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Hearing on Intellectual Property Rights Issues and Imported Counterfeit Goods

The issue of intellectual property in China continues to demonstrate its remarkable durability. The fact that the US and China have been relatively low-key about the issue over the past several years has more to do with other, more pressing US concerns such as the war in Iraq and the Bush administration's domestic agenda than with actual patterns of piracy and counterfeiting in China which, if anything, have been increasing in number and complexity since the early 1990s when IP appeared to drive Washington's trade policy with Beijing.

It is my considered opinion that that the majority of Beijing's elite decision makers genuinely believes in the importance of protecting intellectual property rights, even if it is for nationalistic or other self-interested reasons (i.e., economic growth, the strategic payoffs from a vibrant innovative – and protected – knowledge base, etc.). Insofar as this problem persists, much of the reason is due to limitations on state capacity: China's top leadership can only expend the necessary resources to sustain two or three major campaigns over the long term. That explains the paradox of why China can regulate the most intimate behavior of 1.3 billion people through its stringent population control policy but cannot crack down in a sustained manner on a problem as seemingly straightforward and obvious as copyright piracy.

Piracy and counterfeiting in China is widespread and the violators have established extensive production and distribution chains that are usually several steps ahead of the Chinese authorities. Because of this diffusion in the manufacturing and distribution stages of the production line, fines that are meted out tend to be quite small (the merchandise on hand is always kept in limited quantities in order to ensure that fines are minor if the sellers are caught) and can simply be factored into the costs of doing business. Moreover, despite Beijing's good intentions, local governments often benefit from IPR violations. In many cases, the entire economic well-being of a locality may depend on counterfeiting. Insofar as counterfeiting provides employment and thus economic and social stability, local protectionism is especially difficult to resolve because it nestles such economic calculations within a political context. And Chinese consumers also gain from purchasing cheaper products on the black market because the legitimate prices are so out of synch with what they can purchase on the street.

Washington's record has been mixed on this issue. In the past, the United States successfully pressured Beijing to change its laws, but this has had little impact over enforcement. We have provided education so that the average man on the street in China understands IPR as well or better than his US counterpart, but legitimate product is still priced out of the range of what he can afford. We have worked closely with the PRC's legal infrastructure while largely ignoring China's potentially far more powerful administrative enforcement apparatus. If we want to stop piracy and counterfeiting in China, it is important that we take into account some of the basic

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dimensions of the enforcement environment for intellectual property in China that rarely make it onto the public (and often, private) discourse over the issue.

In the space that I have been allotted here, I will highlight the two dimensions of the IPR issue that I feel are most important. Since the debate usually focuses on the national level and on the formal legal IPR regime as a civil and commercial legal issue, I will focus on (1) the administrative enforcement apparatus and (2) the IPR provisions in the Criminal Law of China. Although I will concentrate on the *challenges* facing efforts to protecting intellectual property in China, I believe that only by understanding these challenges can we transform them into opportunities to improve the Sino-US dialogue over intellectual property in China, and, ultimately, the state of IP enforcement in China.

Institutional Structure of China's IPR Administrative Enforcement Bureaucracies

First, to understand the environment of IPR enforcement in China, we need look to China's extensive administrative enforcement bureaucracies, to identify shortcomings within these institutions, and to be creative in working with our Chinese counterparts in seeking ways to overcome them. For example, China's copyright enforcement apparatus is extremely weak in terms of its personnel, operating budget, and bureaucratic reach. By contrast, that of the anti-counterfeiting enforcement apparatus is actually quite extensive and dynamic, resulting a slightly better enforcement record (and one that thus can improved with far less effort than is the case with copyright).

Although the National Copyright Administration is staffed by technical specialists and officials with strong and legal backgrounds, the logic of organizational consolidation and streamlining governs the administrative structure of China's copyright enforcement apparatus, particularly below the national level. The Provincial Press and Publications Department is nestled within, and subordinate to, the Provincial Press and Publications Administration. The Press and Publications Administration makes all the decisions regarding personnel, budgetary, and any additional *ad hoc* resources that are to be allocated to the Copyright Department (direct communication between the Copyright Department and the provincial government would be a significant breach of organizational reporting relationships). This embeddedness forces the copyright enforcement agencies to be dependent on their host units, creating problems when the other units' priorities diverge from copyright enforcement. Indeed, this dependence is virtually guaranteed by the impossibly low personnel allocations for copyright management: in 1999, China had only two hundred people – one for every six million Chinese citizens – are engaged in full-time administrative copyright work.

