95-294 E
February 21, 1995

CRS Report for Congress

Congressional Research Service • The Library of Congress

The China-U.S. Trade Dispute on Intellectual Property Rights

Wayne M. Morrison
Analyst in International Trade and Finance
Economics Division

SUMMARY

Allegations of China's inadequate protection of U.S. intellectual property rights (IPR) have been a source of trade tension between the United States and China over the past few years. On February 4, 1995, the United States Trade Representative (USTR) announced that he would impose sanctions on an estimated $1.08 billion worth of Chinese products unless China (by February 26, 1995) takes significant steps to improve its IPR enforcement regime and improve market access for U.S. products. This report examines the history and status of the current U.S.-China IPR dispute and discusses possible trade policy implications of the dispute.

WHAT ARE INTELLECTUAL PROPERTY RIGHTS?

Intellectual property rights refer to legal forms of protection (including state, national, and international laws) of various intangible assets which result from research, innovation, creativity, and commercial reputation. Protected intellectual property rights mean that various intangible property cannot be copied, used, changed, or sold without the authorization of its owner. Legal methods of protecting intellectual property include patents, copyrights, and trademarks. A *patent* is a governmental grant of a property right to the inventor of a product or process (which is new and has industrial application) that gives the patent holder exclusive right to the invention over a limited period of time. A *trademark* is any word, symbol, design, or device used to identify a product or service. A *copyright* refers to literary and artistic works (such as books, computer software, motion pictures, and sound recordings).[1]

Financial losses for U.S. firms resulting from foreign violations of U.S. IPR are considered to be significant by U.S. industry officials. For example, the International Intellectual Property Alliance (IIPA), an association of eight U.S.

[1]Definitions of patents, copyrights, and trademarks are shortened versions of definitions described in the Office of the United States Trade Representative, Press Release, February 4, 1995, p.6-7.

CRS

copyright-based industries, estimates that international piracy of copyrighted products by 42 countries plus the Commonwealth of Independent States (CIS) cost U.S. firms $8.6 billion in lost trade during 1994, including $5.2 billion from computer programs, $1.4 billion from motion pictures, $1.3 billion from records and music, and $0.6 billion from books.[2]

PROTECTION OF U.S. IPR: SPECIAL 301

Section 182 of the 1974 Trade Act (as amended), commonly referred to as *Special 301,* is the primary U.S. trade statute used to protect U.S. IPR in foreign markets.[3] The provision directs the USTR to identify countries that deny adequate protection of U.S. IPR, and to initiate investigations against "priority foreign countries," whose practices are considered to be the most serious or harmful in terms of denying adequate protection of IPR or fair market access to U.S. persons who rely on intellectual property protection.

Once a country is identified as a priority foreign country, the USTR begins an investigation and seeks negotiations with that country. If an agreement is not reached within six months (extendable to nine months), the USTR must determine if the foreign practice violated U.S. rights under a trade agreement or was "unreasonable" or "discriminatory." If an affirmative determination is made, the USTR may decide to issue trade sanctions, usually in the form of 100 percent import tariffs on selected products. The USTR usually attempts to assess sanctions comparable to the estimated financial losses of U.S. firms resulting from lack of protection of U.S. IPR and the denial of market access.

THE CHINA-U.S. IPR DISPUTE

The 1979 U.S.-China Trade Agreement that governs trade relations between the two countries specifies that both countries will afford each equal national treatment in the protection of patents, copyrights, and trademarks. In 1985, U.S. officials expressed concern over IPR protection in China during talks held under the U.S.-Chinese Joint Commission on Commerce and Trade (JCCT), and similar concerns were raised in market access negotiations begun in 1987.

In April 1991, the USTR designated China as a priority foreign country under Special 301 and launched an investigation in May 1991 of four specific deficiencies in China's IPR practices: (1) deficiencies in the patent law, in particular, the failure to provide product patent protection for chemicals, pharmaceuticals, and agrichemicals; (2) lack of copyright protection for U.S. works not first published in China; (3) deficient levels of protection under the copyright law and regulations; and (4) inadequate protection of trade secrets.

---

[2]*International Intellectual Property Alliance,* Press Release, February 13, 1995, p. 6-7.

[3]This provision was added by Section 1303 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418).

