

**Testimony of Patrick A. Mulloy, Commissioner,
U.S.-China Economic and Security Review Commission**

**Before the
Subcommittee on Federal Financial Management,
Government Information, and International Security
of the
Senate Committee on Homeland Security and
Governmental Affairs**

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**Hearing on “Ensuring Protection of American
Intellectual Property Rights for American Industries in
China”**

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November 21, 2005
Beverly Hills, California

Thank you Chairman Coburn for inviting me to testify today before the Subcommittee on Federal Financial Management, Government Information, and International Security which you chair. I would like to submit the following prepared remarks for the record, and will use my time this morning to briefly highlight a few key points about China's continued violations of the obligations it assumed to protect intellectual property rights – patents, trademarks, industrial designs, and copyrights – when it joined the World Trade Organization.

China is enjoying enormous economic benefits from having joined the WTO, such as being assured of very low tariffs on the goods it ships to the United States. This has brought increased investment to China and a huge increase in the exports it ships to the United States. This has brought increased investment to China and a huge increase in the exports it ships to our country.

China, by joining the WTO, has become a wealthier country. It should, therefore, carry out its WTO obligation to protect intellectual property rights which is something we bargained for both in

supporting the creation of the WTO and in subsequently agreeing to China's entry into it. Since China is failing to do so, at an enormous cost to our citizens, our government should be much more aggressive in using the tools available to us to put pressure on them to fulfill their commitments. This could include putting higher tariffs on Chinese goods that they most want to send to our market. If we bring a WTO case against China and win it, we can be authorized to do just that. We should also strengthen our efforts to keep counterfeit goods made in China out of our market. These goods, such as pharmaceuticals and auto parts, pose a health and safety risk to our citizens.

Let me talk a bit about the benefits China is reaping from its trade with the United States, and then discuss the deleterious impact its failure to carry out its obligations to protect intellectual property rights is inflicting on our economy, and what the U.S.-China Commission has recommended we should do about it.

I. Highlights of the U.S.-China Economic Relationship

- In 2004, total U.S. goods trade with China was \$231 billion, making China the United States' third largest trading partner, behind Canada and Mexico. China was the United States' second highest source of imports, behind Canada, and its fifth largest export destination, behind Canada, Mexico, Japan, and the United Kingdom.
- The U.S. goods trade deficit with China hit a record \$162 billion in 2004 and was the United States' largest bilateral trade deficit – more than twice that of the U.S. goods deficit with Japan, which ranked second. Imports from China reached \$197 billion and U.S. exports to China totaled \$35 billion. These figures represent an increase over 2003 in imports from China (28 percent), exports to China (22 percent) and the overall U.S. goods trade deficit with China (31 percent). Since 2001, the year that China joined the World Trade Organization (WTO), U.S. exports to China have increased 81 percent, and U.S. imports from China have increased 92 percent, leading to an increase in the U.S.

bilateral goods deficit of 95 percent. From 1990 to the end of 2005, the United States will have accumulated over \$1 trillion in trade deficits with China. The Chinese government now controls U.S. dollar reserves of over \$750 billion. It invests some of these dollars in U.S. Treasuries; by doing this – which helps keep U.S. interest rates low – they have gained some leverage over the United States.

- The U.S. goods trade deficit with China represents nearly a quarter of the overall U.S. goods deficit and grew at a faster rate in 2004 (31 percent) than the overall U.S. goods trade deficit (22 percent). In fact, the increase in the U.S. goods trade deficit with China of \$38 billion in 2004 accounts for nearly one-third of the \$119 billion total expansion of the U.S. goods trade deficit during that year.
- The U.S. goods trade deficit with China is spread across nearly all major product categories. Of particular significance is the growing U.S. deficit with China in goods designated by the Department of Commerce as advanced technology products (ATP). U.S. ATP imports from China grew more than 55 percent in 2004, leading to a U.S. ATP deficit with China of more than \$36 billion. Since China joined the WTO, the U.S. ATP deficit with China has increased six-fold, from \$6 billion to \$36 billion.

II. China's Weak Intellectual Property Rights (IPR) Protections and Enforcement

IPR piracy in China remains rampant and is a paramount trade concern for a broad array of U.S. firms whose intellectual property is central to their business success. U.S. exporters are concerned about the theft of their intellectual property and its reproduction and sale in China at a fraction of the cost, while U.S. producers are concerned about having to compete against Chinese firms that can make technology and design advances at low cost using pirated intellectual property.