Budgetary outlays are based upon personnel allocations, and the operating budgets for the copyright agencies are correspondingly infinitesimal. Additional budgetary outlays are made to the Press and Publications Administration, which, at its own discretion, may request these funds from the provincial government which evaluates such requests on a case-by-case basis. In theory, the Press and Publications Administration allocates additional staff on a temporary basis from its other sub-units to compensate the Copyright Department's personnel shortfalls. In reality, such "conscripted" is costly and genuine coordinated activity is sporadic and ineffective. Mobilizing extra personnel from other Press and Publications offices raises preparation and coordination costs, incurs opportunity costs (by preventing staff from performing their regular duties), and increases inefficiencies brought about by intra-agency bargaining between the Press and Publications Administration and the Copyright Department, an exercise in which the latter is at a disadvantage.

Below the provincial level in which the negative effects of administrative consolidation and inefficient outcomes for enforcement become even more pronounced. Corresponding units of the Press and Publications Administration and the Copyright Department are merged within, and subsumed under, the bureaucracy headed at the national level by the Ministry of Culture. These sub-provincial units combine press, publications, copyright, and the responsibilities of other potential competing administrative agencies (such as those of radio, film and television, and even sports) with the local organizational goals of the Culture bureaucratic system.

Please refer to Figures 1a and 1b

The two principal administrative enforcement bureaucracies charged with anti-counterfeit enforcement power are the Administration for Industry and Commerce (AIC) and the Quality Technical Supervision Bureau (QTSB). These two bureaucracies share several characteristics. First, the AIC and the QTSB extend all the way down to the county level (the AIC extends even further, to the village and township level). Second, both bureaucracies are enforcement agencies and thus have the right to levy fines and confiscate, destroy, and auction counterfeit goods. Third, after initially rebuffing outside pleas to redouble their anti-counterfeiting efforts, both bureaucracies quickly understood that such enforcement could provide an enormous amount of extra-budgetary income through “case handling fees,” side-payments, and outright bribes. Moreover, until 1999, these offices could legally hold onto the money they collected and redistribute them in-house as they saw fit (many still do).

Please refer to Figure 2

In other ways, the two bureaucracies are quite different. First, although there is considerable variation on this point, QTSB personnel have a reputation of being more educated, professional, and less prone to corruption than their AIC counterparts. Part of this is because many of the early “foot soldiers” of the AIC (who have since risen in the ranks) were relatively less educated People’s Liberation Army troops demobilized in the mid-1980s. Second, and related, the QTSB is a largely technical bureaucracy in which some level of higher education is necessary to undertake the inspection and analysis of product quality, measurement, and standards. Each enforcement agent in the QTSB must pass an examination before being admitted to the enforcement ranks.

Third, the scope of responsibilities for the two bureaucracies is different. The AIC has enjoyed a long organizational history, and has been able to amass a large number of responsibilities over time. These cover the range of administration, management, and regulation of China’s growing market-oriented economy. Sometimes, these responsibilities are in conflict. For example, the AIC derives income from enterprise registration and continuing management fees, yet at the same time it is ordered to shut down enterprises found to be violating trademarks. Enterprise registration and market management directly or indirectly provide local AICs with a substantial amount of extra-budgetary income. Enterprise registration and market management are relatively straightforward tasks and rarely involve any real risk. Enforcing commercial laws and regulations, including those pertaining to trademarks, requires locating the violating factory, warehouse, or retail outlet and confiscating the offending merchandise, which are costly, time-consuming, and potentially dangerous undertakings. Taking the path of least resistance often meant that the AIC would allow counterfeiting to continue.

But this began to change when the AIC found a rival claimant to its enforcement portfolio, namely the Quality Technical Supervision Bureau. The Technical Supervision Bureau (TSB) was established in December 1988 (since 1998, it has been renamed the Quality Technical Examination Supervision and Quarantine General Bureau – at the national level, and the Quality Technical Supervision Bureau at the provincial level and below). The broad responsibilities of the QTSB include regulating the formulation and implementation of national and local standards and measurements and protecting consumers through the supervision of national and local product quality standards. The QTSB responsibilities most relevant to this analysis have to do with product quality and consumer protection from substandard or dangerous goods. Insofar as counterfeit merchandise is of inferior quality relative to its legitimate counterpart, and as the unknowing purchase of counterfeit products harms the consumer, the QTSB can target the manufacture and sales of such offending merchandise. In and around 1994, the then TSB began to interpret its role quite liberally to include directly and aggressively combating the production and sales of counterfeit goods, intruding upon what had essentially been the exclusive domain of the AIC.

