

CAN CHINA FINALLY FOLLOW- THROUGH ON ITS COMMITMENTS?

Christina Almeida

Introduction

The United States feels that China is not properly combating the violation of Intellectual Property Rights and thereby is not following the agreed upon rules of the World Trade Organization with respect to Intellectual Property Rights. The World Trade Organization (WTO), which encompasses the principles established under the General Agreement on Tariffs and Trade, is a legal basis for regime treaties between countries. In order to become a WTO member, a country must agree to abide by a set of clearly defined and agreed upon rules. In particular, part three of the WTO agreement states that the WTO's intellectual property (IP) agreement incorporates rules for trade and investment in ideas and creativity. IP should be protected when international trade is involved. The WTO Agreement on Trade-Related aspects of Intellectual Property Rights (TRIPS) is essential to the insurance and enforcement of protection of the IPR of all countries. TRIPS "stipulates specific obligations related to the administrative and judicial procedures including, inter alia, provisions on evidence, injunctions, damages, measures at the border against counterfeiting, and penalties" in the case of IPR Violations.¹

After China's accession to the WTO in 2001, the Chinese committed to reform its policies in order to implement and impose WTO rules, including the protection of Intellectual Property Rights. More than a decade later, China is now considered the world's largest infringer on U.S.-owned copyrights, patents, trade secrets, and trademarks.² China's continuous IPR violations are due to several "shortcomings" in its IPR regime. The protection of IPR is an elemental WTO commitment and China's record is one of the worst regarding this commitment. Infringement of U.S. companies' IP results in lost sales to China from the United States and other countries, lost royalty payments, and it also presents a great risk to U.S. and Chinese consumers who may unknowingly purchase unsafe, counterfeit pharma-

ceuticals. The level playing field promised as part of China's WTO ascension has not yet arrived, and with its tardy advent, the WTO has failed to make a concerted effort to combat China's evident violation of its own regulations regarding IPR protection.³

Resulting from China's consistent disrespect for IPR, U.S. intellectual property-intensive firms have lost an estimated near \$50 billion due to China's IPR violations. These same companies reported that better enforcement in China could lead to around one million new U.S. jobs.⁴ Because of China's state capitalism and inadequate governance, the consequences of China's failure to abide by WTO regulations is incessantly aggravated by the WTO's comparative inability to efficiently deal with China's "mercantilist state-directed" economy.⁵ The Chinese government must take action against violators, and China must be held responsible for its actions—or lack thereof—and adequately be disciplined.

Large and popular companies are the main losers in the battle for IPR protection in China. Due to this dynamic, it is no surprise that sizeable international companies like Apple have faced a myriad of challenges in securing its patents. In fact, the company perfectly exemplifies the exceptionally weak IP protection that is generally afforded to big foreign firms by the Chinese government. Apple continuously files cases of IPR violations in China to no avail. In 2011, the loopholes in the company's IPR protection were highlighted by the opening of a fake Apple store in Kunming, the capital of the southwestern Chinese province of Yunnan. An IP professional, Horace Lam, even commented that with a lot of big listed U.S. companies their "IP protection is a joke."⁶ China's lack of IP protection is realized in the form of steep costs to companies because patents can be used without compensation, which allows for the development of its competitors in China. The cost of protecting IPR in China is only a "fraction of that in the west... anybody who doesn't spend \$4,000 extending their foreign patents to China needs their head examined."⁷ In fact, that same year after a prolonged dispute between Apple and Proview Technology, a Taiwanese-owned company registered trademarks for the name IPAD in several countries before Apple did.⁸ The first step in aiding this rampant violation of IPR by China is to identify and then analyze previous attempts that have failed to remedy the situation.

Background & Dissection of the Problem

Throughout the past two centuries, the United States has seen dramatic shifts in foreign trade and global economic policies. Since the Great Depression, WWII, and the Cold War, the U.S. has wholly embraced the liberalization of trade. After the Great Depression and WWII, Americans became convinced that free trade would promote economic growth, social stability and instill confidence in a free-market system based on fairness, transparency and the rule of law. Inspired by these shared beliefs, U.S. policy makers forged a bipartisan consensus towards trade liberalization by building on the momentum of the Bretton Woods conference, which formed the General Agreement on Tariffs and Trade (GATT) in 1947. Even through the Cold War, Presidents such as John F. Kennedy and Ronald Reagan continued to promote free trade by enacting significant tariff cuts and trade expansion. Traditionally, the U.S. has utilized a multilateral approach with respect to trade. However, despite the commitment to multilateralism, the U.S. has begun to pursue bilateral trade agreements with other countries. Bilateral negotiations and discussions concerning IPR between the U.S. and China date back to the mid 1970's. Nevertheless, as time has passed, the U.S. and other countries remain disgruntled by China's slow or non-existent progress in implementing the rules and regulations pertaining to IPR. The U.S. even threatened China with enormous trade sanctions under section 301 of the US Trade Act of 1974, pushing China to sign a "memorandum of understanding on IPR protection," yet China continued to fail.⁹ Evidently this threat did not frighten China enough to cause them to do something about the violations.

