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The China-U.S. Trade Agreement on Intellectual Property Rights: Implications for China-U.S. Trade Relations

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SUMMARY

The United States has pressed China over the past several years to improve its enforcement of U.S. intellectual property rights (IPR) in China and to provide greater market access to intellectual property-related products, such as computer software, CDs, and audio-visual products. Trade tensions over these issues nearly led the United States to impose trade sanctions against China in 1992 and 1995. In March 1995, the United States and China signed a new and detailed IPR trade agreement, which pledges China to substantially reform its IPR enforcement regime and improve market access. This report examines the U.S.-Chinese IPR dispute and analyzes the implications of the new IPR agreement on future U.S.-Chinese trade relations.[1]

WHAT ARE INTELLECTUAL PROPERTY RIGHTS?

Intellectual property rights refer to legal forms of protection 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.[2]

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[1]This report updates and revises the CRS Report entitled: *The China-U.S. Trade Dispute on Intellectual Property Rights*, by Wayne M. Morrison, February 21, 1995 (Report no. 95-294E).

[2]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).



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. 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.[3]

PROTECTION OF U.S. IPR: SPECIAL 301

Section 182 of the 1974 Trade Act (as amended), commonly referred to as *Special 301,* is one of the primary U.S. trade statutes used to protect U.S. IPR in foreign markets.[4] The provision directs the United States Trade Representative (USTR) to identify countries that deny adequate protection of U.S. IPR, and to initiate investigations against "priority foreign countries," whose IPR practices are considered to be the most serious or harmful 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 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.

On November 26, 1991, the USTR determined that insufficient progress had been made in resolving Chinese intellectual property rights violations. The

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

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

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 were 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.

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 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 would have been subject to 100 percent import tariffs effective February 26, 1995. China in turn threatened counter sanctions against U.S. firms. However, an IPR agreement was reached on February 26, 1995 and officially signed on March 11, 1995.

ISSUES INVOLVED IN THE RECENT IPR DISPUTE

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

IPR Enforcement

USTR officials argued that, while China has fulfilled most of its obligations under the 1992 IPR agreement by enacting new IPR laws, it had 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 estimated that 90 to 100 percent of computer software, motion pictures, videos, sound recordings, and books and periodicals sold in China are pirated.[5] The

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[5]*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.

IIPA estimated the 1994 trade losses for U.S. firms resulting from China's copyright piracy alone at $866 million.[6]

Of particular concern to U.S. trade officials was that Chinese firms have been producing pirated compact disks, laser discs, and CD-ROMs on a large scale and have begun exporting them around the world. The USTR identified 29 factories in China which are allegedly producing pirated products and demanded the Chinese government take direct action against them. The USTR also argued that China had failed to establish an adequate enforcement regime to investigate and take action against violators of U.S. IPR. To date, only a limited number of individuals or firms in China had been prosecuted for IPR violations, and foreign firms had been largely unsuccessful in recovering financial damages in Chinese courts resulting from IPR violations by Chinese firms.[7]

Market Access

The USTR contended that Chinese trade barriers to intellectual property-related products (especially audiovisual products, sound recordings, and published materials) were a major cause of widespread IPR violations in China. For example, the Chinese government limited imports of foreign "quality films" to 10 per year. As a result, most foreign films could not be legally imported and ended up being shown in China on pirated videos. Other U.S. market access concerns involved 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.[8]

THE MARCH 1995 U.S.-CHINA IPR AGREEMENT

The new IPR agreement pledges China to substantially beef up its IPR enforcement regime and to remove various import and investment barriers. Specifically, China agreed to:

- **Take immediate steps to stem IPR piracy in China over the course of the next three months** by taking action against large-scale producers and distributors of pirated materials, and prohibiting the export of pirated products such as CDs, LDs, and CD-ROMs.

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

[7]Other complaints on China's enforcement regime included 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.

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

Chinese officials have pledged that if such firms are found to be in violation of IPR laws, they will be shut down, their business licenses revoked, and their pirated-making machinery destroyed.

- **Establish mechanisms to ensure long-term enforcement of IPR laws**, such as banning the use of pirated materials by the Chinese government, establishing a coordinated IPR enforcement policy among each level of government, enhancing IPR enforcement agencies, creating an effective customs enforcement system, establishing a title verification system in China to ensure that U.S. audio visual works are protected against unauthorized use, reforming China's judicial system to ensure that U.S. firms can obtain access to effective judicial relief, establishing a system of maintaining statistics concerning China's enforcement efforts and meeting with U.S. officials on a regular basis to discuss those efforts, improving transparency in Chinese laws concerning IPR, and strictly enforcing IPR laws.