The result has been competition between the two bureaucracies over the enforcement portfolio and all the positive benefits now associated with it. The result has been a substantial (yet still inadequate) increase in anti-counterfeiting enforcement. This competition has also been lubricated by the increasing presence of foreign (and domestic) IPR-intensive firms that often provide additional financial support to these agencies through bribes, side-payments, and agreements to underwrite some of the extra costs that accompany enforcement (i.e., destruction of merchandise, rental of special vehicles, overtime, etc.).

None of the foregoing is to suggest that either the AIC or the QTSB is above actively participating in counterfeiting operations themselves. The AIC, in particular, continues to have a stake in deriving income from counterfeiting operations, either through enterprise registration, retail rental income, or through outright collusion and kickbacks. Nevertheless, the competitive dynamics discussed above have shifted AIC behavior to be, on balance, more favorably disposed towards anti-counterfeiting enforcement than it was before. If for no other reason, it is because they can get more money by levying large fines than by “nickel and diming” the foreign and domestic companies who desire better enforcement. This shift, in turn, has been accelerated and deepened by the growing number of foreign commercial actors on Chinese soil.

Finally, it should be noted that the AIC and the QTSB have been centralized to the provincial level since 1999. This means in theory that they are far more insulated from the interference of the local governments below the provincial level if AIC/QTSB priorities diverge from these governments. In practice, it appears that the outcomes are decidedly more mixed. I urge the commission to read an article I wrote on this centralization in order to understand this issue better.² I attach a copy of this article as a pdf.

This extended discussion of China’s administrative enforcement apparatus is important for three reasons. First, by comparing the bureaucratic structure of these institutions, we can find different causes of non-enforcement even if the effects (that is, the non-enforcement itself) are the same. Second, by identifying where specific weaknesses within the Chinese administrative enforcement apparatus, we can identify actual areas for improvement in our ongoing discussions with Beijing. This not only gives us more credibility vis-à-vis our Chinese counterparts, it also gets at some of

² Mertha, “China’s ‘Soft’ Centralization: Shifting *Tiao/Kuai* Authority Relations Since 1998,” *The China Quarterly* 184 (December 2005): 792-810. All articles and book chapters written by the author and cited in the footnotes can be found at the following web site: <http://artsci.wustl.edu/~amertha/>

the real problems. Finally, this exercise should remind us about the complexity of the task at hand and to underscore the difficulties the Chinese themselves are facing in coming to terms with the issue.

China's Criminal Law

Because AIC/QTSB anti-counterfeiting enforcement (to say nothing of copyright protection) in China is substandard, I, along with many others with whom I have spoken, believe that China should utilize its IPR provisions within the revised Criminal Law to go after the pirates and counterfeiters. For policy to be implemented systematically and successfully, many argue that some sort of "deterrence" is necessary. Without such a "fear factor," there is simply too much of a positive economic incentive to continue the illicit activity. This is a conclusion that is strongly held by an increasing number of trademark owners operating in China. As a result, there has been a steady effort by foreign companies and the investigation firms in their employ to revisit what has been a seemingly distant but sought-after goal for the past half-decade: placing anti-counterfeiting enforcement squarely within the arena of criminal prosecution.

The 1997 revised Criminal Law has specific provisions for intellectual property offenses. Section 7 provides for sentences of up to three years in prison or hard labor and a fine for IPR-related offenses. If the value or the quantities involved are deemed particularly "huge," the sentence is between three and seven years and a fine. The baseline appears to be if the product sold on the market is valued at 50,000 RMB (\$6,000 USD) or more (although this appears in the "economic crimes" section of the Criminal Law and not the "intellectual property" section). Sentences of more than seven years, even the death penalty, can be invoked if the economic crimes (i.e., counterfeit production and sales) in question involve serious injury to or in the death of the consumer, and the stipulations regarding pharmaceuticals and foodstuffs are particularly severe. According to one source that I interviewed, "three-time losers," recidivists who have been found guilty of three counterfeiting offenses, can be automatically turned over to the Public Security Bureau (PSB).

