Prepared Statement of
Ted C. Fishman

Senate Homeland Security and Governmental Affairs Subcommittee on Federal Financial Management, Government Information and International Security

Tom Coburn, MD, Chairman
Thomas R. Carper, Ranking Minority Member

Oversight Hearing on "*Ensuring Protection of American Intellectual Property Rights for American Industries in China*."

Monday, November 21, 2005, 10 a.m.

John H. Mitchell Theater at the Museum of Television and Radio, 465 North Beverly Drive, Beverly Hills, CA 90210

No subject is more important to the vitality of the American economy than the protection of our knowledge economy. Americans have made a bargain with the world in which we relinquish low-cost, labor-intensive manufacturing, suffer the closing of thousands of factories and the shedding of millions of jobs provided we replace our old cut and sew and rust belt jobs with higher value knowledge industry and service jobs. I stress that the bargain Americans expect is that lost jobs will be replaced by higher paying ones. To date, that has not been the case, and the practices that are the topic of this hearing, which we might label "China's Loose Intellectual Property Regime," are at the heart of why the this bargain is sending millions of Americans backward economy instead of ahead. At the hearing today the woes of the entertainment industry will get a thorough and welcome hearing. And yet, the problems of movie makers, recording artists and authors may well pale, in economic terms, to those of Americas thousands of manufacturers, their owners, workers and communities.

Allow me to begin by lauding and thanking the *Subcommittee on Federal Financial Management, Government Information and International Security* for taking up the topic of China's lax enforcement and its implications for Americans. Also, I ask your understanding. Because of the urgent nature of this hearing, and the short notice necessary to its scheduling, my remarks are more prone to assertion than usual. I look forward to probing this topic deeper, to following the subcommittee's work and helping the members in any way I can.

In preparing for these hearing I made calls to some of the many industry and trade associations that I have spoken with over the last two and a half years as I reported several pieces for the New York Times Magazine and prepared for my book, *China, Inc.* Trade associations, as you know, speak for collections of companies and interests, but need not necessarily identify individual companies that feel the impact of negative trends in their industries. As a result, the issue, though essential to our economic future, often seems as though it is doomed to exist in a kind of shadow in which general harms are articulated but the victims themselves are hampered from describing the particulars. The dangers to victimized companies are many. Complaining too loudly, many fear, will jeopardize any future plans of penetrating the Chinese market. Government and business interests are often so closely bound up that officialdom, so the fear runs, can and will act punitively against foreign firms that out Chinese counterfeiters and pirates. There are also the consequences at home to fear. Acknowledging a threat from counterfeiters shows weaknesses that companies do not like to make public. They also alert corporate clients to alternatives in the marketplace and may send a companies' best customers shopping. There are also legal liability issues to consider, and the mere acknowledge of a threat from counterfeiters may bring an added, and perhaps prohibitively expensive, burden to police supply chains.

I thought I would expand on a few of the issues related to China's intellectual property regime that I often hear articulate by manufacturing trade associations and by companies to speak to me, sometimes publicly and sometimes confidentially, about their concerns.

First, companies routinely find that is simply impossible to protect their proprietary products and processes in the Chinese market. The monetary harm to lost sales is self-evident for those trying to build businesses in China. But there is another broader implication. China's loose intellectual property regime stands as a giant informal trade barrier to American companies. The fear of theft prevents American firms from wading into the world's fastest growing economy with valuable products they would otherwise be enthusiastic about selling, and even developing or improving. I recently spoke at a large conference of Silicon Valley CEOs and was surprised to learn how few of them were willing to brave the China market, particularly if they were in possession of advanced, disruptive technologies. The reason was fear of theft. In a conversion I had just prior to this hearing, an executive at the Society of Plastics Industry said that one of that group's members was negotiating in China with a potential partner who happened to be an established player in the local market. When the negotiations came around to intellectual property protection, the partner simply refused to offer any assurances that the American company's proprietary goods or methods would be safe. Indeed, the Americans were assured that they would be copied. The competitive reality in China all but demands that companies play pirate, because if they do not, their competitors will.

