COUNTERFEITING AND CHINA'S ECONOMIC DEVELOPMENT

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Written Testimony of

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I. Introduction

China has the most serious counterfeiting problem in world history. According to recent estimates by the PRC's own State Council Research and Development, in 2001 China was flooded with between $19-$24 billion worth of counterfeit goods. This figure, although substantial, may underestimate the size of the problem. Brand owners estimate that between 15-20% of all well known brands in China are counterfeit. Brand owners claim that they are losing tens of billions of dollars in China due to counterfeiting. Microsoft's annual losses alone due to commercial piracy in China are estimated to be $10 billion.

Counterfeiting is now estimated to account for 8% of China's gross domestic product. Many municipalities and towns in China depend upon counterfeiting to sustain their local economies. There are millions of people, perhaps tens of millions of people, involved in counterfeiting in China. There are hundreds of thousands of people involved in anti-counterfeiting.

Although the current situation suggests a formidable problem, future trends are a source of even greater concern. First, despite the intense international attention focused on the counterfeiting problem in China for the past decade, counterfeiting in China appears to be getting worse, not better. I will give a specific and detailed example of why this is so. Second, the PRC government lacks the political will to engage in a crackdown on counterfeiting or to make any meaningful progress in addressing the problem. The result is that for the foreseeable future, there is unlikely to be any real improvement in the counterfeiting problem in China.

II. Counterfeiting in China, China's Economic Development, and Global Competitiveness

China's unprecedented economic growth through the decade of the 1990s was fueled in large part by a substantial infusion of foreign direct investment (FDI), much of it by the world's leading multi-national enterprises (MNEs). Throughout much of the 1990s, China trailed only the United States as a recipient of FDI. Briefly in 2002, China surpassed the United States as the world's largest recipient of FDI, with capital inflows of about $50 billion. According to recent statistics, China now ranks third in the world, with capital inflows of about $60.6 billion, behind only the United Kingdom ($78.3 billion) and the United States ($96.8 billion). China is far and away the largest recipient of FDI among developing countries. For example, China receives nearly 8 times the FDI that India receives, even though India is often considered to be China's closest economic rival among developing countries.

FDI is the best means of technology transfer in the world today. In addition to the capital that is injected, FDI often involves the transfer of patents, copyrights, trademarks and other forms of intellectual property as part of the process of investment. In many cases, the intellectual property component of the FDI is the most important part of the investment. For example, the value to Coca-Cola of its trademark is worth many times more than the hundreds of millions of dollars that Coca-Cola has invested in China. When a global pharmaceutical company sets up a manufacturing facility in China, the company will invest capital to establish the physical plant. More importantly, the company will hire local scientists and engineers and will teach them how to use the company's patents and other forms of technology. In today's economy, a company's advanced technology, know-how, and other forms of intellectual property are often the most crucial element of its success. FDI in China provides access to this technology.

China is using its unprecedented access to some of the world's most advanced technology as a means of leapfrogging into the modern industrial age. China has been able to use this technology to upgrade its industries and to become globally competitive in a short span of time. For example, in the 1980s, China began as an original equipment manufacturer (OEM) for a number of multi-national companies in producing color television sets that were distributed under various international brand names. These MNEs provided detailed specifications and technical training and assistance to Chinese manufacturers. Once the Chinese OEMs manufactured these TVs, the MNEs would put their private labels on these sets and sell them under their own brands. Having developed OEM capabilities, absorbed technology, and learned about distribution, supply, and marketing from MNEs, China now makes TVs directly for export to large distributors, such as Wal-Mart and Costco. In the short span of a decade, China has become a dominant player in the area of televisions and other consumer electronic goods.

