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**POLICY OPTIONS ON INTELLECTUAL
PROPERTY RIGHTS**

CHINA REGIONAL STUDY

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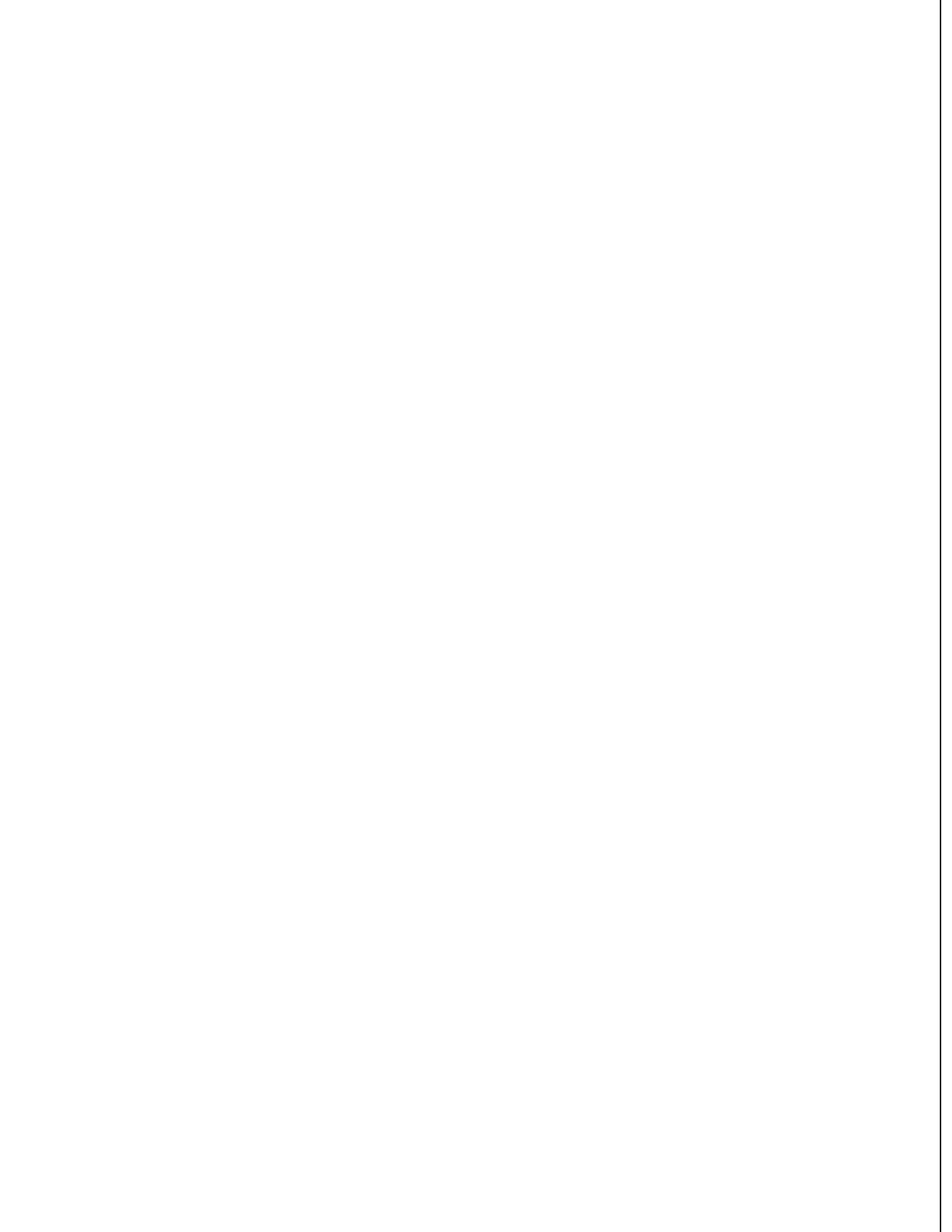
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INTRODUCTION

The Chinese government's inability to enforce international laws on Intellectual Property Rights (IPR) is a growing concern for United States (US) policy makers. Our government's policy on IPR with respect to China must be modified to ensure our national strategy objective of growing free and fair international trade is achieved without undue harm to either the Chinese or US economies. After a brief overview of the relevant background, three policy options are presented and analyzed leading to a recommended policy called Hard Industry Enlightenment.