On November 26, 1991, the USTR determined that insufficient progress had been made in resolving Chinese intellectual property rights violations. The USTR decided to extend the investigation, but ordered to be printed in the Federal Register a draft list of products imported from China that would be subject to possible U.S. trade sanctions, if an agreement was not reached by January 16, 1992. China in turn warned that such action would prompt retaliation against U.S. products. However, last-minute negotiations yielded a Memorandum of Understanding (MOU) on January 16, 1992, and as a result, the USTR decided to terminate the investigation. Under the agreement, China pledged to strengthen its patent, copyright, and trade secret laws and to improve protection of certain U.S. intellectual property. Subsequently, China enacted several laws and various regulations to improve IPR protection.[4]

RECENT DEVELOPMENTS

On April 30, 1994, the USTR issued its annual Special 301 review. The USTR announced that China had made significant progress in implementing the 1992 IPR agreement by enacting new IPR laws, but stated that enforcement of such laws was weak. The USTR warned that China would be designated as a priority foreign country by June 1994, unless it improved its IPR protection regime. On June 30, 1994, the USTR designated China as a priority foreign country under Special 301, initiated an investigation, and subsequently began new talks with Chinese officials.

On December 31, 1994, the USTR announced that the two sides had failed to reach an agreement and issued a list of Chinese products imported by the United States being considered for possible U.S. trade sanctions barring an agreement by February 4, 1995. On February 4, 1995, the USTR announced that insufficient progress had been made in talks with Chinese officials and issued a list of Chinese products, with an estimated value of $1.08 billion, which will be subject to 100 percent import tariffs.[5] The USTR stated that the sanctions would not take effect until February 26, 1995 in order to permit enough time to allow goods that have already been shipped from China to clear U.S. customs.

ISSUES INVOLVED IN THE CURRENT IPR DISPUTE

The two main points of contention between the United States and China over IPR involve China's enforcement regime as well as market access to intellectual property-related U.S. products in China.

---

[4]For a description of China's adherence to the MOU on intellectual property, see U.S. General Accounting Office, *U.S.-China Trade: Implementation of Agreements on Market Access and Intellectual Property* (GAO/GGD-95-61), January 1995, 68 pages.

[5]The $1.08 billion figure is based on data on total U.S. imports for consumption of the targeted Chinese products for October 1993 through September 1994. The actual total level of products affected by U.S. trade sanctions could vary from the USTR's original estimate.

IPR Enforcement

USTR officials argue that, while China has fulfilled most of its obligations under the 1992 IPR agreement by enacting new IPR laws, it has failed to adequately enforce those laws.

According to the USTR, piracy of U.S. copyrighted products in China has escalated in recent years and has "reached crises proportions." The USTR estimates that 90 to 100 percent of computer software, motion pictures, videos, sound recordings, and books and periodicals sold in China are pirated.[6] The IIPA estimated the 1994 trade losses for U.S. firms resulting from copyright piracy in China at $866 million.[7]

Of particular concern to U.S. trade officials is that Chinese firms are allegedly producing pirated compact disks, laser discs, and CD-ROMs on a large scale and have begun exporting them around the world, including to the United States. The USTR has identified 29 factories in China which are allegedly producing pirated products and has demanded that the Chinese government take direct action against them.

The USTR believes that China has failed to establish an adequate enforcement regime to investigate and take action against violators of IPR. Only a limited number of individuals or firms in China have been prosecuted for IPR violations, and foreign firms have been largely unsuccessful in recovering financial damages in Chinese courts resulting from IPR violations by Chinese firms.[8] The USTR wants the Chinese government to institute structural changes to improve intellectual property protection over time, such as creating a border enforcement regime, instituting a copyright verification system, and providing access to IPR courts.

Market Access

The USTR contends that Chinese trade barriers to intellectual property-related products (especially audiovisual products, sound recordings, and published materials) are a major cause of widespread IPR violations in China. For example, the Chinese government currently limits imports of foreign

---

[6]*Testimony of the Honorable Charlene Barshefsky, Deputy USTR*, before the House Subcommittee on Asia and the Pacific and on International Economic Policy and Trade, of the House Committee on International Relations, February 2, 1995, p. 6.

[7]This includes $351 million for computer programs, $345 million for records and music, $120 million for books, and $50 million for motion pictures.

[8]Other complaints on China's enforcement regime include internally inconsistent laws; a lack of transparency in the enforcement structure; a lack of consistent application of the laws throughout various levels of government; a lack of funding, training and education of IPR enforcement officials; the absence of clear and effective criminal penalties; possible conflicts of interest; the use of pirated software by Chinese government agencies; and absence of an effective border control mechanism to stop the export of pirated products.

