contains built in incentives to continue to *permit* infringements as a way of protecting tottering state-owned enterprises. We have no expert view on this but observe that China has sought to preserve the import and distribution monopolies that are pervasive in the copyright sector. The thesis seems to apply more, however, to the patent and trademark areas of IP protection, rather than to copyright, where it is becoming clearer to us at least that the harm from copyright piracy is falling increasingly on Chinese creators and Chinese companies (some rather large too). These companies, because they are either state-owned (and find it difficult to confront their own government for its failures), or are private (and the government, like many governments in developing economies, are not yet responsive to the entreaties of their private sector) face a governmental response that derives primarily from internal bureaucratic needs, first and foremost. An illustration might be the apparent unwillingness of the Chinese authorities to lower the thresholds for initiating a criminal prosecution so that they become workable in practice (a result not accomplished in our opinion in the new Judicial Interpretations issued in December 2004) and to follow with criminal prosecutions and deterrent penalties. The reason given is that bringing more criminal cases would risk overwhelming the enforcement bureaucracy. However, many other governments face this same potential argument and have nevertheless determined that criminal enforcement is a necessary condition to reducing piracy (as well as being a WTO obligation). Furthermore, we should not underestimate the problem that the central government faces in controlling what happens at the provincial level. We believe, however, that, through the Politburo and the Party structure, this impediment can be overcome, if the political will is there. It may be that such political will CAN be generated if the proper "incentives" are there. An example of this would be when the Chinese government (at the highest "political" level), in 1996-97, closed many of the CD factories that were exporting pirate optical disk product globally under threat of U.S. trade retaliation.

Regardless of the reasons why the Chinese government has not, at least yet, decided to take deterrent criminal actions against major acts of piracy (as required by TRIPS), to make necessary amendments to its criminal law (as required by TRIPS), to further amend its Judicial Interpretations to reduce the hurdles to effective criminal prosecutions, and to increase administrative penalties and impose them at deterrent levels, they are nevertheless under an international obligation (in the WTO), and a bilateral obligation (under the 1995-1996 bilateral agreement settling the Section 301 case) to do so. Moreover, it is not in China's own interest to undermine its own domestic creative industry and to continue to foster trade friction with its key trading partners. Other governments in the Asian region have made the political determination that effective enforcement is in that country's own interest. China must do the same and do so NOW.

Thank you very much for the opportunity to participate in this Roundtable.

Notes:

1. Anne Stevenson -Yang and Ken DeWoskin, China Destroys the IP Paradigm, Far Eastern Economic Review (March 2005)