BACKGROUND

Intellectual property refers to the creations of the human mind. Intellectual Property Rights (IPR) are the rights given to individuals over those creations. Those rights are typically defined into two main areas:

Industrial property, which includes inventions (patents), trademarks, industrial designs, and geographic indications of source; and Copyright, which includes literary and artistic works such as novels, poems and plays, films, musical works, artistic works such as drawings, paintings, photographs and sculptures, and architectural designs. [1]

The concept of IPR is a strictly a modern product of European thought which began to coalesce during the 18th century. As the industrial revolution created the need to protect this new form of wealth generation, especially from one's economic rivals, the European nation states began to enter into an evolving series of IPR treaties starting in 1870. That evolution has culminated in the current World Trade Organization (WTO) Trade Related Aspects of Intellectual Property Rights (TRIPS) agreement. TRIPS is the standard by which all WTO countries define, enforce, and resolve disputes on IPR.

China has made significant progress with respect to IPR in the past 20 years. Intellectual property was - and in many parts of the country still is - a foreign concept to most Chinese.

Unlike the European cultures, there is no indigenous history of IPR prior to 1949 and the communist regime considered all property rights to belong to the state until the end of the Cultural Revolution. The US and China entered into their first formal agreement on IPR in 1992 and then readdressed the issue in 1995 and 1996. In anticipation of joining the WTO, China put new TRIPS compliant copyright, trademark, and patent laws in place in Dec 2001. One of the key reasons the US supported the accession of China into the WTO was to gain the advantages of TRIPS.

The Chinese government appears committed to honoring her WTO obligations. Recent books, media talk shows, government reports and speeches have all stressed the importance of IPR protection to China's economic progress. A host of training programs, both in country and back in the US, are underway to train Chinese business and legal people. Major crackdowns on counterfeiting and piracy have been conducted. Weak criminal penalties and poor enforcement combined with sophisticated adversaries makes reducing IPR violations a real challenge.

IPR violations have a major adverse impact on US business interests. Counterfeiting is a \$16 billion industry in China [2]. Knock offs are available all over China and the latest software and DVDs are available in counterfeit form many times before the legal items are available in the states. The International Intellectual Property Alliance estimates our companies lost \$1.5 billion in 2001 due to the piracy of audio-visual products and software, and that piracy levels for those products reached 90 percent [3]. Estimates of losses in other consumer products run from 15-20 per cent of total sales in China with some individual firms claiming losses of over \$200M [4]. It is too early to determine how the latest WTO measures will impact the situation, but past history clearly illustrates the serious nature of this problem if it remains relatively unchecked.

POLICY OPTIONS AND ANALYSIS

Option 1: Hard Mercantilist.

Policy Statement. The US will take a hard line mercantilist stance on strict Chinese adherence to international IPR standards. We will aggressively push the World Intellectual Property Organization (WIPO) to fully enforce all elements of TRIPS. But if enforcement doesn't rapidly produce positive results, we will take unilateral action to severely restrict Chinese imports and new foreign direct investment in China. We shall put strong diplomatic pressure on our key allies to do the same and are prepared to limit their access to US markets if they fail to comply.

Pros. The time to strike is now. In fact it may be now or never. The Chinese economy is already feeling the pinch from the sluggish worldwide economy and is not postured to withstand even a short-term further reduction in exports. The large migration of workers from the countryside to the city keeps enormous pressure on the Chinese economy to continue to expand. Just as important, our economic leverage will never be stronger. American companies have not had an opportunity to take advantage of the recently reduced tariffs to increase their negative exposure to decreased China exports. The recently completed mid-term. elections give us a full two years to accomplish the task and push the unpleasant short-term effects out of voter's minds. The trade deficit continues to grow thereby increasing our dependence on cheap Chinese imports and increasing the consumer pain from restricted them. We will never have a better opportunity to forcibly reshape the IPR landscape to our competitive advantage.

The administration will gain political support from the China Hawks. Along with a market for it's low value added exports, China is dependent on foreign investment and technical knowledge to expand into more profitable markets. Withholding that investment will decrease their rate of GDP forcing the communist party to lower military investments due to ever increasing domestic needs.

The administration will gain political support from labor unions. Organized labor has always argued that China trade steals American jobs and favors the rich investors over Joe six-pack. Siding with labor on this issue will weaken a core Democratic constituency group.

