

**COUNTERFEITING IN CHINA AND
ITS EFFECT ON U.S.
MANUFACTURING**

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Written Testimony of

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I. Introduction

In terms of size, scope, and magnitude, trademark counterfeiting in China is considered by many to be the most serious counterfeiting problem in world history. A recent study by the PRC State Council Research and Development Center reported that in 2001 the PRC economy was flooded with between \$19-\$24 billion worth of counterfeit goods. Brand owners in China estimate that 15 to 20% of all well-known brands in China are counterfeit and estimate their losses to be in the tens of billions of dollars per year. Counterfeiting is estimated to now account for approximately 8% of China's gross domestic product.

China has also become the platform for the export of counterfeit products to other countries in Asia, Europe, and the United States. In 2003, China accounted for 66% or over \$62 million of the \$94 million of all counterfeit and infringing goods seized by the US Customs Service at ports of entry into the United States. Of course, the value of what is seized can represent only a tiny fraction of what actually enters the US market. An ominous development is that beginning in 2004, exports of counterfeits from China to the United States and other parts of the world may begin to increase significantly for the foreseeable future.

II. Origins and Causes of Counterfeiting

There are several explanations for the unprecedented size and scope of counterfeiting in China:

(1) *Foreign Direct Investment and Advanced Technology.* In recent years, China's economy has enjoyed unprecedented growth for an economy of its size with growth rates of 9.8% from 1980-92 and at 9% more recently. According to some estimates, China is on track to have the world's largest economy in the first decades of the twentieth first century. This is a remarkable achievement for a nation that was mired in backwardness and poverty just several decades ago.

This economic growth has been fueled in large part by foreign direct investment from multi-national enterprises. In the 1990s, China emerged as the world's second largest recipient of foreign direct investment behind only the United States and in 2002, China surpassed the United States to become the world's largest recipient of foreign direct investment with \$50 billion of foreign capital inflows. FDI is the best means in the world today for the transfer of advanced technology, intellectual property, and other forms of valuable information. In many cases today the intellectual property component of a FDI in the form of patents, copyrights, and trademarks is the most important component of the foreign investment. For example, the value of the Coca-Cola trademark in

China is worth more many more times to that company than the millions of dollars in capital that it has invested in China. The same is true for the patents and copyrights owned by pharmaceutical companies and software companies doing business in China today. However, while MNEs are creating a transfer of technology through FDI that is being absorbed into China's legitimate economy through joint ventures and wholly foreign owned enterprises, some of this intellectual property is also being diverted into China's illegitimate economy as pirates steal this technology to engage in counterfeiting and other forms of commercial piracy. It is no coincidence that China, the world's largest recipient of FDI, advanced technology, and intellectual property also has the world's most serious commercial piracy problem.

(2) *State Support of Counterfeiting and Local Protectionism.* No problem of this size and scope could exist without the direct or indirect involvement of the state. In China, the national government in Beijing appears to be sincere in its recognition of the importance of protecting intellectual property rights, but national level authorities are policy and law-making bodies whereas enforcement occurs on the ground at the local level. At this level, local governments are either directly or indirectly involved in supporting the trade in counterfeit goods. Counterfeiting has become so important that this illegal trade now supports entire local economies and a crackdown on counterfeiting would result in a shutdown of the local economy with all of the attendant costs of unemployment, dislocation, social turmoil, and chaos. Because the costs of a crackdown at the local level can be so severe, counterfeiting is heavily defended at local levels.

(3) *Ineffective Legal Enforcement and Lack of Deterrence.* China has a developing legal system that is weak in many respects by comparison to legal systems in advanced industrialized countries such as the United States. While China's intellectual property laws are now considered by most observers to be in compliance with the standards set by TRIPS, enforcement of these laws remains inadequate and fails to create sufficient deterrence to counterfeiting.

The combination of these factors – the world's largest influx of foreign direct investment and widespread access to advanced technology, direct or indirect government involvement and support of the counterfeit trade, and a weak legal system that does not create sufficient deterrence for counterfeiters in a very lucrative trade – has resulted in a counterfeiting and commercial piracy problem that is unprecedented in world history.

III. Overview of Counterfeiting in China

The illegal trade in counterfeit goods in China can be divided into two components: manufacture and distribution.