Although the number of cases that end in criminal prosecutions is still very low, the cases that *do* result in prosecutions often carry sentences that are quite severe. One foreign company reported that it was able to secure thirty-four criminal prosecutions, with an average jail sentence of three years. Although three years seems modest, incarceration in prison or in a labor camp for any amount of time can act as a powerful deterrent. It is not simply that conditions can be terrible, but there is a tremendous social stigma attached with having gone to prison. A prison sentence often means losing one's livelihood, one's family, and any prospects for a decent job in the future. This is true all over Asia, but it is particularly true in China. Moreover, in China it is impossible to "trade in" one's jail time for monetary compensation, as was the case in Taiwan. Indeed, one private investigator expressed some concern that current attempts towards increased criminalization of counterfeiting could create a situation where the punishment would go far beyond establishing the deterrent effect necessary, that it would actually become a tool for repression. Moreover, he implied that some foreign trademark owners were indifferent to such an outcome or about how such a trend might negatively impact the fundamental rights of Chinese citizens. This is something that we should keep in mind, especially given the rising trend in which their clients are pressuring them to conduct raids so that the 50,000 RMB threshold is met and the case can be brought to criminal court.

But this could backfire: if various individuals along the enforcement chain feel that the criminal penalties are too high, and if they have enough discretion, they may simply drop the case or

knock it down to a lesser offense. Nevertheless, at present, this concern appears to be the exception and not the rule as momentum for the criminalization of counterfeiting continues to grow, as it has over the past five years.

In addition, there is also a great deal of reluctance on the part of the Public Security Bureau (PSB) and the People's Procuracy to intervene, although the numbers have begun to slowly, but steadily, increase. One investigator said that in the four years he had been in Shanghai, he has participated in three thousand enforcement actions. In the thirteen years he lived in Taiwan, he had participated in just over half that number. The big difference is that in Taiwan, they were all prosecuted as criminal offenses. In 1996, one-quarter of one percent of all trademark-violating cases were being prosecuted under China's revised Criminal Law. Today, the number is between two and two-and-a-half percent. Although this number is still small, it does represent a five to ten-fold increase in five years. One US company was able to secure only one criminal prosecution in 1999. The following year, the number went up to three. In 2001, the number jumped to twelve and doubled in 2002. At the same time, this same company undertook between five- and six hundred enforcement actions in 2001 alone. Half of them were prosecutable under the Criminal Law, but only a dozen were actually prosecuted. Another knowledgeable source indicated that ninety percent of cases with which he was familiar could have been prosecuted in the criminal court but instead were handled administratively.

The main reason why these numbers remain low is that resistance to the invocation of the Criminal Law for anti-counterfeiting offenses comes from several directions. First, the AIC, QTSB, and other enforcement agencies are extremely unwilling to hand over their cases – and their thus their administrative jurisdiction – for criminal prosecution. AIC and QTSB units have realized over time that the “really big money” was not in exacting case fees and bribes from foreign clients but from using the fines levied against the counterfeiters to enhance their own official and unofficial operating budgets.

After working for years to establish relations with foreign companies and their private investigation agencies, and amassing significant financial and other benefits in doing so, the AIC and the QTSB are loath to give these up. First, a criminal conviction means that the counterfeiter will not only go to jail, he will be put out of business. Thus, the AIC loses both a source of revenue through enterprise registration and regular management fees it collects, while more corrupt AICs also lose the opportunity to skim money off of the fines that they levy on the counterfeiter. Second, handing cases over to the PSB leaves the AIC and the QTSB with no records to indicate that they have undertaken the initial investigation of the case, and their activities do not make it onto their own enforcement quota reports. And if the cases get “bounced” back to the AIC or QTSB, there is a good chance that they have already gone cold and will be next to impossible to pursue with any expectation of success. Third, it diminishes the notion that the AIC and the QTSB are effective enforcement agencies in the eyes of superiors within the government, a reputation these two bureaucracies have painstakingly nurtured over several years. One investigator said that in his two years in Shanghai, he has never seen one case of the AIC or the QTSB voluntarily passing off a case to the PSB. Oftentimes, the AIC or QTSB will increase the fine (with the acquiescence of the investigator or company) in exchange for being able to hold onto the case.