Cons. Our cost of living and level of unemployment will increase. The probability of China being able to quickly conform fully to TRIPS is very slim. No government can change century old norms and lucrative illegal practices overnight. The resultant trade sanctions will deprive our economy of the major source of cheap low-end consumer products thereby driving up the cost of living. There is no reason to believe the Chinese will not retaliate by reducing US imports and causing lost jobs in our heavily export dependent industries of aerospace, farming and heavy machinery.

The Chinese people will view trade sanctions as yet another imperialistic attempt to keep them down. The resultant rise in nationalistic tendencies could lead to strong support for increased military spending and muscle flexing, especially with respect to Taiwan.

By implementing this policy we are ignoring the economic lessons of the great depression. Hard protectionist measures were a key contributor to a reduction in the worldwide economy that required a world war to recover from. The world economy already has one of its key players - Japan - caught in a deflation spiral with the US and Germany near the edge. Latin America is in another fiscal crisis and the East Asian Tigers are still recovering from the 1997 currency crisis. A large reduction in world trade could lead to a full blown global recession.

A hard line approach ignores our own history and makes us look like hypocrites. The US has not always been a strong supporter of IPR. During the early days of the republic, IPR violations were widespread and accepted by the government [5]. By the time the US became a full-fledged international competitor and major exporter in the mid 20th century, she became a strong supporter

of IPR just like the other major western powers. The key point is the evolution of IPR from violator to supporter is a natural part of the process of developing a modern export based economy. The short-term resultant cost is the price we pay for advocating free trade.

Option 2: Smartly Encouraging History to Repeat

Policy Statement. The US explicitly recognizes the natural role of IPR evolution in an emerging economy and will take positive actions with the Chinese to speed that process along. At the same time we will take proactive steps to limit the damage to our own economy during this transition period by using our competitive advantage in high technology to provide new techniques/approaches to discourage counterfeiting and piracy. In addition, we embrace the WIPO as the primary mechanism for enforcing the existing laws and settling disputes.

Pros. This policy allows us to claim the international moral high ground. By letting history take its course we openly acknowledge the "sins" of our past and refute the claims that we are arrogant imperialists. That symbolism will not be lost on the Chinese people. By ceding IPR enforcement and dispute settlement to the existing international system we further soften our "evil hegemonic" image. These actions neutralize the Chinese government's ability to blame foreigners for any policy hardships or missteps, create a positive environment for reform, and place the burden of ownership squarely on their shoulders. What is more American than helping folks pull themselves up by their own bootstraps?

A positive approach encourages the growth of pro IPR sentiment within the general public and the communist party. History shows that IPR becomes an accepted part of the culture once economic growth is sufficient to enable a strong middle class. As people start to profit from their own intellectual property they naturally want their IPR enforced. By not punishing the Chinese people for their current IPR violations we allow incomes to rise and a middle class to start to take

root. By providing IPR education to that growing middle class and the government bureaucracy we provide the intellectual framework needed to recognize the benefits of IPR and support government actions to create, and enforce strong IPR statutes. Special emphasis on the rising entrepreneur class will speed the transformation as those folks are already feeling the sting from IPR violations. Those entrepreneurs will bring their desires for IPR reform with them upon joining the communist party in response to the government's active recruitment drive of these rising economic stars. In China, change comes from within the party - not from the outside.

Focusing on a technical solution plays to our nations strengths and limits the economic damage from weak IPR enforcement. We have the world's most innovative and technically sophisticated workforce. A coordinated information campaign and tax credits for basic research in anti-tamper technologies will provide the spark necessary to jump-start that workforce. Applying new anti-tamper techniques will slow down the IPR violations, and resultant loss of revenue, by increasing the costs of illegal copies. Research into anti-tamper technologies also has high dual-use benefits given our increasing need to secure the secrets embedded in our modern weapon systems.

Under this approach we will continue to benefit from cheap Chinese imports. The vast Chinese labor pool provides a ready export platform for manually intensive enterprises. Our trade relationship keeps consumer prices and therefore inflation low.

A final advantage is our ability to revector if unforeseen events prevent a successful conclusion. Since all of our actions are positive, any blame for failure will rest squarely with China, and securing international support for a more punitive approach will not be difficult.

Cons. In the short term, US firms and workers will continue to be negatively impacted by IPR violations. It will take time for any culture change to take place during which our economy will suffer a continued loss of revenue from counterfeiting and piracy. Business and labor leaders will

probably not quietly accept continued violations as the cost of converting a central planned economy into a market driven one.