Notwithstanding legal improvements, IPR violations in China continue virtually unchecked. Piracy rates in China remain above 90 percent across all copyright industries.¹ Counterfeiting in China has reached such epidemic proportions that two-thirds of the counterfeit products in the world are of Chinese origin.² Of the \$94 million worth of counterfeit goods seized at the U.S. border in 2003, 66 percent originated in China.³

Take the example of the U.S. software industry, an industry that should be enjoying enormous market opportunities in China. Instead, the Business Software Alliance estimated that losses to the U.S. software industry due to piracy in China amounted to \$1.47 billion in 2004.⁴ According to industry testimony, U.S. software sales to China have stalled due to IPR concerns:

*Rampant piracy has effectively stalled growth in U.S. software exports to China, despite China's escalating use of computer and software technologies. Consider that in 1996 China was the sixth largest market for personal computers and the twenty-sixth largest for software; it is now the second largest market for personal computers but still only the twenty-fifth largest market for software. This growing gap between hardware and software sales is the inevitable consequence of a market that does not respect intellectual property rights or reward the significant investment required to develop and market innovative software products.*⁵

The U.S. entertainment industry is another whose competitiveness has been heavily affected by the current IPR situation in China. The Motion Picture Association of America (MPAA) reports that China's piracy rate reached 95 percent in 2004 and that during 2003 69 percent of the VCD

¹ U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Assessing and Enforcing Compliance*, testimony of Eric H. Smith, February 4, 2005, p. 312.

² U.S.-China Economic and Security Review Commission, *Hearing on China and the WTO: Assessing and Enforcing Compliance*, testimony of Terence P. Stewart, February 3, 2005, p. 82.

³ Congressional-Executive Commission on China, *Intellectual Property Protection as Economic Policy: Will China Ever Enforce its IP Laws?*, testimony of Daniel C. K. Chow, May 16, 2005.

⁴ International Intellectual Property Alliance press release, *U.S. Copyright Industries Concerned about USTR's 2005 Special 301 Decisions on China and Russia* (Washington, DC: April 29, 2005).

⁵ U.S.-China Economic and Security Review Commission, *Hearing on U.S.-China Trade and Investment: Impact on Pacific Northwest Industries*, testimony of Jesse M. Feder, January 13, 2005, p. 109.

and 85 percent of the DVD discs manufactured in China were pirated product.⁶ The industry estimates that U.S. film companies have lost over \$1 billion in revenue due to piracy in China over the past seven years, with \$280 million of those losses coming in 2004.⁷ Particularly troubling is the MPAA's finding that exports of pirated goods from China to the United States, the United Kingdom, and other countries have increased steadily over the past several years.⁸ Commenting on its competitive concerns, the MPAA told the Commission that "[n]o legitimate supplier of films, whether local or foreign, can compete with pirates who pay no taxes, endure no censorship obligations, and bear none of the costs of running a studio."⁹

This past July, the Motion Picture Association (MPA), an international association with which MPAA is affiliated, entered into an agreement with China's Ministry of Culture (MOC) and State Administration of Radio, Film and Television (SARFT) whereby every three months MPA will submit to MOC and SARFT a list of movies scheduled to be screened in China by its member companies and the Chinese agencies will focus IPR enforcement efforts on seizing and prosecuting pirated videos of these movies that enter the market before their video release date.¹⁰ Both the industry and the Commission await evidence that the promises are being fulfilled. That the industry had to negotiate for its own protection is a troubling sign that the U.S. government has failed in its role as guarantor of the economic rights of its citizens and companies.

While China's domestically produced films also suffer from piracy, there is evidence that when the Chinese government has chosen to do so, it has been able to control piracy in certain areas. In the case of domestic films, where the government has a financial stake in the films or the theaters

⁶ U.S.-China Economic and Security Review Commission, *Hearing on China's High Technology Development*, testimony of John G. Malcolm, April 22, 2005, pp. 241-242.

⁷ U.S.-China Economic and Security Review Commission, *Hearing on China's High Technology Development*, testimony of John G. Malcolm, April 22, 2005, p. 243.

⁸ U.S.-China Economic and Security Review Commission, *Hearing on China's High Technology Development*, testimony of John G. Malcolm, April 22, 2005, p. 242.

⁹ U.S.-China Economic and Security Review Commission, *Hearing on China's High Technology Development*, testimony of John G. Malcolm, April 22, 2005, p. 241.

