Contending with Chinese counterfeits: Culture, growth, and management responses

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Abstract Almost every product imaginable is being copied and manufactured in China, then either sold there or exported elsewhere. While some improvement in the overall intellectual property rights (IPR) environment in China has occurred recently, the issue of piracy remains a daunting one. To understand Chinese IPR conditions requires a look at the rapid growth of the nation’s economy, as well as its history. With booming economic conditions has come an equivalent surge in the manufacture of counterfeit product, and ideologically the country’s political culture has not lent itself to the concept of ownership of intellectual property. Both Confucianism and Communism hold no interest in individual ownership; historically, censorship has been considered more important than copyrights, and inventions as belonging to the state. Though it is virtually impossible to estimate the value of counterfeit product originating in China, totals may reach over $150 billion. Both firms doing business in China and foreign governments are dissatisfied with the current level of IPR protection. Managers need to be proactive on many levels to be sure their intellectual property is adequately protected.

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1. The scope of Chinese counterfeiting

Fighting counterfeit goods in China is an ongoing problem. Just about every product under the sun is being pirated there, and then sold in-country or exported. The United States Trade Representative (2012), or USTR, has identified more than 30 so-called ‘notorious markets,’ eight of which are located in China. The scope of the problem is vast and the level of deception to which pirates will sink—or rise, as the case may be—is mind boggling. For instance, consider the fact that China is now consuming more high quality Bordeaux wine than the region produces annually. How is this possible? The difference is made up of low quality wine placed in fake Lafite Rothschild bottles, or used to refill genuine ones; indeed, it has been reported that empty Lafite bottles are worth as much as US$450 to these ‘recyclers’ (BoozeMonkey, 2012). In one well publicized case, a counterfeiter was sentenced to 4 years in prison and fined more than $23,000 for

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refilling bottles of Remy Martin, Martel, Hennessey, and other high level cognacs and scotch whiskeys (Matthias & Jiang, 2011). This case, at least, seems to indicate that the Chinese judicial system is taking counterfeiting more seriously than it has in years past.

A full understanding of current intellectual property rights (IPR) conditions in China requires some historical analysis. To begin, the Chinese economy experienced minimal growth early on; in fact, from 1300 to 1950, per capita GDP actually decreased. Under the Communist regime, economic conditions did not improve very much until Deng Xiaoping took charge and initiated the Chinese economic miracle. Since 1978, annual GDP growth has been about 10%. With this boom has come a corresponding wave of exported counterfeit products. By a huge margin, China is the main source of pirated goods coming into the United States and the European Union.

Reviewing the history of intellectual property (IP) in China, it is clear that Chinese political culture did not lend itself to the concept of IP ownership. Confucianism required control of information, and it is a traditional Chinese belief that inventions draw on past knowledge belonging to all citizens. The basic tenets of Communism dovetailed with these attitudes. Over the last 100 years and under constant pressure from foreign powers, China has enacted adequate copyright, trademark, and patent laws. The most recent problems come from weak enforcement. Foreign governments and firms doing business in China remain dissatisfied with the level of IPR protection. It continues to be a critical management responsibility, to be sure intellectual property is safeguarded. This requires a fully developed program.

2. The growth of the Chinese economy

For centuries, the Chinese economy was stagnant. According to Maddison (2001), total Chinese GDP in 1500 was approximately $62 billion in constant 1990 U.S. dollars. This grew to about $230 billion by 1820 and only $240 billion by 1950. Over the same period, total GDP in Western Europe advanced from approximately $44 billion in 1500 to nearly $1.4 trillion in 1950. In China, per capita GDP actually fell from about $600 in 1300 to only $439 in 1950.

The advent of Deng Xiaoping as leader of the Communist Party dramatically improved the economy of the People’s Republic of China (PRC). From 1978 when Deng took power, the Chinese economy has grown rapidly, maintaining an impressive annual average GDP growth rate of about 10% for the last 30 years. In 2011, China logged the world’s second-largest GDP at $11.3 trillion (Central Intelligence Agency, 2012).

The PRC’s growth is based largely on exports to virtually every other country, and exports approached $2 trillion for 2011. With this explosion, China has become the chief source of counterfeit products globally.

