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The China-U.S. Intellectual Property Rights Dispute: Background and Implications for China-U.S. Economic Relations

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SUMMARY

The United States has pressed China over the past several years to improve its protection of U.S. intellectual property rights (IPR) and to afford greater market access to intellectual property-related products, such as computer software, compact disks (CDs), and audio-visual products. U.S. threats of trade sanctions against Chinese products helped produce trade agreements in January 1992 and February 1995 that pledged China to improve its IPR enforcement regime and expand market access for IPR-related products. However, despite these agreements, U.S. and IPR industry officials have charged that IPR piracy in China remains rampant, and is costing U.S. firms $2.3 billion in lost trade annually. On May 15, 1996, the U.S. Trade Representative (USTR) threatened to impose approximately $2 billion in trade sanctions against China for failing to abide by the February 1995 IPR agreement. This report outlines the history of the U.S.-Chinese IPR dispute and examines its ramifications for future U.S.-Chinese economic relations.

WHAT ARE INTELLECTUAL PROPERTY RIGHTS?

Intellectual property rights refer to legal forms of protection of various intangible assets that 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.[1]

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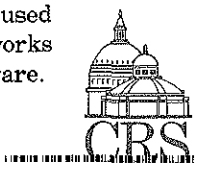
[1]A *patent* is a governmental grant of a property right to the inventor of a product or process (which is new and has industrial application) that gives the patent holder exclusive right to the invention over a limited period of time. A *trademark* is any word, symbol, design, or device used to identify a product or service. A *copyright* provides legal protection to literary and artistic works (such as books, motion pictures, and sound recordings), and certain types of computer software.



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. 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 IPR practices are considered to be the most serious or harmful to U.S. persons who rely on intellectual property protection.[2]

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% import tariffs on selected products.

U.S.-CHINA IPR ISSUES: 1985-1993

The 1979 U.S.-China Trade Agreement that governs trade relations between the two countries specifies that both countries will afford each other 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 auspices of the U.S.-Chinese Joint Commission on Commerce and Trade (JCCT), and similar concerns were raised in market access negotiations begun in 1987. Concerns over China IPR protection led the USTR to place China on its Special 301 priority watch list in 1989 and 1990.

In April 1991, the USTR designated China as a *priority foreign country* under Special 301 and launched an investigation of four specific deficiencies in China's IPR practices: (1) 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 Chinese 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 IPR violations and issued a draft list of products imported from China, valued at $1.5 billion, that would be subject to

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[2]Since the enactment of Special 301 (Section 1303 of the Omnibus Trade and Competitiveness Act of 1988, P.L. 100-418), the USTR has issued a three-tier list (beginning in 1989) of countries that are considered to maintain inadequate regimes for the protection of U.S. IPR or deny market access: (1) *priority foreign countries* that are considered to be the worst violators of U.S. IPR and are subject to a USTR investigation and possible U.S. trade sanctions; (2) *priority watch list countries* that are considered to have serious deficiencies in their IPR regime, but do not currently warrant an investigation; and (3) *watch list countries* that have been identified because they maintain IPR practices or barriers to market access that are of particular concern, but do not yet warrant higher level designations.

U.S. trade sanctions, barring an agreement by January 16, 1992. China in turn threatened counter sanctions against U.S. products. However, an agreement was reached on January 16, 1992. China agreed to strengthen its patent, copyright, and trade secret laws, and to improve IPR protection for U.S. computer software, sound recordings, agrichemicals, and pharmaceuticals. The USTR placed China on its Special 301 watch list in 1992 and 1993.