¹⁰ "MPA press release, "China's Ministry of Culture, SARFT Sign First Anti-Piracy Memorandum with MPA," (July 15, 2005). http://www.mpa.org/MPAAPress/2005/2005_07_15.doc.

showing them, the government has reportedly been able to control piracy so the films can be viewed only in theaters, resulting in a large theater viewership that pirated films are generally unable to realize.¹¹ This suggests that the Chinese government has considerably more power to enforce IPR protections than it has exerted to date.

IPR violations in China go well beyond the software and entertainment industries, with many U.S. industrial firms now being heavily affected. As noted above, General Motors is suing Chinese automaker Chery for illegally copying the design of one of its models. IPR infringements have also affected products like pharmaceuticals and gauges, raising health and safety concerns. The Commission heard testimony on this from a U.S. gauge manufacturer:

For the first time, to the best of my knowledge, Chinese counterfeiters have approached domestic customers for our product in an attempt to sell them copies of our instruments. I recently came into possession of one of these counterfeit gauges. These clones bear our name and address, as well as a label with a CE stamp on it certifying that the product has passed a battery of tests that are required in order for the product to carry this designation and be exported to the EU. In addition, the label on the case of the fake gauge also carries our catalog part number, and the initials of a calibrator as well as a final tester—all misrepresentations. When the product was checked on a test station it was found to be grossly inaccurate. One of the ramifications of this, beyond solely the ethical consideration, is that of creating a potential safety issue for whoever uses the faulty instrument.¹²

China's lack of adequate IPR protections also give Chinese firms a competitive advantage over U.S. firms by allowing many to obtain key technology and design inputs – from software to

¹¹ U.S.-China Economic and Security Review Commission, *Hearing on China's High-Technology Development*, testimony of Darcy Antonellis, April 22, 2005, pp. 258-259.

¹² U.S.-China Economic and Security Review Commission, *Hearing on U.S.-China Trade and Investment: Impact on Pacific Northwest Industries*, testimony of David A. Blackburn, January 13, 2005, p. 168.

assembly line design – at a fraction of the cost to their U.S. competitors. Removing the need to shoulder comparable production costs gives Chinese firms in many sectors the ability to heavily under-price U.S. firms, in capital-intensive as well as labor-intensive industries. Some observers contend that for these reasons the Chinese government views a lax IPR enforcement regime as part of its industrial policy:

China's failure to police its intellectual property rules often looks less like ineffective government than a conscious policy to shift the highest value goods from other economies into the country. It is, in essence, the largest industrial subsidy in the world, and brilliantly, it costs the Chinese nothing. In 2005, China will most likely be the world's third-largest trading nation, and counterfeiters give the country's increasing number of globally competitive companies the means to compete against powerful foreign rivals that pay for their use of proprietary technologies.¹³

The U.S. government has spent the last 15 years working with China to improve its IPR protection and enforcement regime with little to show in the way of concrete results. This has been the case despite the fact that bilateral agreements on IPR were concluded with China in 1992, 1995, and 1996, China's accession to the WTO and its accompanying agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), and high-level IPR enforcement commitments by China in the 2004 meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT). Improving China's enforcement of IPR was again the major topic of the JCCT talks that took place this past July. The Commission remains skeptical that China will make any substantial progress in curbing its level of IPR violations without aggressive U.S. enforcement efforts under U.S. law and in international venues.

¹³ U.S.-China Economic and Security Review Commission, *Hearing on China's High Technology Development*, testimony of Ted C. Fishman, April 22, 2005, p. 275.

III. Enforcing China's Compliance

Despite incomplete compliance with WTO obligations, China has faced only one WTO dispute to date. As discussed in Section 1, the United States filed a dispute in March 2004 concerning China's discriminatory VAT on semiconductors that favored domestic producers. Japan, Taiwan, Mexico, and the European Union all joined the complaint after it had been filed. China quickly settled the dispute to the satisfaction of the petitioners before the case reached adjudication.

A number of China's practices in other areas are similarly ripe for WTO adjudication.

Intellectual Property Rights

As detailed in Section 1, violations of intellectual property rights (IPR) in China continue virtually unchecked. However, this is no longer primarily a function of lax IPR laws: China has improved many of its laws regarding IPR since its accession to the WTO. The major remaining legal loophole is a high monetary threshold that must be cleared before criminal charges apply. This threshold contradicts provisions of the WTO's TRIPS Agreement that calls for criminal treatment of IPR violations on a commercial scale irrespective of the value of the loss.¹⁴

China's principal IPR deficiency is effective enforcement of its laws, which is among its WTO commitments.¹⁵ To date, with industry sources citing piracy rates above 90 percent, it is starkly

¹⁴ Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), Part III, Section 5, Article 61: "Members shall provide for criminal procedures and penalties to be applied at least in cases of willful trademark counterfeiting or copyright piracy on a commercial scale. Remedies available shall include imprisonment and/or monetary fines sufficient to provide a deterrent, consistently with the level of penalties applied for crimes of a corresponding gravity. In appropriate cases, remedies available shall also include the seizure, forfeiture and destruction of the infringing goods and of any materials and implements the predominant use of which has been in the commission of the offence. Members may provide for criminal procedures and penalties to be applied in other cases of infringement of intellectual property rights, in particular where they are committed willfully and on a commercial scale."

