Statement before the
Section 301 Committee
Office of the United States Trade Representative

Hearing on “Section 301 Investigation: China’s Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation”

A Testimony by:

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I am honored by the opportunity to testify before this committee to share my views about Chinese policies and behavior related to intellectual property rights (IPR). The purpose of this investigation “is to determine whether acts, policies, and practices of the Government of China related to technology transfer, intellectual property, and innovation are actionable under the Trade Act” of 1974. This investigation is justified. Its outcome, though, should not be preordained but rather follow where the evidence takes it. Similarly, any policy steps that follow this investigation should be rooted in both fairness and pragmatism and driven by the goals to improve China’s IPR behavior, constrain its industrial policy, and safeguard American commercial and national interests.

As an expert on Chinese industrial policy, the goal of my testimony is four-fold: 1) To put China’s practices with regard to IPR in the broader context of Chinese economic policy; 2) To provide a brief balance sheet of the commercial outcome of Chinese efforts to date; 3) To explain why China’s performance with regard to IPR is of particular importance to the United States and global economy; and 4) To propose how the United States could most effectively respond to Chinese policies and behavior.

This testimony is based on almost 30 years of experience traveling to China and conducting research on China’s policy process, broad industrial and technology policies, and specific sectors. This research has involved: 1) Careful reading of secondary and primary sources; 2) Interviews with Chinese companies, trade associations, lawyers, engineers, industry analysts, and government officials; and 3) Interviews with their non-Chinese counterparts in industry and government in the United States and elsewhere. My interviews are confidential in order to facilitate open and frank conversation. My analysis is grounded in a political economy perspective. My aim is not to merely understand the legal context of policies and regulations or the purely commercial or technical aspects of industries and technologies, but to recognize that legal arrangements and policies are in part contests for political and commercial advantage and that business outcomes are shaped not only by market behavior but by political institutions and actors and by countries’ national interests.

This experience leads me to offer four insights which I hope are of value to the Office of the United States Trade Representative and the rest of the United States government as it pursues this investigation and the broader effort to protect the American economy and foster innovation.

I. China has gradually developed a complex legal framework and institutions to protect IPR; however, China’s core strategies and policies toward IPR are not rooted in an unbending commitment to rule of law, but rather by a plan to promote industrial upgrading and technology acquisition that results in Chinese companies occupying higher rungs of the value-added chain across the full spectrum of industries both in China and in other markets.

Industrial policy is not new to China, but the level of ambition and effort visible today far outstrips earlier eras. China has long moved on from focusing on labor-intensive industries such as textiles and toys. Even though it still invests heavily in steel, petrochemicals, energy, and other heavy industries, the key focus of industrial policy is on advanced technologies that have been commercialized or on the cusp of reaching markets, from semiconductors to robotics to new-energy
vehicles to medical devices. Many are familiar with the “Made in China 2025” plan, which has set high domestic-content goals for a range of sectors. That said, this plan is just one of a large number of detailed industrial policies and the more encompassing 13th Five-Year Plan (2016-2020), China’s most important economic blueprint. China’s economic goals are backed up not only by a long list of policy documents, but by a full range of policy tools, including financing, tax benefits and holidays, distinctive technology standards, competition policy, government procurement, market access, outward investment, trade remedies, and, yes, intellectual property rights.

Beyond the goals, policies, and toolkit, Chinese industrial and technology policy is far better organized than ever before. Historically, effective implementation of Chinese policies was inhibited by conflicts between different ministries and between central and local authorities. Those tensions still exist but have been tempered to some extent by the strong hand of China’s top leadership and the creation and empowerment of cross-cutting coordinating bodies, known collectively as “leading small groups” (LSG). There are now over 80 LSGs (almost double the number when Xi Jinping became General Secretary of the Chinese Communist Party in late 2012), many of which focus on the economy, both broad areas and specific technologies. In addition, greater attention than ever is being paid to finding synergies between civilian and military technology capabilities and needs. Not surprisingly, there is an LSG specifically for this task.

In this context, IP is not simply a basic legal concept or means to protect individual inventors, but is an instrumental tool that is part of a larger contest of economic power to be wielded by Chinese companies and the country as a whole.

