

Away from the Shanzhai-route: Intellectual Property Rights in China

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ABSTRACT

Since 2010, China's policy is aimed at going from an imitation to an innovation economy. For decades however, imitation in the *Shanzhai*-economy¹ has been the dominant strategy for most Chinese businesses – due to poor government efforts in enforcing Intellectual Property laws. This calls in the question if a healthy creative industry can exist in China without protection of Intellectual Property Rights. In answer, this paper thus explores the *Shanzhai*² phenomenon, its origins and the challenges that face China's economy and its creative industries today. It concludes that the challenges are going to be tough, but must be unavoidable tackled if China's creative industries want to flourish.

Keywords: China, Counterfeiting, Shanzhai, Intellectual property rights, Creative industries

¹ 山寨經濟
² 山寨

1. INTRODUCTION

In addition to a booming economy, China has built up a notorious reputation in the last three decades as a global copier. The rise of consumer culture, coupled with a decay of moral (socialist) values, has fueled the demand for fake goods and improper business conduct (Cheung, 2009). In this so-called “Shanzhai-economy”, Chinese manufacturers rapidly produce large quantities of knock-offs and copies that flood local and global markets, giving the nation the label “knockoff kingdom” (Keupp, Beckenbauer, & Gassmann, 2010, p. 2). Although China surpassed rival Japan in 2010 to become the second-largest economy in the world, it still scores poorly in legal protections for and enforcement of Intellectual Property Rights (IPR) (Cao, 2014; Cheung, 2009; Keupp et al., 2010).

In spite of the fact that China's economy initially survived the 2008-2009 Financial Crisis well, its export figures dropped dramatically in May 2009 and have not shown signs of a full recovery since (Ran, 2012). Beginning in 2010 with a speech by former President Hu Jintao, innovation and creativity have become the focal point of Chinese policy to synchronize the local economy with the rest of the world and to boost exports. In addition, Beijing has made new promises to respect IPR and to update and enforce existing IP laws (Hu, 2012). In 2013, Hu's successor President Xi Jinping continued building on the former promises as part of a much needed total overhaul of China's economic structure (Rosen, 2014). After decades of producing “Made in China” and imitations without stringent enforcement of IPR, it appears the stakes are high this time.

This raises questions about the importance of IPR and whether enforcement of IP laws is necessary for a healthy, creative market. After all, China's economy has done well for so long without serious enforcement of IP laws. Why not continue on the present route of the “Shanzhai-economy”? Below

I thus begin by analyzing the term “Shanzhai” and its origins. Section 3 summarizes the progress of the Chinese government in IPR since the beginning of the 1980s and discusses the challenges regarding counterfeiting that lie ahead in contemporary China. Section 4 explores China's creative industries and the importance of enforcement of IP laws in relation to the economic environment. The final section offers conclusions and the answer to the question raised in this paragraph.

2. THE ORIGINS OF SHANZHAI

The Chinese term for fake products is *Shanzhai*³. It refers to a fortified mountain village where bandits returned with their loot. The term originated in the Song dynasty and is a fixed element in the popular novels of the *Shuihu Zhuan*-genre⁴; a collection of “Robin Hood”-like stories (Hennessey, 2012). In contemporary China, those “fortified villages” are abundant in every corner of the street, defying any government regulation or enforcement. Even in the first tier cities, one does not have to look far to stumble across stores with clothing and shoes of Odidoss, Daiads, Calvim Klain, and other copies of popular brands. A Polystation is produced as an alternative for the widely popular game console, while the modern Chinese businessman looks slick with his iPhone-like smart phone. However, this knockoff has the famous logo replaced by a pear (Wabash, 2014).

This form of *Shanzhai* can be regarded as playful and innocent. It does not overly confuse consumers and can even contribute to promotion and awareness of the authentic brand (Beebe, 2014; Raustiala & Sprigman, 2014). However, *Shanzhai* goes further than products alone. Whole brands and their stores have fallen victim to counterfeiting. For example, Apple has nineteen official stores in China (“Apple Stores in China,” 2015). Remarkably however, far more stores than those nineteen can be found throughout the nation. Store design and products are identical to the

³ 山寨

⁴ 水滸傳 (also known as Water Margin, Outlaws of the Marshes, Tale of the Marshes, and All Men Are Brothers) is one of the four great classical novels of Chinese literature, depicting the story of how 108 outlaws formed an alliance to fend off foreign invaders and suppress rebel forces.

authentic Apple Store, and even in some cases the operating instructions and warranty certificates are included.