A. Manufacture and Organized Crime

The manufacture of counterfeits appears to be concentrated in the southeastern region of China, mostly in Fujian and Guangdong Provinces. Fujian, located across the China Straits from Taiwan, is the ancestral home of many Taiwanese. Guangdong Province is adjacent to Hong Kong and the ancestral home of many Hong Kongese. Both Guangdong and Fujian Provinces were some of the first areas opened to foreign investment in China and were some of the first locations for sino-foreign joint ventures and wholly foreign owned enterprises engaged in the manufacture of famous international brands of consumer products. Both of these areas were among the first areas in China to legally acquire foreign technology used in the production and manufacture of famous brands. Some of this technology and know-how has been acquired for illegal purposes. In a pattern that appears throughout other parts of China, an area where legitimate manufacturing is concentrated has given rise to illegal underground factories manufacturing counterfeits of the genuine products that are manufactured in nearby factories under the authority of the intellectual property owner.

Criminal organizations based in Hong Kong and Taiwan who have maintained connections with their ancestral homelands often provide the financing for the underground factories that manufacture illegal counterfeits in Guangdong and Fujian province. Anecdotal evidence indicates that these are the same criminal organizations that are involved in smuggling products into China, narcotics, prostitution, and pornography. The large sums of money that can be earned through counterfeiting and the relatively innocuous penalties by comparison to those imposed for other types of economic crimes such as smuggling and narcotics have lured these criminal organizations to the counterfeiting trade.

B. Distribution

The manufacture of counterfeit products is of little use if the products cannot be delivered to the end use consumer. For this reason, the distribution of counterfeit products to retail levels of commerce is crucial to the counterfeit trade in China as elsewhere in the world. Large, legitimate wholesale distributors deliver products to state-owned stores or foreign-owned chain stores. Counterfeits cannot enter retail markets through these regular channels.

In China, the distribution of counterfeit products occurs through a series of large open air or partially enclosed wholesale markets located in densely populated areas with convenient transportation access. These markets are often massive in size and can contain more than one thousand outlets, each a wholesale distributor, occupying a stall or a semi-finished storefront. In the author's experience there is no wholesale market in China that does not carry counterfeit and infringing goods for sale. Many wholesale dealers have counterfeit goods on open display while others will display genuine products but have counterfeits in a back room or under the counter and available for the asking. In the heart

of Beijing, hundreds of small retail vendors swarm the Tianyi wholesale market everyday and use three wheel bicycles, lorries, and small trucks to furnish the street stalls, open air kiosks, and small retail stores with abundant supplies of counterfeit and infringing products.

These wholesale markets are established and regulated by the local Administration of Industry and Commerce (AIC), a branch of the local government responsible for promoting, regulating, and policing commercial activity. In a typical situation, AICs will invest their own funds in establishing the wholesale market and will collect rent from each of the individual wholesale distributors. In addition, AICs will issue business licenses for a fee to each individual proprietor. Once the business is in operation, AICs will also collect a management fee from each individual proprietor. In a large wholesale market such as Tianyi, the operating revenues to the local AIC can easily exceed \$100,000 per year. As noted above, many if not most of these wholesale distributors deal in counterfeit goods. As AICs are also one of the primary government entities in China charged with the enforcement against counterfeiting, AICs are faced with a conflict of interest as they are charged with policing and enforcing the very markets in which AICs and the local government have a substantial investment and financial interest. Shutting down these wholesale markets would not only result in a direct loss of revenue to the AIC but would also have many repercussions as many retail businesses, hotels, restaurants, and nightclubs are all supported by the trade in counterfeit goods. In some cities, such as Yiwu discussed below, the entire local economy is connected to the trade in counterfeits.

Based upon the author's working experience in China, there are at least five major wholesale markets in China: Hanzhen Jie in Wuhan City, Hubei Province; Linyi Market in Linyi, Shandong Province; Nansantiao Market in Shijiazhuang in Hebei Province; China Small Commodities City in Yiwu City, Zhejiang Province; and Wuai Market in Shenyang, Liaoning Province. Together these markets serve the entire coastal region of China and its most populous urban areas including Guangzhou in the south, to Shanghai in the east and Beijing and Tianjin in the northeast. A branch of the China Small Commodities City market of Yiwu located in Wulumuqi in Xinjiang Province serves as an export post for the Middle East and Eastern Europe. These markets (represented by circles) and their relationship to the manufacturing centers (shaded areas) are set forth in the map below:

IV. **Barriers to Effective Enforcement Against Counterfeiting**

This section will briefly examine the major barriers that impede effective enforcement against counterfeiting.

a. Local Protectionism

Efforts by both the US government and industry lobbying groups have been largely directed at central level authorities in Beijing to make legislative changes and national commitments to combat counterfeiting. While it appears that central level leaders understand the importance of protecting intellectual property for promoting China's long-term economic development, central level authorities are legislative and policy-making bodies. Actual implementation and enforcement of the law occurs at the local level where there continue to be questionable commitments to suppressing counterfeiting, copyright piracy, and other forms of economic crimes.