"quality films" to 10 per year. As a result, most foreign films cannot be legally imported and end up being shown in China on pirated videos. Other U.S. market access concerns involve China's use of hidden internal quotas, lack of transparency in its trade laws, government monopoly control over the importation and distribution of products embodying intellectual property, and restrictions on foreign investment.[9] The United States has demanded that China take certain steps to open its markets to foreign intellectual property-based products.

Proposed U.S. and Chinese Trade Sanctions

The USTR has indicated that sanctions would be imposed on $1.08 billion worth of Chinese imports if an agreement is not reached by February 26, 1995. Such sanctions would take the form of 100 percent tariffs on 35 categories of imported Chinese products. The top five commodities slated for sanctions are miscellaneous plastic products, answering machines and cellular telephones, sporting goods, wooden articles, and bicycles. The top five items cover over $700 million — about 73 percent of the list.[10]

Press reports indicate that Chinese officials have threatened to retaliate against imports of certain U.S. telecommunications equipment, roll films, game players, cassette tapes, compact disks, cigarettes, alcoholic beverages, and cosmetics. In addition, import restrictions would be placed on U.S. films, television programs, and video tapes and laser discs. Finally, China has reportedly threatened to restrict U.S. auto joint ventures in China.[11]

TRADE POLICY IMPLICATIONS

The current U.S.-Chinese trade dispute over IPR has several important implications for U.S. trade policy. China's economic reforms have contributed to China's high levels of economic growth in recent years; its real GDP grew by nearly 11 percent in 1994. U.S. firms have benefitted from China's economic growth through increased exports to, and investment in, China. However, the Chinese government maintains significant trade barriers on foreign imports, and some analysts believe such barriers are a major cause of the rising U.S. trade deficit with China.[12] One key U.S. trade objective in the current IPR dispute

---

[9]Notice by the Office of the United States Trade Representative, *Federal Register*, Vol 59, No. 132, July 12, 1994, p. 35558-35559.

[10]In choosing its list of sanctions the USTR attempted to target products that (1) were among the fastest growing Chinese exports to the United States (2) were produced mainly by Chinese state-owned enterprises, (3) would not adversely affect U.S. small and medium-sized businesses, (4) would not be component parts of products assembled in the United States, and (5) could be replaced by other sources, domestic and foreign.

[11]*Inside U.S. Trade*, February 10, 1995, p. 22.

[12]The U.S. trade deficit with China in 1994 was $29.5 billion.

is to improve market access for U.S. IPR firms in China; this is part of a larger policy goal to open China's markets to several U.S. industries.[13]

Another U.S. goal is to take effective action against Chinese firms which are exporting pirated materials. The USTR believes such firms have the capacity to flood world markets with pirated products and thus pose a potentially significant financial threat (in addition to losses that have already occurred) to several U.S. intellectual property-related industries.

The proposed $1.08 billion in U.S. trade sanctions against China could have various economic and trade effects. While U.S. trade sanctions would be imposed on a relatively small level of U.S. imports from China (about 3 percent of total U.S. imports from China), they would likely lead to higher prices for U.S. consumers for certain products. Chinese counter-sanctions, if they were imposed, could reduce certain U.S. exports and limit certain types of U.S. investment in China. If the Chinese chose to retaliate against a comparable level of U.S. exports, it could affect about 12 percent of U.S. exports to China.

It is possible (though not likely) that the IPR dispute could escalate into a trade war. The USTR has announced that the proposed sanctions are in retaliation for U.S. IPR losses *in China*. The USTR is also attempting to estimate losses to U.S. firms stemming from Chinese *exports* of pirated products. This could lead to additional U.S. trade sanctions. China might respond by retaliating against major U.S. exports to China, such as aircraft, automobiles, energy equipment, wheat, and telecommunications equipment. Chinese trade and investment sanctions could also lock U.S. firms out of future, potentially lucrative, Chinese markets. Such a scenario would be costly to both countries.

For China, its inability to reach an agreement with the United States on IPR could delay or prevent its entry as a member to the World Trade Organization (WTO). In addition, some analysts argue that refusal by China to take more effective action to protect IPR could hamper efforts to make China a center for research and development, and could limit foreign investment in China from firms that rely on intellectual property.

The Chinese government in recent weeks has reportedly cracked down on IPR violators in China. However, even if the U.S.-Chinese IPR dispute is settled by an agreement before the February 26, 1995 deadline, it is likely to remain a contentious issue for years to come. Disputes will likely arise over China's implementation of the agreement as well as the pace and degree of market-opening measures.

---

[13]The United States is also pressing China to abide by an October 1992 MOU to substantially reform its trade regime. In addition, the United States is attempting to get China to open up its service industries to foreign competition.