However, this does not mean that the PSB has been aggressively taking cases away from the AIC and the QTSB. In fact, it has taken an enormous amount of coaxing to get the PSB to take on IPR cases in the first place. Anti-counterfeiting work is regarded by the PSB as an expansion of responsibilities without a corresponding increase in budgetary revenues. Moreover, there is a perception that IPR cases were “civil” in nature and that they did not have the *gravitas* of

“standard” criminal offenses. There was a gap of about three to four years between the promulgation of the revised Criminal Law and the time that the PSB started to take an interest in IPR cases. But even though the PSB is somewhat more willing than before to bring counterfeiters to justice, it will not send cases to the prosecutor unless chances for a successful conviction, in the opinion of one investigator, are ninety-five percent or higher. Sending a case back to the AIC or to the QTSB gives the PSB the equivalent of a “black eye” and negatively affects its case record file.

Moreover, the prosecutors, like the PSB, will only take a case if they are almost certain to get a conviction. Once the PSB hands a case over to the prosecutors, the latter group has an internal discussion about whether to go ahead and prosecute. Traditionally, their conviction rates have been very high, and prosecutors are resistant to the idea of diluting their success rate with cases that might not end in a conviction. If they decide not to take the case, they hand it back to the PSB, which then passes it off to the AIC or the QTSB, something that PSB does not like to do, for reasons mentioned above. This overly cautious approach to prosecutions is changing, but very slowly.

It also appears that counterfeiters from other locales make up the majority of convictions. It is still very tricky to prosecute “local boys.” It is also difficult to establish recidivism, as there is no national database, and establishing a pattern of counterfeiting often requires coordination among several different bureaucracies at different levels of the vertical administrative hierarchy across several provinces, an almost impossibly complex undertaking.

Finally, in several instances the laws themselves remain vague in critical areas. What demonstrates “huge” or “serious” remains unclear. Moreover, even the seemingly clear and objective criminal threshold of 50,000 RMB is also open to interpretation. Valuation is tricky when the merchandise itself is a fake. If the methodology for calculating the value of the goods only takes into account real production costs and ignores the value of the intellectual property being violated (the preferred method of the enforcement authorities because calculating intellectual property losses is difficult and disputable), this depresses the price and makes it more difficult to establish the 50,000 RMB threshold. And until the recent promulgation of the Judicial Interpretation on the Handling of the Crime of Manufacturing and Selling Inferior and Shoddy Goods on April 10, 2001, a significant loophole existed in which manufacturers could use to assert that they were involved in the manufacture and not the sale of goods and that the 50,000 RMB threshold for *sales* did not apply to them. In some cases, local authorities have been slow to adopt the new interpretation, if they are even aware of it at all.

Thus, while the shift to criminalization is a sound strategy, it is one that will take many years to show results. At present, we must acknowledge that in the short-to-medium term, China’s legal infrastructure does not have the capacity or the authority to effectively handle the sheer volume of potential IPR violations. The courts are under the jurisdiction of local governments which sometimes have a direct interest in looking the other way when it comes to IPR violations. In some cases, the violating factories are owned by the local governments in question. More often, however, local governments want to ensure social stability and this means employing as many people as possible, even if it means employing them in IPR-violating enterprises.

Conclusions and Recommendations

What should the US do? It is always easier to document problems than it is to propose useful solutions to them. With this caveat in mind, I offer the following recommendations. Some of

them follow directly from the analysis I have provided, but others do not (they are drawn from previous work I have done on the IPR in China issue).³

First, as I have argued above, we must understand the bureaucratic landscape in China in which IPR and other policies are managed and enforced or, alternatively, neglected and overlooked. Indeed, it is precisely such a mapping of China's opaque institutional apparatus that yields the most fruitful and basic knowledge for the outside observer about how the Chinese state works and when it doesn't work quite as well, why it does not. It is difficult work, but there is no substitute for this.

Second, although I have focused on the challenges of covering IPR violations in China under the Criminal Law, I believe that this is an extremely important avenue for China to take. The necessary deterrent effect against piracy and counterfeiting can only be provided by the anticipation that they will be prosecuted under the Criminal Law. However, it would also help bring about positive normative change among the ordinary populace by reminding them that intellectual property theft is exactly that, theft.