Chinese local protectionism and corruption are two large supplementary problems for the defense of IPR. Under local Chinese government, IPR infringers feel safe enough to ignore IPR laws passed by the country's central government and/or the international community. Large-scale corruption in China makes IPR infringement an appealing option for local officials. It is due to this misconduct that counterfeits bypass the customs. Furthermore, local coordination amongst varying government IPR enforcement authorities is almost non-existent, making preventative actions against IPR infringement all the more difficult. Chinese enforcement officials, especially local ones, are often not qualified and do not have the skill or comprehension to follow through on complex IPR protection policies. In essence, there

is a manifest lack of transparency, as governments are still unwilling to “provide detailed information about IPR enforcement activities and IPR infringement damages.”¹⁰

The TRIPS Agreement was a precondition for accession to the WTO, and China worked to upgrade its protection of IPR in order to abide by TRIPS standards. China was finally granted membership although many doubts continued to circulate about China’s capability to comply with TRIPS. Shortly thereafter, China enacted a long list of laws, rules, and regulations on IPR in accordance with the TRIPS protocol; however, vagueness in the legislation linked to IPR protection led to complications in the enforcement process. In 2002, a study was conducted by Keith E. Maskus for the World Bank on China’s pre-WTO entry compliance with TRIPS that pointed out at least “twenty-two areas where China fell short, suggesting that China needed to make substantial legislative changes to comply with the TRIPS norms.”¹¹ The Chinese government is too dependent on administrative IPR enforcement, and thus only a small amount of IPR infringement cases are properly dealt with by the judicial system. From 2001 to 2004, Chinese administrative organs allegedly reviewed 169,600 cases of trademark and regulation violations while only 286 cases were actually transferred to judicial forums.¹² Effectively, the country’s actions illustrate and depict the extent to which the lack of strong judicial support and influence can adversely affect the efficiency of IPR enforcement.

China faces several challenges after becoming a WTO member as it continues to undermine IPR protection under the TRIPS Agreement of the WTO. In the early 2000’s, the U.S. and China dealt with IPR violations through lawsuits handled at the local level in China. When an IPR infringement dispute occurs:

The infringed party can launch a lawsuit against the infringing party at the special IPR tribunals of the courts in China. China’s court structure consists of four tiers: the Basic People’s Court at the district level, the Intermediate People’s Court at the city and prefecture level, the Higher People’s Court at the provincial level and the Supreme People’s Court at the national level.¹³

In order for the infringed party to win, they must prepare a painstaking amount of evidence. If the plaintiff wins and the case is serious enough

to constitute a crime, the punishment can include a fine, detention, or a fixed-term of imprisonment of at most seven years.¹⁴

In the past, the United States and China have dealt with IPR infringement in many ways. Locally, they have worked bilaterally through the use of judicial and administrative enforcement mechanisms. However, several other strategies have been endeavored, such as the U.S.-China Joint Commission on Commerce and Trade (JCCT). The JCCT was established in 1983 as a government-to-government consultative mechanism and was instituted with the intent to fashion a medium for settling trade disputes and discussing bilateral commercial opportunities. Beginning in 2003, President Bush and Premier Wen restructured the JCCT, requiring that it hold annual comprehensive meetings. The JCCT also involves a variety of ongoing dialogues that take place throughout the year, which typically include an array of topical issues increasingly of chief concern such as intellectual property rights. The JCCT is a process, and through it “the United States sought resolutions to particular pressing trade issues while also encouraging China to accelerate its movement away from reliance on government intervention and toward full institutionalization of market mechanisms.”¹⁵ Another method for the assessment of WTO member compliance is the Transnational Review Mechanism, which is a multilateral apparatus used in international relations with China. Meetings took place annually for the first eight years, after China became a WTO member, in front of 16 WTO committees and councils with a final review in its tenth year. China agreed to this special WTO system, which requires an annual review of the efforts that it has made to comply with its commitments to the organization.

Starting in 2005, China’s progression towards market liberalization began losing momentum. Speculation began to warrant concern from the U.S. that the Chinese government policies reflected that it had still not completely embraced the WTO principles of non-discrimination, market access, and transparency. It was placed on the Special 301 “Priority Watch List,” which means that China is monitored under Section 306 of the Trade Act.¹⁶ Along with placing China on the Priority Watch List, on which it currently remains, the U.S. created an in-depth strategy (including possible use of WTO mechanisms) to address China’s inefficient IPR enforcement regime. Through this strategy, the U.S. “sought China’s agreement through the JCCT process to take a series of specific actions designed to fix many of the China-related IPR problems, among other things.”¹⁷ Unfortunately, this strategy did not

prove to be effective.