Second, companies find that their products and processes are expertly mimicked in China and then introduced into legitimate supply chains worldwide. In one common scenario, a purchaser of industrial parts walks into an America factory he has long dealt with and is shown samples and prices from a Chinese manufacturer and told to meet a price. The goods, are often exact copies of products that were developed at great expense by the American supplier, but copied at little cost by a Chinese factory. This is a scenario that should kept in mind at this hearing, because it is piracy and counterfeiting in the business-to-business realm that is often overlooked. As much as eighty percent of the trade in American industry is business to business, and piracy and counterfeiting hit this realm hard. The willingness of Chinese manufacturing to turn out fake autoparts is well-documented. The Motor and Equipment Manufacturers Association estimates that U.S. suppliers lose $12 billion a year due to fraudulent parts. In December 2003, authorities uncovered a $700,000 shipment of counterfeit brake parts on their way to shops servicing New York taxis. Writing in *Automotive Industries* in January last year, Maryann Keller noted that "As foreign automotive investment increases in China, local Chinese companies will have easier access to up-to-date technology of parts and components as well as entire cars that they increasingly have the skill to copy. The legal system suggests that foreign companies have little recourse while consumers, be they Chinese of otherwise, care more about the price than they will about the way that goods were developed and brought to market." Then, raising one of the most ominous questions of all, Keller asks, "Will U.S. auto companies complain if a local Chinese company offers them a copy of a part at a fraction of the price they were paying to the company that did the engineering and design work originally?" If history is prelude the answer is yes. Honda, for one, found that the companies counterfeiting its parts in China did such a superb job, and were so aggressive on price, that is was forced to join with the counterfeiter.

Drug companies report that they are seeing an increased threat from counterfeit drugs entering the legitimate supply chains. Working with Chinese authorities, offiacials at

Pfizer have “seized millions of units of counterfeit pharmaceuticals and thousands of kilos of compounds’ used to make them. The drugs appear identical to those they’re copying, and come in packages that indistinguishable from the real thing. In the worst cases, the fakes are commingled with legitimate products. In May of 2003, 200,000 bottles containing counterfeits of Pfizer’s cholesterol controlling drug Lipitor that were sold by mainstream pharmacies in the U.S. were recalled. Fakes can be a death sentence for patients and possibly for companies. We can all be relived that in this case the Lipitor fakes, did no serious harm to patients or Pfizer shareholders. But a report in yesterday’s Chicago Tribune (November 20, 2005) by reporters David Greising and Bruce Japsen offers an unsettling view of the future. The story describes the reporters journey into Chinese shops in search of counterfeit Viagra. The drugs were easy to find, though often impossible to distinguish from originals. When submitted to labs, some of the fakes proved to be nothing but look-a-likes, but surprising others were not just copies, but “supercopies,” with added doses of Viagra’s active ingredient formulated into the pills, presumably, to keep customers loyal. When counterfeiters start trying to augment drugs, they can feed black market channels with compete with legitimate ones on price and potency, but also threaten users with dire consequences to their health.

One other concern is the speed and sophistication Chinese counterfeiters and pirates bring to their enterprises. It is commonly observed that American and other global companies must stay ahead of the competition through constant and bold innovation. This is undoubtedly true. Certainly, those American firms that fail to adapt and innovate will fall to those that do. Yet, there is a catch to the lead by innovating strategies created by China’s copiers. Technology leaders must spend valuable time, brainpower and financial resources to develop their leading products. Copiers can move faster and at much lower cost. The paradox of successful innovation in a knowledge economy is that ideas and processes, exist nowhere and everywhere at the same time, thus making the new almost instantaneously old hat. To learn American ideas and processes is the same as owning them. Unless, that is, law effectively prohibits their cooption. The style of our economy makes America more vulnerable to the Chinese copying our goods than the other way around. Most of the stuff China makes that finds its way onto the world market is physical. The Chinese can borrow and steal our best stuff all they want. Some of our most valuable products—software code, pharmaceutical processes, car designs, the digital files that put movies on disk—weigh nothing and move at the speed of light as email attachments. If Americans want to borrow and steal what China makes we would have to march in with an army and commandeer Chinese factories and workers. Western powers and the Japanese tried that already, in the mid-19th and early twentieth centuries, and won’t likely repeat the experiment. China, however, can colonize the developed world’s best production simply with careful study and a willingness to go its own way on intellectual property protection.

