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# Intellectual Property Rights

Infringements on intellectual property rights (IPRs) have been steadily increasing, according to US business firms, and China is the leading violator. According to Bergsten et al. (2006, 95), “China’s failure to protect intellectual property . . . is probably the second most important source of friction in the bilateral U.S.-China economic relationship.” Annual US losses on a global basis for copyright violations alone have been estimated at between \$2.5 billion and \$3.8 billion.<sup>1</sup> In the last five years there has been an 80 percent increase in US International Trade Commission proceedings involving IPR violations from foreign countries (USTR 2006). In 2004 China accounted for 63 percent of the total value of infringing products seized by US Customs. The next highest source was Hong Kong, accounting for 6 percent; India and Russia accounted for 4 percent combined.<sup>2</sup>

IPR violations were a clear priority and emphasized throughout the Top-to-Bottom Review on China published by the USTR in February 2006. Indeed, the IPR problem with China was mentioned in five of the six “key

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1. See USTR’s Out of Cycle Review Results, available at [www.ustr.gov](http://www.ustr.gov).

2. See US Customs statistics on Top IPR Seizures 2004, available at <http://cbp.gov>. The total value of seizures was only \$87 million in 2004; however, the great bulk of counterfeit products are sold outside the United States.

3. The six objectives are participation, implementation and compliance, enforcement of US trade laws, further market access and reform, export promotion, proactive identification, and resolution of trade problems. Participation was the only category where IPRs were not mentioned.

China trade objectives and priority goals.”<sup>3</sup> The steps outlined in the “key actions” were meant to address IPR violations through additional personnel, consultations with US companies, improved mechanisms for US IPR holders to bring cases to the Chinese authorities, and technical exchanges between the United States and China regarding detection and enforcement.

IPRs are slowly becoming a domestic priority within China as well. During President Hu Jintao’s visit to Microsoft on April 18, 2006, he assured Microsoft Chairman Bill Gates that China would “earnestly protect intellectual property rights. We will honor the pledges we made. The Chinese side has already stepped up our legislative efforts and law enforcement to protect intellectual property rights.” The visit and pledge underscored the growing role private firms play in providing incentives and pressure for increased IPR protection.<sup>4</sup> Yet while the Chinese government has taken steps to curtail infringements, many contentious differences separate China and the United States. For any country to meet international norms, it must have an adequate institutional system to support IPR protection. Enforcement requires a legal framework, inclusive of processes for registration, disputes, and appeals, complemented by good police work and a competent judicial system (Lian 2006).

Few of the conditions for protecting IPRs are met within China. There are many IPR agencies, but they work with little coordination. The agencies may decree conflicting regulations, which are ignored in any event. Government incentives may even favor violating IPRs because public officials are evaluated on the economic performance of their constituencies, and some local firms may be IPR violators (Bender 2006). China has become a party to numerous IPR treaties (appendix table A.4), but it still lacks a domestic institutional system that can effectively protect IPRs.

A major shortcoming is weak enforcement by Chinese provincial authorities. According to Article 61 of the WTO’s Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), IPR laws should be enforced to deter wrongdoers.<sup>5</sup> Raids and seizures have increased in China, but their deterrent effect seems slight owing to inconsequential penalties. Infringing products color 90 percent of the market in almost every copyright sector in China (IIPA 2005a). Slow investigations, weak prosecution, and low fines all undermine the enforcement effort. To launch a criminal investigation, high monetary proof-of-sale thresholds must be satisfied, calculated on the value of the infringed product rather than the original good (\$24,100 for enterprises; Bender 2006). Though the Chinese government reported a 25 percent increase in IPR-related criminal prosecutions for the first half of 2005 (to 1,549 cases), sufficient infor-

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4. See “US: We Mean Business on Piracy, Hu tells Gates,” *South China Morning Post*, April 20, 2006.

5. For the text of the TRIPS agreement, see [www.wto.org](http://www.wto.org).

mation is not available to assess the scope or impact of these cases. Trademark prosecutions are on the rise, but copyright prosecutions are rare. Moreover, there has been a steady reduction in the number of cases that administrative authorities forward to the Ministry of Public Security for Criminal Investigation: 86 in 2001, 59 in 2002, 45 in 2003, and 14 in the first half of 2004 (IIPA 2005b). Regardless of weak IPR protection in China, from 1995 to 2002, US royalty and fee receipts from Chinese enterprises increased by 300 percent, suggesting that US companies are increasingly comfortable with China as a production location. However, since 1994 there has been a decrease in royalty receipts from nonaffiliated firms compared with receipts from affiliated firms.<sup>6</sup> US firms evidently prefer to transfer intellectual property to Chinese firms that they control, as it allows a greater degree of protection against leakage and IPR infringement (Lian 2006).