Recent U.S. Policies

In the past five years, the U.S. has attempted to employ a multitude of varying strategies and tactics in order to combat IPR violations. In 2007, the U.S. filed a WTO case against China, focusing on flaws in the Chinese legal regime for protecting and enforcing copyrights and trademarks. However, the case did not provide “sufficient factual information” for criminal prosecution and liability.¹⁸ Currently, one of the major tools of U.S. Foreign Policy towards China (and other countries such as Sweden) is the ability to file a case against a WTO member that it believes is in violation of a rule. The WTO refers to these as “dispute settlements.” The system works on detailed and clear rules with timetables for completing a case.¹⁹ Despite the aforementioned, the filing of dispute settlements is seemingly rendered ineffective due to the fact that most cases take too long to go through the process and because the WTO is prohibited from restricting trade.

Presently, the overall picture of our relations with China remains complex. One method of dealing with the IPR infringement issue is seizing counterfeit items at the border. U.S. Customs and Border Protection’s (CBP) seizure of data provides insight into the U.S.’ Chinese imports. CBP reported that China was the source of 79% of all U.S. Customs seizures in the fiscal year 2009, while Hong Kong was the source of another 10%. Similar to previous years, footwear and apparel made up the bulk of these seizures.²⁰ The CBP and General Administration of Customs (GAC) strongly encourage brand owners to record their sales in their databases in order to aid in the detection and seizure of counterfeits. There are limited U.S. receipts of royalties and license fees from IP-sensitive services exports to China, which reveals a discrepancy in comparison to the rest of the world. The disparity can largely be attributed to IPR infringement and market access restrictions in China. In 2008, receipts of \$2 million from China for certain copyrighted materials were a small part of the total \$1.5 billion in receipts from the rest of the world. In some instances, the U.S. Department of Justice has prosecuted cases involving theft of trade secrets that have resulted in substantial fines and imprisonment.²¹ The bigger the royalty and license fee flows, the stronger the IPR protection becomes.

Current U.S. Policies

In 2010, the U.S. attempted to work bilaterally with China to remedy the continuing IPR protection problem. The U.S. has been “frank in expressing its view that the two sides need to redouble their efforts going forward.”²² Moreover, the U.S. has continued to reach out to the WTO. Last year, the U.S. focused on “outcome-oriented” dialogue at all levels of engagement, while simultaneously taking real steps to protect U.S. rights under the WTO when China’s actions have been alarming. In 2009, U.S. President Obama and Chinese President Hu orchestrated another apparatus aimed at formulating the highest-level bilateral forum between the two countries to date. The high-level bilateral forum is referred to as the U.S.-China Strategic and Economic Dialogue (S&ED). The formation of the S&ED represented a pivotal step in advancing a “positive, constructive, and comprehensive relationship between the two countries.”²³ The S&ED takes place annually and examines strategic and economic paths. In the economic field, U.S. and China agreed on four promotional pillars, which established the foundation of their economic engagement over the course of the administration.²⁴ Despite China’s repeated anti-piracy campaigns and an increasing number of civil IPR cases heard in Chinese courts, overall piracy and counterfeiting levels in China remained unacceptably high in 2011. The “U.S. industry estimates that levels of piracy in China across most lines of copyright products except business software ranged between 90% and 95% while business software piracy rates were approximately 80%.”²⁵ These numbers are way too high and it is time for the U.S. to provide sustainable guidance and support for this emerging yet extremely powerful global market.

Analysis and Conclusion: What Should We Do?

If China can decrease IPR violations, both the U.S. and the Chinese economy will stand to greatly benefit. Patrick G. McLennan from the University of Denver and Quan V. Le from the Department of Economics at Seattle University examined the relationship between intellectual property rights and the growth rate of per capita GDP from 1996-2006 in a study that surveyed 71 countries. With software piracy data as their proxy for IPR violations, they found that countries with “increasing rates of software piracy have lower growth rates,” and that “states with strong commitments to enact policies to protect intel-

lectual property rights are able to achieve higher growth rates.”²⁶ In a conclusion to their study, they note that since 2003 China’s piracy rate has dropped ten points (on their scale) due to “stronger enforcement actions and government-driven agreements with original equipment manufacturers (OEMs),” which is certainly a positive.²⁷

According to the International Data Corporation (IDC), China has added over 800,000 jobs to its IT sector and 220,000 of those new jobs are attributed to lower government software piracy. The reason for this phenomenon is that, as the violation of IPR decreases, more Multi-National Corporations (MNCs) are willing to invest and do business in China. China’s position on IPR is currently one of the biggest barriers to market entry for MNCs, thus incentivizing them to defer from engaging in business relations within the country. With increased MNC investment, local (domestic) companies will become progressively more multinational, thereby mitigating incentives for them to use pirated software and encouraging the use of legitimate technology.²⁸ Ultimately, this will lead to an increase in jobs, and, in turn, the process will yield higher economic growth. In this scenario, both the U.S. and China win.