II. Chinese companies and other organizations have become leading filers of IPR, including patents, copyrights, and trademarks, but the commercial value of this IPR is stunted because of the weak enforcement of IPR and the relatively low quality of the underlying IP.

By several measures, China has become a leading IP country. For example, more patents are filed in China than in any other jurisdiction, and the great majority of patents are filed by domestic residents, not foreigners. Chinese also are increasingly filing their IP abroad in other countries, including the United States, the European Union and Japan.

That said, relative to the absolute numbers of registered IP, the commercial value of this IP is

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2 These policies are summarizing in Scott Kennedy and Christopher K. Johnson, Perfecting China, Inc.: The 13th Five-Year Plan (Washington, DC: Center for Strategic and International Studies, May 2016).
surprisingly low. First, China’s economy is approximately half the size of that of the United States, but its domestic IP market – for licensing, royalties, etc. – is about one-one hundredth the size of the IP market in the United States. In 2015, patent licensing only generated total revenues of RMB 11.7 billion ($1.75 billion), and sales of patent rights that year totaled RMB 9.25 billion ($1.38 billion). By contrast, in the United States in 2012 (the most recent year data are available), IP licensing revenue totaled $115.2 billion. Moreover, according to the International Monetary Fund, China has had a huge deficit in international IP licensing trade. In 2015, Chinese entities brought in around $1 billion in receipts, but paid out over $22 billion in such fees. This receipts-to-payment ratio of 0.05 is almost the worst of any large IP trader in the world, second only to South Africa. (By contrast, the United States has a ratio of well over 3-to-1.)

Second, in mergers and acquisition deals (M&A), the value of patent and broader IP portfolios of Chinese entities is almost always extremely low and has only a modest effect on the overall valuation of a company’s assets. Non-Chinese acquirers rarely pay much for the IP portfolio of a Chinese company, whereas Chinese often pay very high levels for non-Chinese IP.

And third, in patent infringement cases in China, the average award of a winning plaintiff is a paltry RMB 98,000. By contrast, in the United States, the average award is over $7 million for patent infringement.

Why is the commercial value of IP so low in China? To some extent, it may be the result of policies that condone IP theft and insufficiently vigorous enforcement of IP rights. But it is also likely the result of the low quality of much of the underlying IP in the first place. Some Chinese companies and institutions have made tremendous discoveries and invented new technologies and processes that have substantial commercial and social value, but based on the above data, they are not the norm. This is exactly why even Chinese officials and observers admit that China is a “large IP country,” but not a “strong IP country.”

Four important consequences flow from this context. The first is that creating and marketing new IP is still a far riskier business strategy in China than scaling up existing products or finding a regulatory advantage over one’s competitors. Second, those Chinese that attempt technological innovation are more likely to pursue incremental innovations, such as adaptations and customizations of existing technologies. Third, Chinese have had more success expanding their market share in high-tech sectors than in developing novel technologies. And fourth, given the impediments of successfully developing new technologies that are commercially successful, this context creates a premium on the acquisition of existing technologies, domestic and foreign, through legal and illegal means.

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III. China’s market size gives it enormous power to shape the trajectory of industries and the value of IP globally. If China debases the value of IP, it threatens the health not only of individual competitors, but the supply chains and business models of entire sectors. Conversely, if China provides vigorous protection to IP, both Chinese and non-Chinese alike, and encourages innovation-based success in advanced technologies, this will spur a virtuous cycle of positive competition that will yield higher quality technologies, products and services, which will redound to producers and consumers alike.

There is no understating the importance of China’s size to the issue at hand. Were China a much smaller economy, its IP strategy and the suspected behaviors being considered here would not be worthy of a full-scale investigation of this magnitude or potential penalties that could lead to greater frictions. But as the world’s largest exporter and second largest economy, just about any Chinese initiative in advanced technologies affects the global economy. This applies throughout the supply chain, from raw materials and commodities to the final products and services.