Of course, American innovation often finds its way into physical products, but it is idea work nonetheless. When General Motors develops a compact car for the Korean market, and sinks hundreds of millions of dollars into its development and design, the Chinese copier, Chery Motors, can simply copy the design and processes and save all the time and money GM spent. The copies Chery produced were not gestures in GMs direction, but so expert that a door from one of the Chery models fit perfectly into the space for a door in GMs Korean car. Right now, an American entrepreneur is attempting to bring Chery cars—not the GM copy—into the United States. This repeats a scenario that legitimizes Chinese copiers and is becoming increasing common. The American importer is counting on consumers to remember that Chery is the company the copied a GM car so expertly, so that when buyers come into a showroom and see Chinese cars for thousands less than their American, Japanese or Korean counterparts, they will see a copy as worthy of their money as the originals.

With the previous observation a lead, I would like to suggest a tone for American efforts to reverse China intellectual property regime and create a culture not of avoidance, but of compliance. There is an easy temptation to demonize the Chinese over their practices. We would also do well to understand the motivation for copying, which often are far from demonic. Some commentators argue that there is a cultural predilection in China to copy. Historically, the argument goes, the Chinese revere masterworks and in school learn to copy literature and art. Under the communism of Mao, there was no right to protect one's intellectual property since everything of economic value belongs to the state and practical, industrial ideas, were to be shared by all. There is also the darker side of the argument, one with ethnocentric ugliness. It paints the Chinese as unique sorts of thieves. I strongly urge the committee and any others taking up the issue of China's intellectual property regime to banish the cultural and ethnic arguments. The Chinese have solid, practical, non-cultural determinant reasons for acting as they do. The simple reason patented, copyrighted and trademarked gods are copied is because they can be. In the United States, before the law and enforcement began to catch up with online music services, like Napster, that allowed songs to be downloaded for free, nearly everyone in America with access to the internet and an interest in music, took their music free. There were, and remain, mountains of logic and rationalization that downloaders use to justify the practice. Recently a group of New York University students marched outside a Manhattan Virgin Megastore to demand their so-called digital rights. Some of their arguments may have merit, but are rooted in the desire to swap and share music at no cost. One way to think of China is as Napster Nation. They take because they can, because there is no consequence to their action and because they profit from it. Dare I say that any of us, if we were granted super powers to take anything in this world we wanted without consequence, might find ourselves yielding to temptation? We don't need 5,000 years of history behind us to know that stealing is cheaper than buying.

Even as leaders we might make the same choice as the Chinese leadership. Here's a simple thought experiment. Imagine you were the leader of between 1.3 and 1.6 billion people, most of them desperately poor and modestly educated. Suppose you could transfer to your people the jewels of the world's advanced industrialized nations, paying nothing for much of it and pennies on the dollar for some more. Suppose, in other words, you could steal the best technology, copyrighted materials, brand names and top entertainment for your wanting people. And imagine further that you had little expectation of being held to account for that theft. In contrast, you would be rewarded for it. In fact, that theft would make your country an ever-more desirable home for the very international fashion, technology and knowledge enterprises you were so liberally borrowing from. Anyone here would make that choice—the choice which the Chinese government and people made and still do make every day. One of the precepts of good leadership is to make one's people prosperous and capable, and the Chinese practices have followed that hands down. Remember, the incomes of the Chinese have risen four-fold in twenty years, the use of personal computers is widespread and expert and Chinese factories routinely run on the very same software that their competitors in America use. In all, China's creation of an extremely loose intellectual property regime has paid off handsomely. And, we must admit, impressively. It has been a key element of China's growth. Rather than fault the Chinese for the method of their progress, I suggest we offer admiration, grudgingly, but sincerely. Conceding their success, however, does not mean conceding. It is now time we exercise what means we have to enforce global rules that will also serve the American economy.

Grudging admiration can wake us up to what ought to be our chief grudge against China's loose intellectual property regime. With due respect to the entertainment industry and to those that make consumer software and electronic games, the harms done to those industries are unlikely to move the American people to action. If we are looking to popularize the issue of intellectual property protection, it may be hard to convince the American consumer, fairness aside, that the likes of Hollywood studios and Microsoft deserve to be richer. Indeed Hollywood seems to pit itself, venially, against its most loyal buyers. The case of Sony's CD copyright protection scheme, revealed over the last two weeks, is a sad case in point. On its latest CD releases, Sony inserted what computer experts describe as spyware, a program that was unleashed when music was played on CD which allowed Sony, and hackers, to monitor a user's machine. The program also wreaked havoc with some computer hardware. That was not a wise course for an industry looking for public consensus on it most important issue.