Third, we need to recognize that intellectual property violations are based, first and foremost, on economic, not necessarily legal or "cultural," calculations. Most Chinese (and expatriates living in China) buy pirated software, motion pictures, and music CDs because they are cheaper by several orders of magnitude than their legitimate counterparts. A legitimate copy of Microsoft Office – when you can actually *find* one in China – costs more in China than it does in the United States, about the monthly income of most middle-class Chinese. It is no wonder, therefore, that the Chinese prefer to buy it for a dollar. By bringing the price closer to the black market price, at least temporarily, US companies can use their comparative advantage of virus-free software, product upgrades, and support services. This may mean losing money in the short run, but in the long run these losses pale in comparison to the continuation of the status quo.

Fourth, we should maintain pressure on Beijing because it is by now an accepted (indeed, expected) part of the Sino-US relationship. It is something like white noise in that its absence might lead Beijing to conclude that we have softened our stance. But we must also recognize the limits of such pressure and the fact that it can easily become counter productive. Beijing responds best to respectful engagement (as a result in part of the unfortunate historical legacies of quasi-imperialism in the 19th century), albeit with a demonstrated degree of backbone on our end. If we push Beijing too hard on this issue, it will respond defensively and progress will slow down even more. We should be tough, but we must be careful not to overdo it because we do ourselves no favors in bullying China.

Finally, we need to establish and maintain evolving, adaptive, but realistic expectations. In communicating with various individuals within our government, they have expressed frustration with the oft-repeated Chinese argument that in creating a viable IPR infrastructure China is doing in a matter of years and decades what it took the West centuries to do. Even if we take economic and technological leapfrogging for developing countries into account, the Chinese argument is

³ See Mertha, *op cit.*; and "Shifting Legal Goalposts: Chinese Bureaucracies, Foreign Actors and the Evolution of China's Anti-Counterfeiting Enforcement Regime," in Stanley Lubman, Kevin O'Brien and Neil Diamant, eds., *Engaging the Law in China: State, Society and Possibilities for Justice*, Stanford University Press, 2005, pp. 161-192; "Policy Enforcement Markets': How Bureaucratic Redundancy Contributes to Effective IPR Policy Implementation in China," *Comparative Politics* (forthcoming); and "Political Institutions, Local Resistance, and China's Harmonization with International Law," with Ka Zeng, *The China Quarterly* 182 (June 2005): 319-337.

fundamentally correct. Of course, it can be – and often is – used disingenuously, but that does not make it wrong. China has to establish a viable legal and normative infrastructure in order for IPR and other policies to firmly take root in society. This takes time, and simply cannot be rushed no matter how quickly we would like it to happen. There has to be positive as well as negative reinforcement. The negative reinforcement is easy. The positive reinforcement can take a generation or more. Therefore, although it may be frustrating, we must continue to have realistic expectations of what Chinese state capacity and what it is, and is not, capable of doing at any given stage along our vital and mutually beneficial trajectories of bilateral engagement.

Figure 1a (with the Culture Bureaucracy)