The weakness of official criminal enforcement has spurred private initiatives. In one case, David Benner of Pfizer reported a man he suspected of producing fake Viagra. The ensuing investigation resulted in 12 arrests and seizure of almost half a million pills. Though the Chinese authorities assisted in the case, much of the investigation and progress was due to Pfizer's initiative.<sup>7</sup> In another case, brought by GM Daewoo, enforcement was complicated by the fact that a local government was implicated in the IPR infringement. In January 2005 GM Daewoo sued Cherry Automobile Company, owned partly by the local Chinese government, for producing the QQ, a car virtually identical to GM Daewoo's Spark.<sup>8</sup> As in other private actions, GM Daewoo will be fortunate to recoup its litigation costs alone. Another concern with civil litigation is the inability to enforce judicial decisions: It is estimated that only 40 to 60 percent of final verdicts are carried out, and perhaps only 10 percent when officials in other jurisdictions are needed to execute the judgment (Bender 2006).

Another impediment to IPR protection is that China's industrial policies often abet infringement by delaying the release of legitimate goods. This delay allows counterfeit goods to dominate the market for a considerable period (IIPA 2005b). Aware of these problems and complaints, in April 2004, at the fifteenth annual meeting of the Joint Commission on Commerce and Trade (JCCT), China committed to ensure a significant reduction in IPR infringements; pursue a greater range of criminal investigations and stiffer penalties, applying criminal sanctions to persons with

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6. Affiliate and nonaffiliate transactions are differentiated by a threshold of 10 percent equity shareholding.

7. See Nicholas Zamiska and Heather Won Tesoriero, "Drug Headache: As Battles Fakes in China, Nation's Police are Uneasy Allies," *Wall Street Journal*, January 24, 2006.

8. See "China Pressed to Forcefully Attack Intellectual Property Theft," US Department of State, International Information Programs, January 1, 2005, available at [www.usinfo.state.gov](http://www.usinfo.state.gov) (accessed May 22, 2006).

secondary involvement in pirated and counterfeit products; bring nationwide enforcement actions and increase customs enforcement; ratify and implement the World Intellectual Property Organization (WIPO) Internet treaties as soon as possible and extend the ban on pirated software to local governments; launch a national IPR education campaign;<sup>9</sup> and establish a working group under the JCCT to work with the United States on IPR issues.

Two years later infringement continued to be high, and IPRs were therefore a key discussion topic at the seventeenth annual JCCT on April 11, 2006. China made further pledges at that meeting, including a special campaign focusing on pirated optical disks and legislation requiring legal software to be preloaded on all computers produced and imported into China. To ensure that the public sector did not use infringed products, the Chinese team also discussed US proposals regarding government and state enterprise procedures for managing software assets. China agreed to pursue individual IPR cases raised by the US government and adopted a broad plan to improve overall IPR enforcement.<sup>10</sup> Although the campaign against pirated optical disks and the legislation requiring preloaded software are promising, the JCCT meeting was longer on rhetoric than substance. New Chinese commitments appear minimal, given the very large scale of IPR infringement.

## Accomplishments

In August 2004 the State Council proclaimed a concentrated effort to decrease IPR infringements in sectors where they were common. The campaign lasted until the end of 2005. Though there have been more raids and seizures, fines remain low, and it is still profitable to manufacture pirated goods and pay the fine if caught. It is also not known what happens to the seized materials; some reportedly reenter the market. Only some provinces and municipalities have taken measures to comply with the ban on illegal software.<sup>11</sup>

In November 2004 China's Ministry of Public Security for Criminal Investigation began Operation Mountain Hawk, which outlines procedures for cooperation between national and local police when investigating cases.

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9. As promised, in 2004 an educational awareness campaign was launched. An example of the program includes the broadcasting of a television program called "Intellectual Fortune" in 20 provinces. It is too early to tell what effects the campaign will have. See USTR's Out of Cycle Review Results, available at [www.ustr.gov](http://www.ustr.gov).

10. See US Department of Commerce, press release, "The US-China Joint Commission on Commerce and Trade (JCCT) Outcomes on US Requests," April 11, 2006.

11. See USTR's Out of Cycle Review Results, available at [www.ustr.gov](http://www.ustr.gov).

In December 2004 China announced new judicial interpretations that lowered the minimum threshold required for a criminal conviction for IPR violators.<sup>12</sup> In line with its commitments at the 2004 JCCT meeting, the new interpretation held accomplices liable to prosecution but also deleted the stiffer penalties on repeat offenders and made violations criminal only if done “for profit.” The “for profit” qualification will presumably insulate from criminal prosecution those individuals who download computer software and entertainment and music files for their personal use.