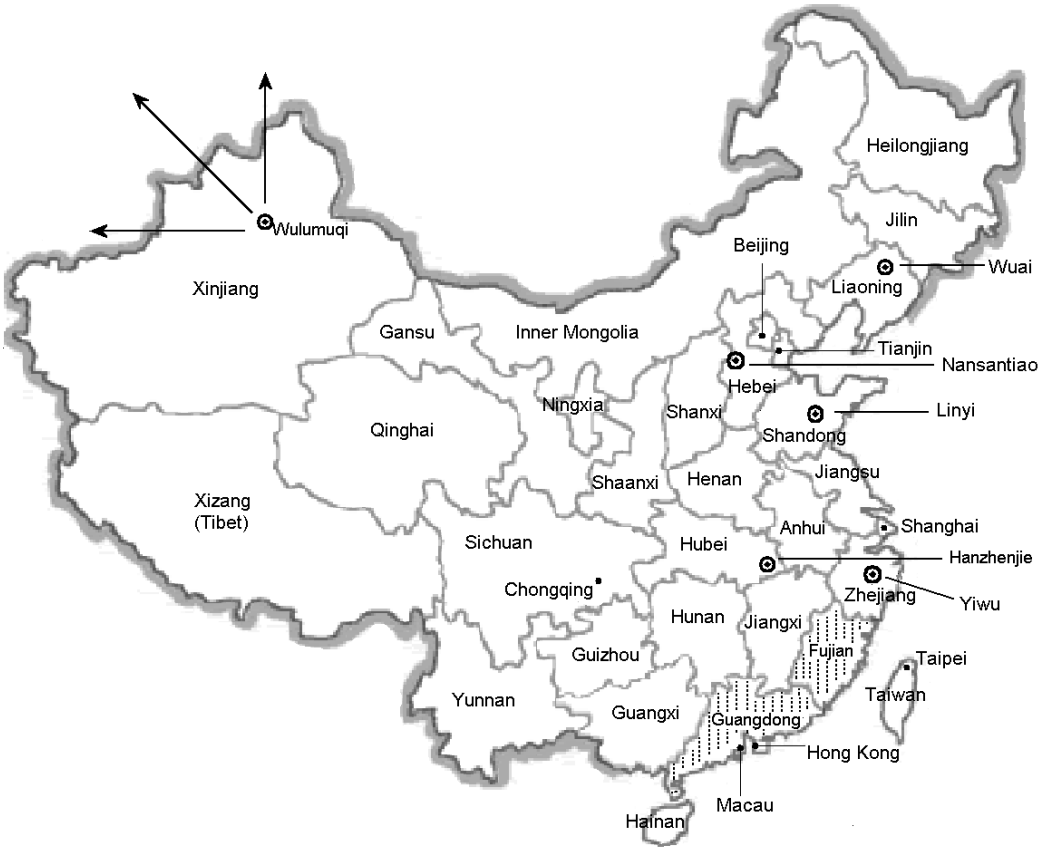
This process of absorbing technology and using it to compete with the technology's original owners and creators is being repeated in China in many industries. China's goal is to use this process to become competitive and dominate in all industries. While China already dominates in some low-technology sectors, China's goal is to dominate not only in low-technology sectors, but also in high-technology sectors. Unlike Japan or Korea, China does not intend to abandon lower-level technology sectors as it moves up the technology ladder. China's goal is to dominate in all sectors – from the lowest, most labor-intensive sectors to the highest and most advanced technological sectors – as quickly as possible. To accomplish these goals, China must have access to advanced technology. FDI gives China this access. Once the advanced technology is introduced into China, China gains access to the technology. Some of this access is lawful, but much of it is through unauthorized copying, theft, and counterfeiting, all of which allows China to obtain technology transfer without the payment of fees.