3. Estimating the size of the Chinese counterfeit market

By volume, China has been identified as the number one source of counterfeit product coming into the United States and the European Union for over a decade (European Commission Taxation & Customs Union, 2011). Its dominance is clearly demonstrated by Figures 1 and 2. In recent years, about two-thirds of counterfeit products seized in the U.S. came from China, and more than 80% of counterfeit goods seized at EU borders were also from there. China appears once again on the United States Trade Representative’s (2012) ‘Priority Watch List,’ a distinction reserved for those countries with the highest level of IPR problems. Following an in-depth study, the U.S. International Trade Commission (2011) estimated that U.S. businesses suffered a total of $48 billion in lost sales, royalties, and license fees in 2009 as a result of IPR infringement in China.

It is impossible to determine the total value of counterfeit product originating in China. In 1998, a confidential report by the Chinese State Council placed the value of counterfeit production at $16 billion (Hopkins, Kontnik, & Turnage, 2003). A later study by the same government agency placed the value between $19 and $24 billion by 2001 (Chow, 2005). Some estimates claim that 60% to 70% of worldwide counterfeit goods are produced in China (Economist Intelligence Unit, 2006; Schwarz & Wong, 2006). Using the $250 billion estimate of worldwide counterfeit goods production from the Organization for Economic Cooperation

*Figure 1. U.S. seizures by country of origin*

*percentage of seizures*
and Development (2009), this would place the value of counterfeit Chinese merchandise between $150 and $175 billion annually. Pirated products include Chateau Lafite Rothschild Bordeaux, Budweiser beer, Gillette razor blades, Marlboro cigarettes, Yamaha motorcycles, and Skippy peanut butter (Dunlop, 2012; Hopkins et al., 2003). In fact, any well-known brand will probably be a victim of product counterfeiting in China.

The Economist Intelligence Unit (2012) ratings of 'degree of property rights protection' in China show a decline from 1995 to 2002 (see Figure 3). There is some improvement in 2003 through 2012, but the expectation is that IP protection will remain at a modest level for the foreseeable future. According to the United States Embassy, Beijing (2012):

Auto parts, watches, sporting goods, shampoo, footwear, designer apparel, medicine and medical devices, leather goods, toys, batteries, and other non-consumer products - the seemingly endless array of counterfeit products that are manufactured and distributed within China, or [are] exported to other countries, continues to grow.

Chinese enforcement authorities even recently detected ‘fake’ Apple retail stores in China (BBC News, 2011). The employees were dressed in...
company gear as they worked, selling counterfeit Apple products.

According to the Business Software Alliance (2012), or BSA, the value of China’s illegal software market is nearly $9 billion while the legal market is only about $3 billion. The BSA claims the piracy rate in China has only declined marginally from 2010 to 2011, from 78% to 77%. According to the National Electrical Manufacturers Association, three quarters of a million counterfeit ground connectors were imported from China and India in 2007. Jim Pauley of Schneider Electric says that most counterfeit products are manufactured in China (Griffin, 2012). The Association also reports counterfeit certification marks, including those of Underwriters Laboratories and the Canadian Standards Association. False certification labels and substandard versions of these products are a threat to both health and safety (National Electrical Manufacturers Association, 2005).

China has also been a major source of counterfeit cigarettes, producing 190 million annually. About 15% to 20% of these are exported, mostly for European and North American destinations (Allen, 2011). It is clear that there is widespread counterfeiting in the PRC of nearly every type of product. In addition, although the Chinese government has been taking more action against counterfeiters in recent years, the scope and size of the problem is extremely large and appears to be growing.

4. History of intellectual property in China

To understand the difficulties of protecting intellectual property, one needs to consider Chinese history. Alford (1995) explains a key Chinese belief: that individual inventions draw on past knowledge, which belongs to all citizens. In addition, Confucianism requires the control of information. Alford dates the earliest efforts to regulate publication of particular works to 835 CE. These regulations were not designed to protect the property rights of authors, but rather to prevent unacceptable ideas from being disseminated. Until the 20th century, there was far more interest in the control of publications than in trademarks or patents.