In principle, China could choose two alternative routes to high-tech success. It could use a bottomless well of cheap financing and market protection to acquire technologies, and then by dumping its products, push out competitors in China and elsewhere. By contrast, China could use its enormous pool of talent, educated in China and abroad, and its entrepreneurial spirit to experiment and innovate in competitive global markets. The former approach could create a vicious cycle and be deeply destabilizing to companies that lack the similar access to credit, but also potentially would cause unnecessary harm to supply chains and business models. The latter would create a virtuous cycle and present a challenge to incumbent companies, supply chains and business models through healthy competition.

Recent experience likely reflects a combination of both vicious and virtuous cycles. The clearest areas where the former, more negative dynamic appears to be true is in infrastructure-related sectors such as steel, aluminum, glass, and cement, but may also be reflected in the solar and wind industries. My concern is that if greater disciplines are not placed on Chinese industrial policy, this negative dynamic could spread to a wide number of high-technology sectors, including robotics, new-energy vehicles, and semiconductors. Nurturing advanced technology is a critical source to raising productivity in the United States and elsewhere, and, central to our long-term prosperity. Our goal should be to see to it that competition from and cooperation with China strengthen this source of jobs and economic growth.

IV. The United States needs to use an “all-of-the-above strategy” to effectively counter Chinese IP practices and industrial policies that damage American interests. These include: engaging in extended bilateral dialogue and negotiation with Chinese government and industry, utilizing the WTO and other international tribunals to enforce existing commitments, strengthening multilateral rules via the WTO and other fora, collaborating with allies, and utilizing American trade laws to investigate and penalize China when necessary. Strategies that lack any one of these components will not be successful.
Chinese industrial policy is comprehensive and strategic. The United States should not follow in China’s footsteps with its own industrial policy, but it needs to develop a comprehensive approach to engaging the Chinese challenge and strengthening the American economy and the foundations of its vibrancy. Furthermore, the United States needs a “whole-of-government” effort in which the various components of the executive branch work in unison with each other and with Congress. Finally, this effort should be measured in years, not months or weeks. China’s economy faces a variety of risks, including growing debt and an aging population, but it has overcome just about every economic challenge it has previously faced, and it is certainly possible that China will grow at 4.0-6.0% over the next decade and that it will continue to amass technologies and market share, in China and elsewhere, along the way. China is a long-term challenge.

An unwillingness to simultaneously use multiple tools will mean failure. Unilateral penalties, should they be warranted, will not be enough on their own to reshape Chinese behavior in a way more consistent with American and global interests. If the United States does not engage in extended dialogue with China, there will be little chance of explaining our perspective to China and finding common ground. If the United States dismisses the WTO’s dispute resolution system, it will lose an important lever to have its position upheld by an independent third party that China itself has said that it recognizes and respects. If the United States gives up efforts to create multilateral rules, regionally or beyond, it will leave wide swaths of global commerce with outdated rules or empty spaces without any rules. The WTO’s Agreement on Trade-Related Aspects of Intellectual Property (TRIPS) and its Agreement on Trade-Related Investment Measures (TRIMs) both need to be updated and supplemented in light of the Internet, e-commerce, and other emerging complex technologies. If the United States does not prioritize the challenges with China and more effectively work with its allies and others facing similar problems, any unilateral action is likely to leave the United States, not China, isolated, not mention more vulnerable to Chinese retaliation.

The United States has rung the alarm bell about Chinese industrial policy. In my own view, although the exact outcome of the current investigation should be based on a dispassionate analysis of the collected evidence, this concern is justified. That said, utmost care is needed at this historical juncture. In 1993, the Clinton Administration conditioned the extension of China’s most-favored nation (MFN) status on improvement in China’s human rights record. A year later, China’s record was essentially unchanged, but the Clinton Administration still extended China’s MFN. Since then, human rights have not been a central element of the relationship. Similarly, if the United States decides to make IP and broader Chinese industrial policy a core litmus test of the relationship, then it is incumbent upon the United States to be as effective as possible. Should it raise the stakes on this issue and come away with no substantial progress, it will be far more difficult for future administrations to effectively engage China on these issues. In sum, my advice is: proceed, but proceed with caution.