III. The Manufacture and Distribution of Counterfeit Goods and the Role of Counterfeiting in Supporting China's Local Economies

The manufacture of counterfeit goods in China tends to be concentrated in southern China in Guangdong and Fujian Provinces, among the first areas opened to FDI. Guangdong is the ancestral home of many people living in Hong Kong and Fujian is the ancestral home of many people living in Taiwan. Criminal organizations in Hong Kong and Taiwan, many of which are also involved in smuggling, narcotics, and prostitution, are now involved in the highly lucrative trade in counterfeit goods. These criminal organizations help to finance the start-up costs for the factories manufacturing counterfeit goods and use international borders to create barriers against law enforcement.

The distribution of counterfeit goods takes place through a series of wholesale markets that are located throughout China. The manufacture of counterfeit goods is not of much use if the goods do not reach the end use consumer. Many of these wholesale markets are financed and established by local governments. Retail and secondary-level wholesale distributors travel to these wholesale markets to order counterfeit goods that are then shipped to densely populated urban areas in China, other locations in China, and overseas.

Major Distributors and Manufacturers of Counterfeit Goods in China



The role of counterfeiting in supporting local economies can be seen in a study of Yiwu, well known as a major distribution center for counterfeits and pirated goods in China. In 1982, the Yiwu government invested $10 million in establishing the Zhejiang China Small Commodities City Group (CSCG), a wholesale market specializing in the trade small commodities, such as household products. The CSCG experienced significant growth through the decade of the 1990s. In 1982, the CSCG earned $470,000 in sales. By 1991, total revenue had reached $100 million, and in 1996 – the last year that such figures were publicly available, the CSCG's total revenues reached $2.2 billion, which represents a growth of about 22 times in a period of five years, and is more than the total revenues of many MNEs in China. In 1996, the total floor space of the CSCG was over 500,000 square meters with over 24,000 booths, each a wholesale distributor. In addition, about 6,000 individual wholesalers have established booths or locations outside of the CSCG market. Each day about 200,000 people visit the market to purchase goods from among over 400,000 different varieties of items. About 8,000 foreign buyers visit the market each day. Each day 2 tons of goods are purchased. The highways and roads to and from Yiwu are heavily congested

day and night with trucks coming from the South that deliver counterfeit goods to Yiwu and trucks leaving Yiwu loaded with counterfeits that have been purchased and are bound for locations throughout China. Based upon the author's own experience working in Yiwu on behalf of an MNE brand owner, about 80-90% of all goods offered for sale in Yiwu are counterfeit or infringing goods.

The CSCG and the trade in counterfeit goods has become essential to the local economy. In the 1990s, the CSCG accounted for nearly 26% of the entire tax revenues of the city and was the single largest taxpayer in the municipality. The payment of tax is essential because it integrates the CSCG and the trade in counterfeit goods into the local economy. In addition to paying taxes, the CGSC and its illegal trade in counterfeit goods has given rise to a whole host of other legitimate businesses that support the trade. Hotels, restaurants, night clubs, transportation companies, and warehouse and storage facilities all depend on the trade in counterfeit goods.

Shutting down the trade in counterfeit goods in Yiwu would result in shutting down the local economy and would lead to the closing of many businesses and high levels of unemployment. A shutdown may also lead to social chaos and unrest, which the PRC government fears more than anything else. A small town by China's standards, Yiwu has a population of about 650,000, the bulk of which depend upon the trade in counterfeit goods. There are hundreds of other towns like Yiwu in China that depend upon the trade in counterfeit goods to sustain the local economy. All told there are likely millions, if not tens of millions, of people in China who depend directly or indirectly on the trade in counterfeit goods for their economic livelihood and survival. A nationwide crackdown would impose significant costs on the PRC government, as it would need to expend significant resources and political capital to deal with the massive economic and social problems that would likely arise as a result.