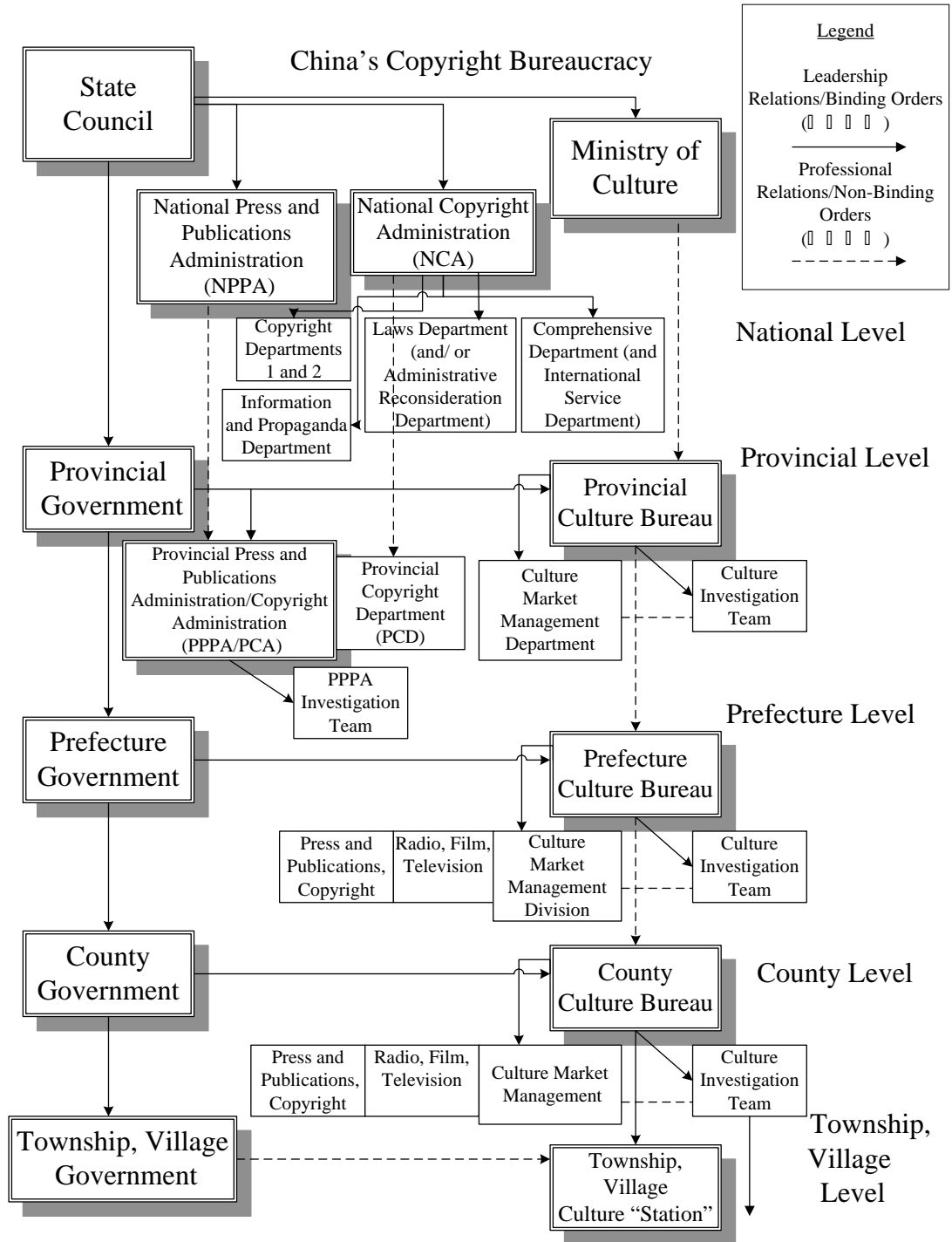


Figure 1b (without the Culture Bureaucracy)