China and the United States increased their cooperation on enforcement matters starting in late 2004. August 2004 marked the first US-China joint investigation effort, Operation Spring, in which a counterfeit DVD export ring was closed down and six people arrested. In November 2004 US and Chinese commerce agencies produced guidelines for case reviews. When US companies report violations, Chinese authorities undertake an interagency review, and with enough evidence, the case is brought to the Ministry of Commerce.<sup>13</sup> The first case brought through this mechanism was launched by the National Basketball Association (NBA): 12,000 slippers were confiscated and an administrative penalty applied.<sup>14</sup>

In early 2005 the USTR conducted an Out of Cycle Review to determine China’s progress in meeting the commitments it made in 2004. The report found that China’s IPR infringements had not been reduced, and therefore the USTR took several actions. In April 2005 USTR elevated China onto its Priority Watch List, meaning more intense surveillance. In October 2005, in accordance with Article 63 of the WTO TRIPS agreement, the United States requested a first round of information on China’s enforcement mechanisms and proceedings.<sup>15</sup> This step was widely seen as a precursor to a US WTO case against China for violating the TRIPS agreement.

Regarding the commitments made by China during the seventeenth JCCT meeting held in April 2006, it is too early to determine whether the government will effectively implement its action plan and deliver on other promises. China has already closed a number of factories producing pirated optical disks; according to Chinese Vice Premier Wu Yi, as of March 2006, 224 production lines had been closed.<sup>16</sup> To implement recent

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12. See USTR, Positive List Of Developments: May 2004–April 2005, available at [www.ustr.gov](http://www.ustr.gov).

13. See USTR, Positive List of Developments: May 2004–April 2005, available at [www.ustr.gov](http://www.ustr.gov).

14. See Clearance Case of Commodities Infringing “NBA” Trademark in Fuzhou, China’s State Office of Intellectual Property Protection of the People’s Republic of China, available at <http://ipr2.mofcom.gov.cn/column/representativecases.shtml> (accessed July 11, 2006).

15. See USTR’s Out of Cycle Review Results, available at [www.ustr.gov](http://www.ustr.gov).

16. See press conference at the Annual Meeting of the US-China Joint Commission on Commerce and Trade, available at [www.ustr.gov](http://www.ustr.gov).

legislation requiring preloaded software, several Chinese computer manufacturers have agreed to purchase US operating systems. Most notably, in April 2006, Microsoft signed four new agreements with Chinese manufacturers to preinstall Windows.<sup>17</sup> The largest of these agreements was made with the Lenovo Group, China's top computer maker and owner of IBM's former PC division; the agreement has an estimated value of \$1.2 billion over the next year. The chairman of Lenovo claims that the new legislation has an impressive impact, estimating that 70 percent of Chinese customers are now purchasing computers with Windows XP installed, compared with 10 percent in November 2005.<sup>18</sup> While these initial steps seem promising, it remains too early to judge the outcome of the 2006 JCCT agreements.

## Evaluation

IPR protection is a problem for every country, including advanced nations. While China's rhetoric has improved, infringements continue to be rampant. Though infringements may decline in the long run, major improvements seem unlikely in the near future, unless China steps up its enforcement effort substantially. WTO cases brought under TRIPS are likely to be drawn out, and successful results may well cover only a single sector or a single province. The United States can nudge the process forward by targeted countermeasures, especially in the wake of a successful WTO case, but ultimately IPR protection depends on China, and unfortunately, economic incentives in China continue to favor violations.

The central government has launched initiatives to reduce the number of IPR infringements, but the provincial and municipal governments often view infringement more as a commercial opportunity than a civil or criminal offense. Without the support of local officials, IPR enforcement will continue to be difficult, even with the central government's lead. Possible solutions include insisting on better funding for enforcement bureaucracies and creating a system of incentives to engage broader support for IPRs. Bounties might be paid to private citizens and public officials who report or apprehend violators. China should also welcome corporate measures and self-help in the broader campaign to protect IPRs. In this respect, the recent initiatives on preloaded software could provide a model for wider application.

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17. See Joseph Kahn, "Chinese Leader Focuses on Business as 4-Day US Visit Begins in Washington State," *New York Times*, April 19, 2006.

18. See Richard McGregor, "Ho Trip to Seattle Lifts Hopes of Sea Change in Piracy Policy," *Financial Times*, April 19, 2006.

The concerns about the relationship between Chinese government and business that run through IPR issues also have national security implications, which came to a head in the summer of 2005 over a bid by the China National Offshore Oil Corporation (CNOOC) to acquire US oil company Unocal. The attention paid to CNOOC in 2005 was surpassed by the US public outcry in early 2006 over the Dubai Ports World acquisition of terminal operations in six US ports. However, the upshot of these two cases is a strong congressional push for greater scrutiny of foreign acquisitions of US companies and assets, which means that national security issues are likely to affect US-China commercial relations in the future, as the next chapter discusses.