IV. Why the Counterfeiting Problem is Getting Worse

Although counterfeiting in China is reaching domestic saturation levels in many industrial sectors, the export of counterfeits from China to countries around the world is a growth area that is likely to increase significantly in the near future. Currently, counterfeits from China are exported overland to countries in Southeast Asia and Central Asia, including Thailand, Vietnam, the Philippines, Indonesia, and Malaysia. Counterfeits also reach Eastern Europe, Russia, and the Middle East, where they are often transshipped to Africa. Some counterfeits reach Africa directly via Nigeria, and more recently Algeria, Morocco, and other northern African states. In addition, counterfeits from China reach Latin America. Brazil and Mexico are key areas through which counterfeits are then transshipped to the United States.

According to some estimates, China accounts for up to 80% of all counterfeit goods in the global marketplace. Not only are counterfeits found in abundance in China, but China is also the leading source of exports of counterfeits. The U.S. Customs Service reported that it seized counterfeit and infringing goods valued at $93 million in 2005, with China (69%) and Hong Kong (6%) – through which many Chinese counterfeits are transshipped) – together accounting for about 75% of the total figure. Of course, the $93 million figure refers to the value of goods seized, and what is seized can represent only a tiny fraction of what actually enters the United States.

Counterfeiters in China have a strong incentive to export. Under China's Criminal Code, criminal liability is possible for sales of counterfeit goods in China that meet certain threshold levels, but it is debatable whether criminal liability exists for exports of counterfeit goods. According to some observers, there might be a loophole in China's Criminal Code that would support an argument that the export of counterfeits – as opposed to a sale within China – is not covered. In addition, while counterfeiters do run the risk of law enforcement if they sell their illegal goods within China, there is much less risk if the counterfeiter ships the goods abroad. Where the goods have been shipped abroad, the boundaries of distance, different time zones, and language make it difficult to trace the origin of the goods back to China or to discover the identity of the counterfeiter. Enforcement authorities within China usually have little interest in the harm or damage that is caused by counterfeit goods from China that are sold abroad.

Although China's exports of counterfeits to the U.S. and other parts of the world are already significant, it is likely that China's exports will increase significantly for the foreseeable future. Under China's prior law, state-owned trading companies had a monopoly over import/export trading rights. Anyone, including counterfeiters, seeking to export goods had to use the intermediary of a state trading company. Although there were many state trading companies willing to assist counterfeiters, the use of a third-party intermediary did create an additional hurdle and expense in the export of counterfeit goods. To implement some of China's commitments when it entered the World Trade Organization, China amended its Foreign Trade Law on July 1, 2004, to eliminate the state monopoly on trading rights. Under the amended law, except for certain types of goods such as crude oil, cotton, and certain foodstuffs, which must be traded by state-owned companies, any business operator has the right to import or export goods after it has registered with the competent state authorities. The elimination of the state monopoly over trading rights means that any counterfeiter is now free to export on its own, without the need to find a complicit state trading company. As a result, many observers expect that counterfeits exported from China will rise sharply in the foreseeable future.

V. The Reaction of MNEs

In reaction to the explosion of counterfeiting and other theft of intellectual property rights, MNEs doing business in China have adopted a non-confrontational strategy of long term cooperation and informal lobbying. In 1999, a group of MNEs formed what is now know as the Quality Brands Protection Committee (QBPC), consisting of many of the most influential MNEs doing business in China and generally considered to be the most well-known industry lobbying group in the PRC. The QBPC regularly conducts seminars and conferences for PRC government authorities but is careful not to criticize the Chinese government. MNEs that approach the United States government have been careful in the past not to ask the U.S. government to initiate any formal action under U.S. federal trade law. Many MNEs have adopted a strategy of publicly praising the PRC government for improving its IP enforcement regime, while privately these same MNEs lament that the piracy problem is worse than ever. For example, when President Hu Jingtao visited the United States recently, Bill Gates, the Chairman of Microsoft, praised China for improvements in protecting Microsoft's intellectual property in China even though Microsoft, according to its own estimates, is losing $10 billion per year to piracy there.

MNEs pursue a non-confrontational strategy because MNEs are afraid of doing anything that might offend the Chinese government and that might lead to retaliation against their businesses in China. For this reason, MNEs avoid any actions that might be interpreted as hostile or threatening, but instead take every opportunity to praise the Chinese government for any improvements in IP enforcement.