U.S.-CHINA IPR ISSUES: 1994-1995

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 China's enforcement of its laws and regulations was sporadic at best and virtually non-existent for copyrighted works. In particular, the USTR cited the establishment of 26 factories in China that were producing pirated CDs, as an example of China's "egregious" violation of U.S. IPR. In addition, the USTR stated that trade barriers had restricted access to China's market for U.S. movies, videos, and sound recordings, and that such restrictions encouraged piracy of such products in China. The United States called on China to take effective and immediate measures to curb piracy (including making raids on certain CD producers), instituting structural changes to improve IPR protection over time (such as creating a border enforcement regime, instituting a copyright verification system, and providing access to IPR courts), and providing greater market access for U.S. intellectual property-based products. 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, valued at about $1.1 billion, which would be subject to 100% import tariffs on February 26, 1995, unless an agreement was reached. China in turn threatened counter sanctions against U.S. products. However, an IPR agreement was reached on February 26, 1995. China agreed to:

- **Begin a "Special Enforcement Period" over the course of the next several months** by taking action against large-scale producers and distributors of pirated materials, and prohibiting the export of pirated products such as CDs, laser disks (LDs), and CD-ROMs. Chinese officials pledged that if such firms were found to be in violation of IPR laws, they would be shut down, their business licenses revoked, and their machinery and products seized and 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.[3]

RECENT DEVELOPMENTS

Several U.S. firms have charged that IPR piracy in China has worsened in China since the 1995 IPR agreement was reached, and have pressed the USTR to take tougher action against China. The International Intellectual Property Alliance (IIPA), an association of eight U.S. copyright-based industries, estimated that IPR piracy by Chinese firms cost U.S. firms $2.3 billion in lost trade during 1995, making China the largest foreign pirate of U.S. intellectual property.[4] The IIPA estimated that Chinese piracy of various copyrighted materials in China runs from 50% to 90%.[5]

On April 30, 1996, the USTR once again designated China as a *priority foreign country* under Special 301 for failing to fully implement the 1995 IPR agreement. On May 15, 1996, the USTR again published a preliminary list of Chinese products that were under consideration for U.S. sanctions, and warned that the United States would impose 100% prohibitive tariffs on approximately $2 billion worth of Chinese products (drawn from the preliminary list) by June 17, 1996, unless China takes more effective action to fully implement the IPR agreement.[6]

The USTR's preliminary retaliation list mainly targets textiles and apparel, consumer electronics (such as telephones and cellular phones, fax machines, answering machines, electric space heaters, and coffee makers), and various

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[3]USTR press release, February 26, 1995.

[4]These losses include $124 million for motion pictures, $300 million for records and music, $1,774 million for computer software, and $125 million for books.

[5]*International Intellectual Property Alliance* news release, April 30, 1996, p.1.

[6]The USTR's preliminary sanctions list contains sanctions valued at $3 billion. The USTR will hold public hearings on the proposed list, after which, a final sanctions list will be developed (barring a U.S-China agreement) which is likely to total approximately $2 billion. (Source: *USTR press release, May 15, 1996*. Obtained from the USTR World Wide Web Site.)

miscellaneous manufactured products (such as surgical gloves, jewelry, paper sacks and bags, cookware, and sporting goods). In choosing the preliminary retaliation list, the USTR sought to target products that are predominately produced in the southern coastal regions of China (especially Guangdong Province), where most of the Chinese plants producing pirated products are believed to be located. In addition, the USTR sought to choose products for sanctions in which alternative suppliers existed so as to minimize the possible effects of higher-priced Chinese goods on U.S. consumers and the economy.[7] However, such sanctions, especially in the short run, would likely lead to higher prices for some products in the U.S. market.

China has warned that it would retaliate against U.S. sanctions by (1) suspending imports of U.S. audio-visual products (such as movies television programs, videotapes, CDs, and LDs); (2) assess additional 100% tariffs on U.S. products, including motor vehicles and spare parts, agricultural and husbandry animal products, vegetable oils and fats, and telecommunications equipment; (3) suspend new U.S. investment in China for tourism, trade, and representative offices; and (4) suspend approval of new applications by U.S. firms for IPR protection of agricultural chemical products and pharmaceuticals.[8]