¹⁵ Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), Part III, Section 1, Article 41: "Members shall ensure that enforcement procedures as specified in this Part are available under their law so as to permit effective action against any act of infringement of intellectual property rights covered by this Agreement, including expeditious remedies to prevent infringements and remedies which

apparent that China has failed to fulfill those commitments.¹⁶ China pledged to enact a specific plan for protecting IPR during the April 2004 meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT). Subsequently, USTR conducted an out-of-cycle review of IPR protection in China and determined that China had not delivered on the promises made at the 2004 JCCT.

USTR maintains a watch list of countries with the most egregious failings in IPR protection. Those countries with the most egregious IPR violations that “are not engaged in good faith negotiations or making significant progress in negotiations to address these problems” are designated “Priority Foreign Countries” and face the possibility of U.S. sanctions.¹⁷ Priority Foreign Countries can move to the less severe, transitional category of Section 306 monitoring if they enter into good faith negotiations or make significant progress in addressing cited problems. As a result of USTR’s out-of-cycle review, China was demoted from Section 306 monitoring to the Priority Foreign Countries list.¹⁸ This change in designation reflects the conclusion that China’s participation in negotiations regarding IPR issues has not been in good faith, as evidenced by unabated IPR violations.

The July 2005 JCCT meeting resulted in more promises by China to take specific actions intended to reduce the theft of intellectual property. The Commission recognizes that these steps, if completed, would improve the status of IPR in China, but reiterates that China repeatedly has made similar pledges to no effect.

constitute a deterrent to further infringements. These procedures shall be applied in such a manner as to avoid the creation of barriers to legitimate trade and to provide for safeguards against their abuse.” In the 2005 JCCT, China agreed to increase the ratio of criminal prosecutions to administrative prosecutions, which may have some practical effect but will not satisfy China’s obligations under the TRIPS article above.

¹⁶ U.S. Trade Representative, *2005 Special 301 Report* (Washington, DC: 2005).

¹⁷ U.S. law provides for the possibility of sanctions, but any sanctions applied under U.S. law would still be subject to U.S. obligations under the WTO.

¹⁸ U.S. Trade Representative, *Out-of-Cycle Review Results - China* (Washington, DC: April 29, 2005).

China's failure to protect IPR is clearly within the jurisdiction of the WTO, given China's explicit obligations under the TRIPS agreement. Because China is not making satisfactory progress in this area, the United States should initiate action through the dispute resolution process at the WTO to address China's failure to comply with both the criminal penalties and enforcement provisions of TRIPS. In October 2005, USTR requested information from China regarding China's IPR enforcement efforts.¹⁹ USTR's request exercises U.S. rights under the WTO's TRIPS agreement, but it will not automatically result in WTO consideration of action to require China to alter its approach to IPR protection. The U.S. can and should pursue further steps toward this end.

Related U.S.-China Commission Recommendations:

Challenging China's IPR Violations

- The Commission recommends that Congress support the U.S. Trade Representative in taking immediate action under U.S. law and in international venues pertaining to China's violation of IPR obligations, particularly China's failure to meet the requisite standards of effective enforcement, including criminal enforcement, explicitly imposed by the Trade Related Aspects of Intellectual Property Rights (TRIPS) Agreement.

Coordinating with the European Union and Japan on China Trade and Security Matters

- The Commission recommends that Congress work with the Administration to undertake more active efforts to coordinate with the EU, Japan, and other interested nations as appropriate to address mutual trade- and security-related concerns with China. Among these areas should be the following:
 - European governments and Japan share U.S. concerns about continuing large-scale IPR violations in China. Brussels, Tokyo, and Washington should coordinate their

¹⁹ U.S. Trade Representative press release, "USTR Pursues WTO Process to Probe IPR Enforcement in China" (Washington, DC: October 26, 2005).

strategies on improving Chinese IPR compliance, particularly through joint action in the WTO.

Thank you for your leadership in this important matter, and for giving me the opportunity to present the views of the U.S.-China Economic and Security Review Commission concerning it.