It is possible to build consensus on the issue by beginning not in Americans' home theaters, but on our shop floors, and in our laboratories and offices. Once one looks there, it is possible to see far beyond the harms usually associated with Chinese piracy. Most often, the harm from piracy is quantified by tallying the lost sales of items that could be sold by legitimate producers if China did not make fakes. Using this way of counting, the U.S. Commerce Department estimates that the world's legitimate intellectual property holders lost around $80 billion to China in 2003-4.

But still the numbers do not begin to describe how piracy is essential to the competitive edge that makes China such a tough competitor. Nearly every good turned out of Chinese factory for export benefits from the country's loose intellectual property regime. That includes the goods that will make America's estimated 2005 $200 billion-plus trade deficit with China. Trade deficit numbers are scary, but they are also a good, albeit indirect, measure of how well American companies—the ones that bring in Chinese goods—profit by taking advantage of China's low-cost manufacturing.

Ron Hollis, the CEO of Quickparts, an Atlanta company that makes custom parts that go into other machines, recently returned from China. There he scouted for new business. On his factory visits he routinely asked whether any of the software in use was legitimate.

Almost none was, he was told nonchalantly; as if an admission that software were legitimate were also an admission that the factories were wasting money.

"In a U.S. factory like mine where engineers spend their days on sophisticated work station with advanced industrial design software, the yearly cost to run software at a single station can cost $60,000," Hollis says. "It can add up to millions a year and be a shop's highest cost. Chinese factories pay nothing for that."

Pirated technology is so common in China, that it is a competitive disadvantage to pay full boat for it. Software used without license fees, reverse engineered advanced machinery, often created with the help of Chinese government research institutes, and proprietary processes and production lines are all common features of the Chinese workplace.

How do we address the problems we face with China's IP regime? First we must acknowledge that bullying is getting us nowhere. China's practices are growing worse over time not better, despite a recent rash of laws that ostensibly address the issue. Also, like any nation that sees itself world power, China does not react kindly to external scolding and ultimatums. Then, too, there is the mixed message Americans deliver to China. We buy $200 billion more worth of goods from China than we sell to the country because China gives American businesses and consumers what we demand most, ever lower prices. The picture of Chinese cargo ships off American ports waiting unload increasing numbers of low-cost goods is not a complete one. Before those dships arrive, American have had to order the goods. If the orders come from powerful buyers, they are usually joined by strong demands to keep prices low. Big box retailers often demand that their suppliers cut their costs every year, threatening them with anathematization if they do not. The question of how those costs are cut is rarely asked, and the insistence that costs not be cut by resorting to technology piracy is never made. Instead, with a wink and a nudge, American buyers insist that Chinese producers cut costs any way they can, and thus put pressure of their suppliers to cut corners and steal technology. The benefit to consumers is great. Americans, on average, save around $600 a year on account of China's low-cost manufacturing. But there is a cost, too, that can be measured in factory closings and lost jobs at home. In the long run, we will see the cost in our collective economic might and political power. Chinese counterfeiting and piracy hits the heart of American industry two ways. First it is an essential element of China's low-cost manufacturing machine, because piracy saves Chinese companies from having to pay the technology costs that weigh heavily on American factories. Americans have learned how to compete against low cost Chinese labor. We do it by automating. But we cannot compete away technology costs, because our legal system demands, rightfully, that they be paid. On the American shop floor, and in the American office, technology is among the highest cost items and American firms spent a high proportion of their budgets on it. In China, technology is a very small component of costs.

Or this problem at home, we need a solution at home. The U.S. could insist that corporate buyers of Chinese-made goods certify that their goods were not made in factories were pirated technology runs the show. This kind of monitoring is already used by U.S.

companies who inspect their suppliers in low-wage countries to make sure they are not using child labor or abusive management techniques. The system is not perfect, but it has made a difference in how American companies and their suppliers do business.

If Americans want to continue to shed old-fashioned manufacturing and move into evermore sophisticated knowledge work, then we must find a way from keeping our “New Economy” from transferring to China at no cost. For a short time we still matter enough to the Chinese to effect a change. Our trade deficit alone with that country is nearly 15 percent of China’s economy. If we don’t protect our economy now, we will find we have far less economic clout after the most vital parts of our economy has been cloned in China.