In the late 19th century, negotiations with Chinese officials began to take place. Thereafter, it took about 20 years for new laws to be enacted regarding copyright, trademarks, and patents. Even these were unsatisfactory to the treaty powers working in China. Although the Chinese believed that economically successful countries had patent and trademark law, they did not easily understand the Western concept of intellectual property. In one case, the Jiangnan Bureau of Commerce issued patents to Chinese for imitation rather than innovation.

When the Chinese Communists took over in 1949, their approach toward intellectual property reflected traditional Chinese attitudes toward both inventions and control of information. According to Mertha (2005), although laws were passed giving recognition and some remuneration to inventors and authors, few took advantage of them. Instead, there was unauthorized copying and trademark use in the 1950s. The intellectual property environment reached its low ebb during the Cultural Revolution, when even meager payments for inventions were eliminated. Starting in the mid 1970s, the Chinese moved to create new laws for patents and trademarks. Copyright law took an even more convoluted path before finally being issued in 1990. From the time of normalized relations with China in 1979, the U.S. initiated negotiations aimed at convincing the Chinese to improve patent, copyright, and trademark laws. China agreed to protect foreign interests via the U.S.-China Bilateral Trade Agreement of 1979. As a result, China issued new patent and trademark laws, and joined the Paris Convention.

By 1988, new legislation provided the United States with trade sanctions against countries abusing U.S. firms’ intellectual property. This law also established an annual report from the United States Trade Representative on unfair trade practices and the aforementioned Priority Watch List. The U.S. continues to pressure China using provisions of the 1988 Trade Act. According to a United States Trade Representative (2012) report prepared at the end of 2011, China has enacted a relatively good set of IP laws since its accession to the World Trade Organization. However, the USTR report states that, although the Chinese government has initiated many anti-piracy campaigns, counterfeiting remains a serious problem which causes significant harm to U.S. businesses. Despite the fact that China is a member of the World Intellectual Property Organization, the Paris Convention, the Berne Convention, and the Madrid Protocol, the United States Trade Representative (2012) report states that “effective enforcement of China’s IP laws and regulations remains a significant challenge.”

5. IPR enforcement

As portrayed by Figure 4, the Economist Intelligence Unit (2012) identifies great risk in the PRC’s legal and regulatory environment. This facet of the Chinese economy is perceived as significantly
more important than most of the other risk factors that are measured.

Understanding the intellectual property environment in China also requires a careful review of the enforcement of existing laws. Chow (2005) identified two main barriers to effective enforcement: local protectionism and inadequate punishment. Despite central authorities’ best intentions, protectionism arises because particular localities may benefit from counterfeiting. Indeed, this activity often provides jobs and generates revenue that is vital to the local economy. Chow states that certain “areas in China are entirely supported by the trade in counterfeit goods and local residents are ready to use any means necessary to protect their illegal trade.”

Since 2004, at meetings of the U.S.-China Joint Commission on Commerce and Trade (JCCT), China has made commitments to significantly reduce IPR infringements. Both the JCCT and the USTR favorably mention the Chinese Special IPR Campaign launched in 2010. At the most recent JCCT meeting, China announced that it had made permanent the State Council-level leadership structure originally designed to implement the Special IPR Campaign to continue to coordinate intellectual property rights enforcement. This group is chaired by Vice Premier Wang Qishan (U.S. Department of Commerce, 2011). In November 2011, the Ministry of Public Security announced the results of a “national crackdown on counterfeit goods” (Di, 2011). It claimed the uncovering of nearly 29,000 cases of IPR infringement, the raiding of more than 22,000 production centers, the busting of nearly 7,000 criminal gangs, and the seizure of counterfeit products worth nearly $3 million. In May 2012, The General Office of the State Council announced a new IPR Protection, Anti-Counterfeiting Agenda (PRC Central Government, 2012). This agenda includes campaigns focused on trademark rights, copyrights, patents and online websites with a special emphasis on counterfeit foods, cosmetics, medicines, chemicals, and auto parts.

The United States Trade Representative (2012) has identified several factors that contribute to the continuing challenge of IPR protection in China. These include persistently high levels of trademark counterfeiting and copyright piracy; both physical and internet market sales of counterfeit product; the production and availability of counterfeit pharmaceuticals, including disclosure of test data; and failure to impose “penalties that are sufficient to change behavior.”