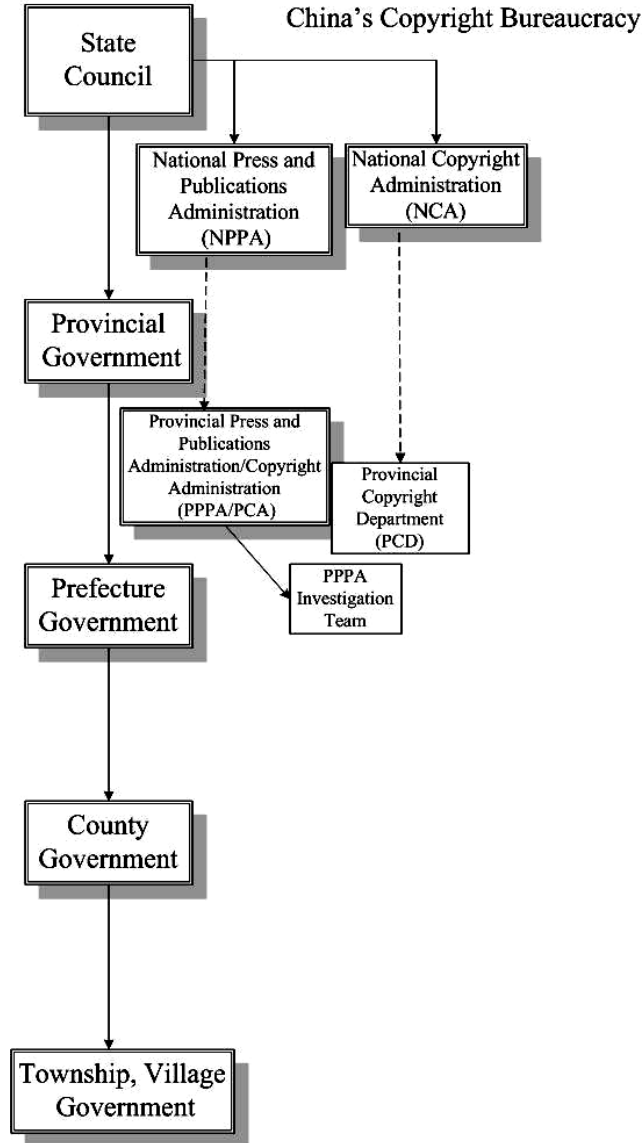
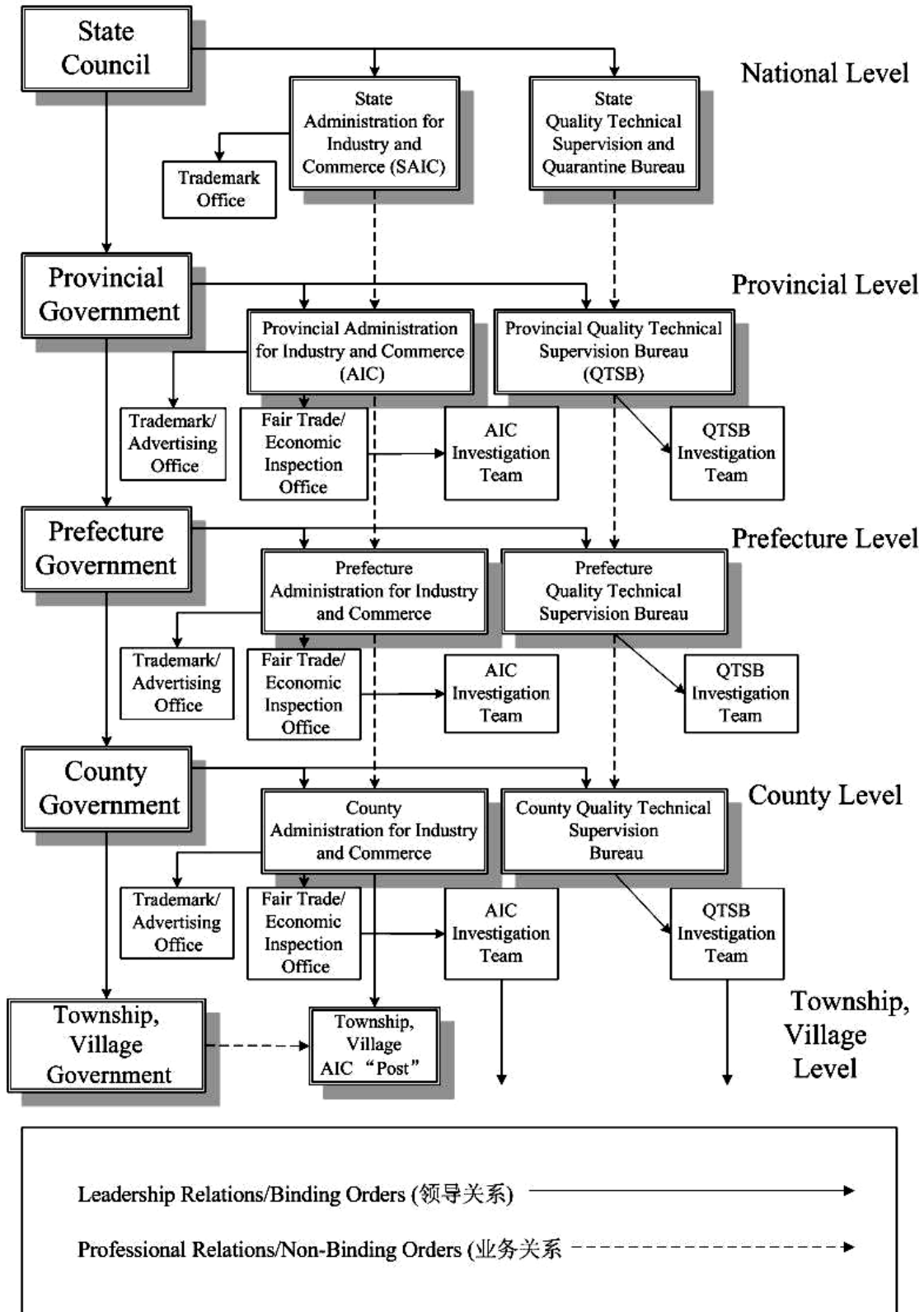


Figure 2

China's Anti-Counterfeiting Bureaucracies*



(*Since 1999, AICs and QTSBs have switched from horizontal to vertical leadership relations up to the provincial level)