A strong market driven economy provides the means for a stronger Chinese military. Until the world is no longer the stage where military power is the final guarantor of national security and foreign policy it will be illogical not to assume China will strive for those benefits. Our foreign policy will need to account for this increased power level as will our political handling of the China Hawks in our own administration and Congress.

Option 3: Hard Industry Enlightenment

Policy Statement. The US acknowledges that, as the Chinese economy matures there will be bumps along the road to full IPR compliance. We will work with the Chinese and international organizations like the WIPO to provide a smooth and timely transition to a mature market driven economy. We will rigorously work to deter - unilaterally if necessary - international imports of counterfeit or pirated goods from China. In parallel we will actively encourage advances and expansion in our own advanced manufacturing enterprises through tax incentives for capital expenses and worker continuing education.

Pros. A national focus on exports from hard industries reduces the impact of IPR violations on our economy. The products of advanced manufacturing are difficult to copy. Unlike soft copyrighted goods one cannot quickly, or easily, set up shop and begin turning out counterfeits. The entry cost into advanced manufacturing industries like liquid crystal displays, microprocessors, and machine tools are high due to both the sheer amount of capital and technical sophistication required. The indigenous technical progress of hard industries provides the increasing returns necessary for the incumbent to maintain their competitive advantage [6]. The net effect is that vibrant advanced manufacturing enterprises are highly resistant to IPR violations and therefore

provide good long-term export potential. Our vigorous campaign to keep illegal Chinese products from reaching other shores will minimize the negative impacts while we restructure our economic base.

In his study on hard industries, Eamonn Fingleton concluded that along with resistance to IPR violations, those industries provide a stronger economic benefit than less resistant information age industries [7]. Countries with a high manufacturing orientation produced a higher rate of average wage growth rate than their information age counterparts. Information age industries also have poor export prospects due to the local nature of many of the products and their labor-intensive nature. As technologies mature they will naturally migrate to less developed countries. There is no way to prevent that migration and maintain a vibrant economic base. The key is to stay ahead of that curve by maintaining the hard industry edge.

Our proposed package of incentives for business and workers provides the proper balance to maintain our edge. By using broad based criteria - not tied to any specific technology area - we avoid the trap of industrial planning and do not stifle the dynamic, and unpredictable, process of creative destruction. No economy is better at the art of creative destruction. However, a strong belief in the virtues of that art form is not universally shared across the workforce (our past efforts in trade adjustment assistance notwithstanding): We will inoculate those virtues into our culture by a broad based information and education campaign. Our information campaign will equate lifelong learning with economic prosperity and national security. Tax incentives for individual continuing education, and for company based retraining efforts, will provide the incentive for the workforce to stay current with the advances in manufacturing processes. Finally we will reach all the way back into our secondary education system and develop the courses and techniques for providing the skills required for lifelong learning. .

The complementary solution in this case improves the economic condition of both nations. Our IPR policy should be tailored to increase the GDP of both China and the US. By taking a positive proactive stance on improving China's IPR enforcement both options 2 and 3 produce the desired objective in the long term. Both options are centered on realistic assessments of the evolution of IPR in an economy transitioning from state planned to market based. Some near term losses to US firms from counterfeiting and piracy are the cost of our national security strategy of encouraging the development of free and fair trade. Neither option postures us in an imperialist manner and both play to our sense of fair play and technical advantage. The key discriminator is the depth of our domestic actions.

The implicit assumption in option 3 is the root of the best IPR solution is not within China but within our domestic economic policy. We have a lot more influence over our own economy than China's. Migration of lower-value economic activity to lesser-developed nations is a fact of modern economic life. Trying to reverse that phenomenon is not realistic. Humans will always work to improve their own lives and that means "stealing" jobs from other countries. (also remember that overall our own standard of living benefits from the resultant cheap imports). Producing new intellectual property faster than another country can assimilate it is the only real long-term solution to IPR. Only option 3 fully recognizes that key realism.

By creating investment incentives in domestic manufacturing and human capital and proactively assisting China's evolution into a true market economy, Option 3 will achieve the required complementary solution and maintain our economic dominance. The most advanced manufacturing economy enables the most advanced military, economic, political and information elements of national power. Therefore, a policy of Hard Industry Enlightenment is the recommended policy option for the IPR issue.

Endnotes

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