Local level leaders are evaluated by the economic performance of their local political units and counterfeiting can be a boom to the local economy. The trade in counterfeit goods can absorb large numbers of unemployed workers, generate substantial revenues, provide tax revenues, and support other legitimate industries such as warehouses, hotels, restaurants, and nightclubs in the local economy. In the town of Yiwu in Zhejiang Province, well known as the center of commercial piracy in China, everyday at least 200,000 customers visit the over 33,000 wholesale stores and outlets selling over 100,000 varieties of products. Industry experts estimate that over 90% of the daily use and consumer products sold in Yiwu are counterfeit or infringing goods. Yiwu serves as a wholesale distribution center for products sold all over China. Yiwu also does a brisk export trade to countries in Africa, Asia, and South America. According to Yiwu government authorities, total sales of its wholesale business totaled \$2.4 billion in 1997 – the last year that figures were made publicly available – more than the total business of most MNEs in China. These wholesale businesses also account for a substantial portion of the taxes paid to the local government supporting a host of public services. Most of the businesses that sell counterfeit and infringing goods in Yiwu negotiate a fixed amount of taxes to be paid to the local government in lieu of payment based upon graduated tax rates linked to revenue. It is no exaggeration to say that the entire local economy in Yiwu is built on the trade in counterfeit and pirated goods and that shutting this illegal trade would be tantamount to shutting down the local economy. The trade in counterfeit and pirated goods has transformed Yiwu from a poor farming town into an economic model that other towns are seeking to emulate.

Not only are local leaders reluctant to shut down productive economic activity, local government entities often have a direct financial interest in the illegal trade itself. For example, in Yiwu, the local administration of industry and commerce has invested millions of dollars in the construction of the wholesale markets that sell counterfeit and

infringing goods and charge monthly management fees to the businesses that sell these illegal goods. The AIC is also the same body that is in charge of enforcement against trademark counterfeiting and infringement. In Yiwu and in many other locations, the local AICs may have a financial interest in the very activity that they are supposed to suppress. In addition, the bulk of the wholesale and export of counterfeit products in Yiwu is owned and operated by a large corporate conglomerate that is owned by former and possibly some current government officials and Party leaders. These current or former government officials and Party leaders are able to exert enough influence on local enforcement authorities to protect the flourishing trade in counterfeit goods. Although Yiwu is an extreme example of the obstacles that are created by a local environment that is supported by counterfeiting, the same types of issues are present in many locations throughout China. In addition to having local officials that may have a direct or indirect financial interest in counterfeiting and piracy, local enforcement officials, prosecutors, and judges may be beholden to the local governments that appointed them and may face pressures to protect the local trade in counterfeit and pirated goods.

Overcoming local protectionism cannot be done simply through the drafting of new laws on intellectual property protection or the periodic “strike hard” campaigns initiated by central authorities against counterfeiting and piracy. While most of China’s top leaders acknowledge that counterfeiting is a serious problem, China has a long list of problems of varying degrees of urgency. Any decision by central authorities to suppress local protectionism will involve significant political and social costs at a time when the PRC faces many difficult problems competing for the limited resources of the central government. Where local authorities are unwilling to shut down an economic activity that is perceived to be beneficial to their local economies, PRC central authorities will need to expend significant political resources to overcome the resistance of local authorities. Cracking down on counterfeiting may also result in serious social turmoil caused by the loss of employment, the shutting down of legitimate businesses, and other painful consequences. Faced with the significant costs involved in any serious nationwide campaign against counterfeiting, China’s central authorities will naturally avoid incurring such costs, if possible. To date, it appears that China’s central authorities lack the political resolve or commitment to launch a serious nationwide crackdown on counterfeiting.

b. Lack of Adequate Sanctions and Criminal Prosecutions

Local protectionism and the lack of mandatory guidelines for the imposition of serious fines and criminal sanctions have resulted in an enforcement system that does not adequately deter counterfeiting. Most brand owners in China are successful in using administrative authorities to bring raids and seizures, but many brand owners complain that counterfeiters and pirates are often back in business in a matter of weeks after an enforcement action has been completed. Set forth below are recent enforcement statistics reported by the State Administration of Industry and Commerce, the central level authority with primary authority over trademarks:

AIC TRADEMARK ENFORCEMENT ACTIVITY, 1997-2000

Year	Cases	Avg Fine	Avg Damages	Criminal Prosecutions
1997	15,321	\$679	\$40	57 total or 1 in 268 cases
1998	14,216	\$699	\$41	35 total or 1 in 406 cases
1999	16,938	\$754	\$40	21 total or 1 in 806 cases
2000	22,001	\$794	\$19	45 total or 1 in 489 cases

Source: State Administration of Industry and Commerce Annual Statistics

The average fine imposed on the counterfeiter or infringer in 2000 is \$794, an increase of more than 15% over the 1997 figure but is still so low as to be considered a cost of doing business in a very lucrative trade. The amount of compensation awarded to brand owners in 2000 stands at \$19, a negligible amount. Damages awarded by AICs seek to award the brand owner the profits earned by the counterfeiter after deducting all expenses (as represented by the counterfeiter) and are not based upon economic losses suffered.

Turning to the issue of criminal prosecutions, administrative authorities are to transfer cases that involve criminal liability to judicial authorities for criminal prosecution. The standards for criminal liability for counterfeiting are set forth in the Criminal Law of 1997. For example, under Article 140, a producer or distributor who has sales of inferior quality counterfeit goods exceeding RMB 50,000 (\$6000) but below RMB 200,000 (\$24,000) must be sentenced to a term of imprisonment of up to two years and must also pay fines. As the level of sales increases, so does the severity of the criminal punishment. Other provisions in the Criminal Law use a similar approach based on sales of counterfeit or inferior quality goods. *See* Criminal Law, Arts. 141-148. As the statistics above indicate, however, the number of cases transferred by administrative authorities for criminal prosecutions actually declined from 57 cases (1 in 268 cases) in 1997 to 21 cases (1 in 806 cases) in 1999. The 45 cases (1 in 489 cases) transferred for criminal prosecution is still below the 1997 figure even though the number of infringement cases brought in 2000 represents a 43% increase over the 1997 figure. These levels of criminal prosecutions are too low to serve as a deterrent to wrongdoers.

One reason for such a low criminal prosecution rate is that administrative authorities are often reluctant to transfer cases to judicial authorities. Administrative authorities expend time and resources in conducting raids and seizures but are unable to collect fines from the perpetrator when a case is transferred. AICs authorities will also have to transfer to judicial authorities confiscated products, machinery, and other evidence that might otherwise be sold at a public auction with the proceeds retained by the AICs. An additional reason is that the current practice in the PRC is to set a high

evidentiary bar for criminal cases by requiring physical evidence of completed sales in the form of sales orders, sales receipts, ledger and account books, and tax documents. Counterfeit goods seized on the premises, packaging, or the equipment used in the manufacture of counterfeit goods, no matter how large the quantity, are not considered evidence of sales. Few if any counterfeiters keep such physical records of their illegal activities and gathering probative evidence has proven to be a difficult burden for most brand owners.

V. Exports from China

Recent changes indicate an ominous development: exports from China are likely to increase dramatically beginning in 2004.

a. Exports to the United States

In 2003, U.S. Customs seized a total of \$94 million of counterfeit and infringing goods in ports of entry in the United States. Of this total, products originating in China accounted for 66% of the total and \$62.4 million of the total. The 2003 figures for China represent a significant increase over comparable 2002 figures when China accounted for 49% of all counterfeiting and infringing products and \$48 billion of the total \$98 million of illegal product seized by US Customs.

United States Customs Service IPR Seizure Statistics 2003

Trading Partner	Domestic Value	Percent of Total
China	\$ 62,468,018	66%
Hong Kong	\$ 8,236,507	9%
Korea	\$ 3,219,268	3%
Pakistan	\$ 2,010,465	2%
Mexico	\$ 1,966,929	2%
Malaysia	\$ 1,331,925	1%
Philippines	\$ 1,224,058	1%
Canada	\$ 1,189,160	1%
Switzerland	\$ 676,197	Less than 1%
Thailand	\$ 662,112	Less than 1%
All Other Countries	\$ 11,024,588	12%
Total FY 03 Domestic Value	\$ 94,019,227	
Number of Seizures	6,500	

Counterfeits from China and Hong Kong (through which many counterfeits produced in China are transshipped) accounted for \$80 million or 75% of the total. No other country accounted for more than 3% of counterfeit products. As it is well-known that many counterfeit products, such as auto parts, that originate in China are transshipped through other countries, such as those in South America and through Canada, before ultimately entering the United States, China accounts for a significantly higher percentage than the 66% set forth the 2003 US Customs statistics. It is possible that China accounts for as much as 80% or more of the counterfeits goods that enter the United States.