Mertha (2005, p. 3) found that “the bureaucratic apparatus charged with managing and enforcing intellectual property in China, particularly at the local level, is...convoluted and opaque.” The Chinese bureaucracies tasked with implementing intellectual property policy exemplify ‘fragmented authoritarianism,’ meaning that authority below the top of the Chinese political system is disjointed. Mertha identifies two dimensions of fragmentation: functional and geographic differences separating agencies. These differences allow...
agencies to effectively veto the implementation process. In a study of the Chinese counterfeit DVD market, Wang (2010) concludes that many local officials, while responsible for both regulation of IP laws and developing entrepreneurship, are under tremendous pressure to produce significant economic development results so they resist strong enforcement of IP regulations.

Successful foreign companies within China have established alliances with enforcement agencies on the local level, and have also used private investigation agencies and law firms which cement good relationships with particular local officials. Discussions with Jack Chang—Senior IP Counsel of General Electric Company for Asia and Chairman of the Quality Brands Protection Committee (QBPC), an organization of 152 brand holders dedicated to IP protection—reinforce this point. The strategy of the QBPC has been to cooperate with local law enforcement in stopping counterfeit trade. Chang also believes that using both honor and shame will be effective in motivating officials to move against counterfeiters (Jack Chang, personal communication, January 5, 2011). According to Pfizer’s Director of Global Security, the company works on many levels to protect its intellectual property rights. In addition to engaging law enforcement, Pfizer organized roundtable discussions and seminars with Chinese ministries to exchange information and experience related to fighting drug pirates (Schwarz & Wong, 2006).

Mertha (2005) concludes that top-down pressure on the national government can help to change policy, but this must be combined with pressure on the local level to improve enforcement. Chang feels that many high ranking officials in China want to stop counterfeiting, but must rely on local law enforcement to carry out work in the field. A number of these individuals are interested in reducing counterfeiting while some have other priorities. In some cases, actions taken at the international level by the U.S. government result in counterproductive ramifications at the local level. For instance, the recent World Trade Organization disputes brought by the U.S. government may have had the effect of raising nationalistic feelings and reducing local cooperation (Jack Chang, personal communication, January 5, 2011).

6. Recent events

The Chinese, themselves, are beginning to put pressure on their government to improve IP enforcement. In 2011, China filed more patents than any other country, surpassing both the United States and Japan (Maleske, 2012). Clearly, the stakes have risen. Today, indigenous manufacturers have their own intellectual property to protect. Firms such as Lenovo and Haier, as well as other innovators, are calling on the government to enforce anti-pirating laws. However, despite what the USTR calls ‘welcome progress,’ China remains on the United States Trade Representative (2012) Priority Watch List.

As the Economist Intelligence Unit (2006) articulated years ago, at the state level, China’s government seems to be aware of the importance of solving the piracy problem since this issue could have a negative effect on trade relations or investment. But the farther you get from Beijing, the more difficult it is to police.

Some firms are trying new tactics. Chanel filed a lawsuit in Las Vegas against a counterfeiter in China for selling fake goods in the U.S. via the internet. Following a judge’s ruling that defendants could be served notice by email, the firm filed another lawsuit against nearly 400 websites, many based in China. Similar cases have also been filed in federal court in Las Vegas by Tiffany and Louis Vuitton. The suits request orders to disable or seize website domain names such as chanelonline.com, replica-coco-lv.com, tiffanyand-co.com, and chanelhandbags-outlet.net, which sound similar to the legitimate corporate names (Ritter, 2011).

Another novel approach has been taken by Gucci and Tiffany. These firms have petitioned in federal court to freeze assets of counterfeiters in Chinese banks. Each of the banks has branches in New York. This followed a judgment against counterfeiters which enabled the designers to recover damages from the counterfeiters. The firms face an uphill battle since the Federal Reserve Bank of New York fears this kind of judgment might drive foreign banks out of the country (Flitter, 2011).

7. Management response: A seven step guide

It is clear that governments alone cannot solve the entrenched counterfeit product problem in China. Owners of intellectual property must take action to protect their rights. My recommendations toward this end include seven major steps, as outlined next.