IMPLICATIONS OF THE U.S.-CHINA IPR DISPUTE FOR U.S.-CHINA ECONOMIC RELATIONS

The current U.S.-China IPR dispute represents a significant impasse in U.S.-China economic relations. The United States has conceded that China has made some progress in improving its IPR protection regime. However, while Chinese officials have conducted raids and have seized thousands of pirated products, most enforcement has been at the retail level rather than at the source of production. U.S. government and IPR industry officials have identified at least 34 pirating factories in China that are mass-producing products (such as LDs, music and video CDs, and CD-ROMs,) and have charged that Chinese officials have done little to halt these operations. Such facilities are of particular concern to U.S. officials because a large share of their production is being exported to other countries, thus resulting in billions of dollars in lost sales for U.S. firms.[9] U.S. officials assert that, left unchecked, the growth of pirating firms in China could result in progressively larger economic losses for

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[7]Textiles and apparel were targeted for several reasons: (1) they represent about one-quarter of Chinese exports to the world, (2) a large share of these products are made by Chinese state-run factories, (3) clothing production is largely concentrated in southern China, (4) a wide variety of alternative suppliers exist, (5) several Chinese textile and apparel producers have attempted to circumvent U.S. quotas through transshipments, and (6) U.S.-brand clothing products have been pirated in China and exported to the U.S. market.

[8]Reported in *Reuters*, May 15, 1996.

[9]The United States is pressing China to develop an effective customs service to stop the export of pirated products.

U.S. IPR industries.[10] In addition, U.S. officials assert that reducing Chinese trade and investment barriers to U.S. IPR-related products is a critical element to reducing IPR piracy: Unless Chinese individuals can purchase products freely in the market, they are more likely obtain to pirated versions of such products through other means.

Chinese officials acknowledge that IPR piracy is a big problem, but argue that they have made great progress in fighting such practices. They are critical of U.S. demands to close down certain plants that are allegedly producing pirated products, arguing that such plants should be allowed to operate as long as the government certifies they are operating legally.[11] In addition, Chinese officials claim that it will take years for the government to establish an effective IPR enforcement regime, such as the training of police, lawyers, and judges, to deal with IPR issues. Finally, Chinese officials argue that foreign-owned firms (including Hong Kong and Taiwanese) in China are responsible for a share of the production and distribution of pirated products.[12]

Failure to resolve the IPR issue could have several consequences. First, sanctions by both nations could lead to a significant reduction in economic relations between the two countries (and possibly a trade war).[13] Second, it could increase congressional support for a termination of China's most-favored-nation (MFN) status, which would significantly raise U.S. tariffs on a large portion of Chinese exports to the United States. Third, U.S. sanctions against China might impact Hong Kong and Taiwanese investors in China that operate export-oriented facilities that produce the items targeted by U.S. sanctions.[14] Fourth, the United States has specifically linked improved China's protection of IPR to U.S. support for China's accession to the World Trade Organization (WTO) and, hence, China's failure to fully abide by its IPR agreements with the United States could further delay or prevent its WTO bid. Finally, failure by China to improve its IPR regime may discourage future foreign investment in high-tech and other IPR-related industries in China, which could negatively impact China's economic development.

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[10]Some U.S. officials have suggested that the Chinese government should require pirating firms to enter into joint-production agreements with U.S. firms to produce commodities legally in China.

[11]However, U.S. officials have often disagreed with Chinese certifications that certain CD plants are operating legally.

[12]The May 15, 1996 USTR press release acknowledges that U.S. officials have pressed Hong Kong and Taiwanese officials to take action against their investors in Chinese CD factories, and preventing shipment to China of new CD press equipment.

[13]Because China is one of the world's fastest growing economies, many analysts argue that it will become an increasingly important market for U.S. goods and services. A downturn in U.S.-China economic relations could lock U.S. firms out of this market.

[14]Several Hong Kong and Taiwanese investors own plants in China which produce electronic products and textiles and apparel. Many of these commodities are exported to the United States and thus would likely be affected by U.S. trade sanctions.