VI. Why China Lacks the Political Will and Has No Real Incentive to Crack Down on Counterfeiting

Although counterfeiting is a massive problem, China is a one-party authoritarian state that can bring to bear the full coercive power of the state to resolve any single economic or social problem. China was able to effectively resolve the problem of rampant smuggling in the 1990s and has used swift and effective measures to control other widespread social and economic problems. There is no doubt that if the political will existed, China could bring counterfeiting under control within a short span of time – a year or two at the latest. However, the political will is currently lacking in Beijing, due to the following.

The discussion in this paper indicates that in approaching the counterfeiting problem, the PRC government is faced with a balance of two competing sets of interests. On the one hand, counterfeiting now supports many local economies and millions of people in China. Any serious crackdown on counterfeiting will result in serious economic losses and social

costs that will require the expenditure of a great deal of political capital, as well as economic resources. Of course, China has many pressing problems that demand the attention of its leaders and would prefer not to have to incur the significant costs of a crackdown if they can be avoided. On the other hand, China's leaders are well aware that MNEs, the worst victims of counterfeiting, are afraid of doing anything to offend the Chinese government. The PRC government knows that MNEs fear retaliation to their businesses in China and will avoid any actions that might cause any offense. Faced with the significant costs and social consequences of a nationwide crackdown on counterfeiting and a group of MNEs that appear to be intent on avoiding any offense to the Chinese government at all costs, China has no real incentive to incur the significant costs associated with a crackdown on counterfeiting. Rather, China has engaged in a strategy of appeasing MNEs through largely cosmetic changes that do not address some of the fundamental underlying issues, i.e. the importance of counterfeiting to local economies, local protectionism and corruption, and the need to find alternative lawful economic activity that can replace counterfeiting. Unless China finds the political will to engage in a meaningful crackdown on counterfeiting, there is unlikely to be any significant improvement in the foreseeable future.

Appendix

China's Strategies in Counterfeiting Auto parts

China employs three main methods in counterfeiting auto parts:

(1) Reverse engineering: Counterfeiters take a product and reverse-engineer it in order to make an unauthorized copy or counterfeit. The simplest and crudest method is to take the genuine part and make a mold based on the existing part itself. Using the mold, the counterfeiter can then make unauthorized copies (counterfeits) of the original, genuine part. A more sophisticated method is to create a template or blueprint of the part and then use the blueprint to create a new mold. Sophisticated computer programs now allow the use of digital photos as a basis for modeling software. If the counterfeiter starts with a two-dimensional digital photo of the part, the modeling software can create a three dimensional drawing or template for the part that can serve as the basis for a detailed template or blueprint.

(2) Refurbishing: Counterfeiters also take used or discarded parts and refurbish them and pass them off as new parts. For example, a used or discarded car filter or spark plug can be cleaned and repackaged using genuine original packaging and then sold or passed off as new.

(3) Internal and External Theft of Information Technology (IT): Many companies that manufacture auto parts in China have poor or non-existent IT security. Often company computers will contain design and product drawings with precise manufacturing specifications for the product. Many companies have no IT security measures in place that prevent these drawings from being taken internally from the computers in the design compartment by copying these files directly on a memory stick. No security measures prevent the transmitting of these files electronically to other computers. Many persons have access to computer companies both on site and through remote access via outside computers at the home or elsewhere. This creates a situation in which these proprietary designs are kept in an "open store" that is easily accessible by unauthorized users, thieves, and counterfeiters. In addition, companies will often transmit these files in intra-company e-mail without any encryption devices. The use of third-party subcontractors to manufacture parts creates an additional security risk. Many subcontractors who receive access to templates, blueprints, and drawings are even less careful than IT owners about keeping proprietary information out of the wrong hands.