7.1. Develop an IP protection strategy

An overall strategy is a critical responsibility of top management and must involve many if not all of the company’s functions. As we have seen, in China, this requires efforts at multiple levels. The policy must
be clearly communicated throughout the organization, especially to Chinese contractors, distributors, and retailers, as well as to government officials. One knowledgeable attorney stressed the importance of an adequate budget for this program (S. Croxon, personal communication, 2007).

7.2. Establish a brand integrity team

Some firms have extensive and sophisticated anti-piracy organizations. For example, Barboza and Lohr (2007) report Microsoft employed a 75-member team that tracked a Chinese counterfeiting syndicate for more than 6 years before effecting a particularly large seizure of counterfeit software. Others, especially small and medium size firms, may have to develop an ad hoc team.

7.3. Assure the registration of copyrights, trademarks, and patents

As we have discussed, China is a member of the World Intellectual Property Organization, the Paris Convention, the Berne Convention, and the Madrid Protocol. Thus, its government will recognize internationally registered IP.

7.4. Create a monitoring program to direct information about the IP environment to a central database

This program should be designed to capture IP developments in China, as well as the rest of the world. This information must be reviewed by top management on a regular basis to monitor conditions, and to adapt tactics to the latest pirate actions.

7.5. Develop a full information plan directed at employees, distribution channels, contract manufacturers, local law enforcement, and international organizations

Educating employees and channel members, as well as local law enforcement, is crucial. Employees must believe that there is no such thing as ‘good’ counterfeiting. Especially in China, employees frequenting markets where fake goods are sold boosts the counterfeit industry and sends the wrong message to government authorities. Local management, marketing, and sales people should inform various audiences of the threats posed by IP violations. A firm should relay to contract manufacturers, distributors, and retailers that it will take action to protect its intellectual property. And, follow-through must be widely publicized.

7.6. Take actions against counterfeiters on every level—retailers, distributors, and manufacturing sources—requesting injunctions and cooperating with local law enforcement

Use local law enforcement and litigation to fight pirates. Building good relations with local police will help achieve effective action. New strategies involving attempts to gain injunctions in U.S. courts to shut down violating websites or seizing overseas bank accounts in the United States may hold promise.

7.7. Develop an evaluation and feedback system

It is clear that fighting counterfeiters in China is a dynamic task. The strategies that work today may not work tomorrow. As long as demand exists for their goods, pirates will adapt to keep operations going. The measurement of anti-piracy success should not be limited to a simple yardstick such as the number of seizures made. Hopkins et al. (2003) recommend a company look to non-financial measurements such as brand degradation and recovery, public relations, and government cooperation. While these factors can be difficult to quantify, efforts should be made to assess success in each area. Combining all financial and nonfinancial measurements will give management a clear idea of the efficacy of its anti-counterfeiting program.

8. Conclusion

The problem of counterfeit goods originating in China continues to be a major concern for both managers and government officials. To many in the country, intellectual property remains a foreign concept. China is clearly the main global source of counterfeit merchandise. While the total of this production and distribution is not clear, the value may easily exceed $150 billion annually. Products counterfeited in China range from motion pictures to pharmaceuticals to cigarettes, including nearly every industrial and consumer product.

Reviewing Chinese history can provide insight regarding reasons for the obstacles encountered when trying to establish effective IPR protection in China. Traditional Chinese beliefs about the ownership of inventions and the need for controlling information date from the earliest days of the nation through Mao’s regime. After more than 100 years and constant pressure from foreign governments, Chinese copyright, trademark, and patent laws are
acceptable, but enforcement continues to leave much to be desired. China’s arcane bureaucracy makes it difficult even to understand how IPR laws are to be enforced. Despite repeated national anti-copyright campaigns, functional and geographic fragmentation, protection of revenue sources at the local level, and outright corruption allow most of the counterfeit industry to stay in place. It remains to be seen whether the new efforts headed by high level officials will improve IPR enforcement.

The best course for managers involves a full program including all the activities described above. For many reasons, it appears that counterfeiting in China will remain a stubborn problem. Responsible managers must take action to guard the integrity of their brands.

References