- **Provide greater market access to U.S. products** by removing import quotas on U.S. audio visual products, allowing U.S. record companies to market their entire works in China (subject to Chinese censorship concerns), and allowing U.S. intellectual property-related industries to enter into joint production arrangements with Chinese firms in certain Chinese cities.

U.S. and Chinese officials will meet on a regular basis to discuss concerns relating to IPR enforcement and market access, and China will release statistics on its efforts to combat piracy. In addition, the U.S. Government and IPR trade associations will provide extensive technical assistance to Chinese officials to help establish an effective enforcement regime. For example, the U.S. Customs Service, working with a $500,000 grant from the Asian Development Bank, will send officials to China to train and advise Chinese officials on enforcing IPR laws, developing new regulations, and taking effective action against IPR piracy.

RAMIFICATIONS FOR U.S.-CHINA TRADE RELATIONS

The March 1995 IPR agreement with China will likely have a significant effect on U.S.-Chinese trade relations for several reasons. First, it represents a significant commitment by the Chinese to take widespread and effective action against IPR piracy in China, and provide greater market access for U.S. intellectual property-related products and U.S. investment in China. The IPR agreement is one of the most detailed agreements ever reached under a Special 301 investigation; it establishes a wide range of specific actions and timetables which the Chinese have pledged to implement. In addition, the IPR agreement subsequently led China on March 12, 1995 to pledge to resume its implementation of an October 1992 market access agreement, extend talks with U.S. officials on providing greater market access to U.S. agricultural products, and to open new talks on market access to telecommunications services and

insurance.[9] Hence, the IPR agreement appears to have ostensively resolved the IPR dispute, helped to renew China's implementation of market access reforms, and provided impetus to new talks on additional reforms to other sectors of China's trade regime. Altogether, such agreements in the long-run could lead to significant trade opportunities for U.S. firms.

For China, the IPR agreement has reduced trade tensions with its largest export market. Secondly, by affording greater IPR protection and market access, China hopes to attract foreign investment needed to develop its own intellectual property-based industries, such as computer software. Finally, the agreement led the United States and China to agree to resume talks on China's entry into the WTO.[10] Following the signing of the U.S.-Chinese IPR agreement, and subsequent Chinese commitments on market access, the United States reiterated its support of China's accession to the WTO as a founding member, and stated it would approach such talks on a *"flexible, pragmatic, and realistic basis, and to address realistically the issue of China's developing country status on the basis of the Uruguay Round Agreement."*[11] This indicates that the United States may support treating China as a developing country (giving it longer period to implement economic reforms) for certain sectors of its economy as part of U.S. policy on conditions for China's entry the WTO.

While the U.S.-China IPR agreement appears to have improved trade relations between the two nations, it is likely that conflict will arise in the future over such issues as the pace and scope of China's efforts to reform its IPR enforcement and market access regimes. For example, China has often had difficulty in the past getting provincial and local governments to comply with directives from the central government. Hence, some provincial and local governments may continue to be involved in supporting facilities that produce pirated materials or may laxly enforce IPR laws and regulations, unless strong pressure is applied by the central government. In addition, while the IPR agreement allows U.S. audio-visual firms to enter into joint production agreements in China, it does so in only selective cities. Finally, the agreement does not address all trade barriers to intellectual property products, such as high import tariffs and restrictions on foreign distribution of products in China. It is likely that these issues will be addressed in China's WTO accession talks. If not resolved, such issues could delay China's entry into the WTO, and could lead to a deterioration in U.S.-Chinese trade relations.

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[9]In 1991, the USTR initiated a Section 301 investigation of four major Chinese trade barriers, including import prohibitions and quotas, restrictive import license requirements, restrictive import standards, and lack of transparency in Chinese trade laws. On October 10, 1992, the United States and China reached an agreement. China agreed to reduce several major trade barriers over the next five years. China suspended its implementation of the trade agreement in January 1995, after it was unable to obtain membership into the WTO by the end of 1994.

[10]Effective protection of IPR has been major condition for U.S. support of China's accession to the WTO

[11]USTR background paper listing eight points of agreement on trade issues between the United States and China that were announced on March 12, 1995.