Note that the \$94 million figure represents only the value of the products that are seized by US Customs in 2003, which can only be a tiny fraction of what enters the US market. If the total value of the products seized represents 1% of the counterfeiting and infringing product that enters the U.S. market then the total value of counterfeits that entered the US market in 2003 is approximately \$10 billion with China accounting for between \$6 and \$8 billion of that total. It is possible that the actual figures are much higher.

b. Exports from China to Other Locations Around the World

While exports of counterfeits from China into the United States have a direct impact on the rights of IP owners in the U.S., exports by China to countries around the world also have an economic impact on U.S. IP owners for two reasons. First, exports of counterfeits may displace exports of legitimate products by U.S. IP owners. For example, if China exports counterfeit batteries to Canada that are then purchased by consumers, this might decrease demand for legitimate batteries that will deprive U.S. battery manufacturers of an export opportunity. Second, U.S. IP owners need to expend additional resources to combat a global counterfeiting problem that emanates in large part from China. The expenditure of significant resources in time, capital, and management is a drain on U.S. IP owners and a diversion of these resources from a more productive use in building additional business capacity in the United States and other locations that might lead to greater productivity, increase revenues, and the creation of new jobs.

c. Significant Rise in Exports from China

There is likely to be a significant increase in the amount of counterfeit products exported from China to the United States beginning this year (2004) and for the foreseeable future for several reasons.

First, in accordance with its WTO obligations, China has amended its foreign trade laws in December 2003 to eliminate the monopoly on export rights that had been limited to state trading companies. Under prior law, only certain designated state trading companies were permitted to lawfully export products from China to other countries. This restriction meant that counterfeiters had to find a compliant state trading company

that was willing to work together with the counterfeiter in exporting the illegal goods overseas. To be sure, there was no shortage of export companies willing to work with counterfeiters in exporting counterfeit and infringing products, but this requirement nevertheless created an additional obstacle and costs that have now been removed. The effect of the elimination of the monopoly on export rights means that anyone can now lawfully export products from China. Counterfeiters will now be able to export on their own without the need to find a suitable and willing partner and to pay the fees for its cooperation. As counterfeiters are likely to take full advantage of the elimination of this restriction, exports of counterfeits from China to the United States are likely to surge for the foreseeable future.

Second, counterfeiters in China have begun to make use of the Internet to sell counterfeit products to consumers from all over the world. The increase in the use of the Internet, combined with the elimination of restrictions on export privileges, is likely to result in a significant short-term increase in the export of counterfeit products to all parts of the world.

Third, China is now actively negotiating with its trading partners around the world to lessen customs requirements and other impediments for the importation of its products. China has of course legitimate national interests in seeing that its legitimate products are imported by other countries with the least amount of impediments but the lowering of these requirements will also benefit the trade in counterfeit goods as they will also enter into these countries with less scrutiny. China is currently negotiating with several countries on the north coast of South America from where counterfeit products, entering these countries with little scrutiny, might then be transshipped to other countries around the world, including the United States.

Finally, it should be emphasized that China does not have any current criminal laws that apply to the export of counterfeit products. As the earlier discussion indicated, China has criminal laws against commercial scale counterfeiting within China, although the effective enforcement of these laws is impeded by various obstacles. In the area of exports, however, as there are no applicable criminal laws at all, counterfeiters can export with impunity from both civil and criminal liability. While the enforcement of China's laws against counterfeiting within China has serious inadequacies at least these laws exist. In the area of exports there are no laws and given the choice between committing an activity that violates domestic law and being exposed to civil and criminal sanctions and the choice of exporting with impunity, it is likely that counterfeiters will increasingly turn to exports to earn profits.

Given these developments – the elimination of the state monopoly on export rights, the rise of the internet, China's pressure on its trading partners to reduce entry requirements, and the lack of criminal penalties – we are likely to see a significant rise in the export of counterfeits from China to the United States and locations around the world.