Although China has emerged as one of the world’s leading powers, it has become increasingly dependent on the U.S. in order to sustain its growing economy. The Chinese economy has increased its dependence on the United States recently according to Beijing and Washington trade figures. China’s trade surplus with the U.S., through the first 11 months of 2011, was \$272.3 billion—a 7.9% increase from 2010. The Commerce Department predicts that China’s surplus against the U.S. will reach over \$300 billion for 2012. Therefore, if we assume China’s December surplus this year is zero, then 175.6% of China’s overall trade surplus last year will be due to sales to the U.S.²⁹ Simply put, China needs the U.S. to buy their exported goods. Beginning in 2009, China became the U.S.’ second-largest single-country trading partner based on two-way trade and account for 14.5% of U.S. global trade. Reported by “the Chinese Ministry of Commerce (MOFCOM), the United States was China’s fifth-largest FDI provider in 2009, accounting for 4% of total FDI.”³⁰ Considering our long relationship with China and their increased dependency on U.S. consumption of their goods, negotiating with China would be a fairly reasonable task.

Before any negotiations or policies can be implemented between China and the U.S., the U.S. must come to an agreement with the WTO—explaining the situation, the plan, the potential positive

outcomes, and concluding what exactly the U.S. can do as far as concessions and punishments. If the U.S. can garner the full support of the WTO, then the first policy recommendation I suggest is that we offer China a fixed amount of time to correct their IPR infringement problem, offering concessions if it reaches the agreed benchmarks and penalties if it fails to do so. Small steps are essential, as this is not an issue that can be fixed overnight. In order to offer a realistic amount of time, several factors must be considered. Somewhere around five years is a rational amount of time for China to reach its first agreed upon benchmark. The U.S. should offer China a tariff reduction on Chinese imported goods as an incentive for China to strengthen its IPR enforcement regime. If China can significantly lower its rate of IPR infringement within the outlined five-year period, the U.S. should agree to lower U.S. tariffs on Chinese goods by up to 5% or in proportion to how positive the changes in Chinese IPR violations are and depending on what the WTO will allow.

The rate of IPR infringement can be measured through data collected annually from U.S. intellectual property-intensive firms, which previously reported huge losses due to China's IPR violations. If they continue to undermine IPR protection rules under the TRIPS Agreement of the WTO and the violations continue at their current rate or increase within the five year benchmark, the U.S. will directly punish China through a significant increase in tariffs, thereby lowering U.S. consumption and devastating their progressively dependent economy. To further evaluate China's progress, the U.S. can conduct a similar study comparing to the one previously discussed, using different forms of IPR infringements like software piracy as a proxy. Chinese local and central government officials need to understand the positive correlation between increased IPR protection and high economic growth. I also suggest that the findings be publicized in China in an attempt to further our goal. Granting people access to this information will not only increase public awareness surrounding the issue but will also allow the U.S. and China to gain support in the plan to stop IPR violations. Depending on how fast China can decrease IPR violations, it has the potential to witness the creation of over two million new jobs, which could feasibly contribute almost \$70 billion in tax revenues to governments worldwide in less than five years.³¹ This outcome is extremely beneficial for both countries.

Lastly, the U.S. must consider exactly how China can successfully increase the protection of IPR. First, legislation linked to IPR

protection must be more detailed, and as it becomes clearer and more concise, the enforcement of protection will become easier to execute. Second, China must better organize its government from higher level to lower level officials and call for full cooperation amongst all of its citizens. The local and centralized government officials must come to a greater level of collaboration through improved communication and by sharing a common goal to better their economy and foreign relations, particularly the protection of IPR. This new cooperation will discourage local protectionism and root out some of the corruption. If all goes as planned and IPR violations decrease, the Chinese and U.S. economies will prosper. China will have no other option but to trust the U.S. and our new policies because it cannot sustain growth without the U.S.' consumption of their goods (which would drop with increased tariffs). Within five years, China could have even more U.S. consumer spending due to decreased tariffs, millions of new job opportunities, and most importantly, the U.S. could stop losing jobs and money due to China's IPR theft and recognize the direct monetary gain from tax revenues. Both the U.S. and China will experience high economic growth if this new policy agreement is correctly implemented.

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