From my own experience, Chinese in general are unable to distinguish the fake stores from the official ones, and when I express my distrust, it is met by disbelief. To be sure, the products in the fake Apple Store can be authentic, but the store's service is inferior, of course. Consumer education is thus highly needed in China and efforts are now underway, including staged events and regular classes for appraisal of luxury goods (Lu, 2014; Xu, 2013). Nevertheless, the confusion is not limited to consumers alone. At the fake Apple Store in Kunming even the staff there did not know that they were not working for the famous computer manufacturer (BBC News, 2011).

So rampant is the counterfeiting business that experts have suggested a lenient approach to *Shanzhai*. Accordingly, *Shanzhai* can be treated as a culture of grassroots innovation, a subculture in need of preservation (Keane & Zhao, 2012), or even as a form of art (Raustiala & Sprigman, 2014). A distinction between *Shanzhai*-culture and economy has been proposed (Jiang, 2014) and in 2008, *Shanzhai* was even considered for becoming part of the so-called "re-innovation policy" for China's creative economy – as a transition from fake to innovation (Cao, 2014). However, this policy concept is rightly dismissed as an absurd oxymoron, because *Shanzhai* should be defined as something *outside* the control of authority (Hennessey, 2012, p. 629). To avoid ambiguity when referring to *Shanzhai*, I regard the term and practice of *Shanzhai* as the equivalent of "counterfeiting".

3. EFFORTS AND CHALLENGES IN TACKLING SHANZHAI

In this section, I will scrutinize efforts of the Chinese administration in Intellectual Property

Rights (IPR). IPR are a legal necessity for curbing *Shanzhai* practices. However, one of the key issues for China is its "immaturity" in IP (Cao, 2014, p. 42). Basically, an IP system for protection and enforcement did not exist prior to the 1980s. During the Maoist era (1949-1976), creativity and the products of creative thinking were to support "socialism and the dictatorship of the Communist Party in name of the proletariat" and had the sole purpose of promoting nationalism and appeal to the masses (Perris, 1983). Naturally, ownership of an artistic or intellectual concept belonged to the masses as well, and any claim on subjective individual expression was considered "counter-revolutionary", for it "posed a serious threat to the authorities' monopoly of all aesthetic ideas and creative work" (Galikowski, 1990, p. 47).

Regardless, China has made good progress in the last three decades by untangling ownership over intellectual property from politics and by joining international IPR organizations and ratifying mutual agreements. Some of the milestones include the entry of the World Intellectual Property Organization (WIPO) in 1980, the joining of the Madrid Agreement on International Registration of Trademarks in 1989, the signing of the Copyright Law in 1991, followed by the ratification of Patent Cooperation Treatment in 1994, the establishment of a State Intellectual Property Office (SIPO) in 1998, and with China's entry to the WTO in 2001, the agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) was signed (Keupp et al., 2010, pp. 111-112).

The Chinese government regularly launches campaigns to curb the flow of counterfeits, fighting an almost impossible battle. Counterfeiting is simply too deeply rooted in every imaginable industry. According to researcher Ling Jiang (2014, p. 74), an estimated 80% of the world market in counterfeits originates from China. Other data from the period 2008-2010 reveal that a staggering 87% of counterfeit products confiscated by

US customs were traceable to China (Turnage, 2013). Everywhere, but especially in the southern coastal regions, there are clusters of sweatshops specializing in any desirable product. In fact, some factories produce for Western brands during the normal working hours and keep production lines running nights and holidays to make identical counterfeits when law enforcement is off (Neuwirth, 2011).

When anti-counterfeiting campaigns fail to properly address the issue, the official response from Beijing to international critiques usually states that China is a developing nation and counterfeiting can be attributed to unavoidable growing pains. However, rather than economic development, the massive counterfeit industry should be contributed to improper implementation of IP laws and a “weak administration” (Cheung, 2009, p. 99). The list of ratified IP agreements and IP laws looks impressive on paper, but actually there is “a lack of interest in enforcing them” (Keupp et al., 2010, p. 112). In fact, the efforts in IP law and international agreements by China have been addressed as “[...] putting on new clothes without really understanding what is the meaning of the legal system and the rules of law” (Cheung, 2009, p. 94).

In addition, *Shanzhai* is a lucrative business that provides employment and thus helps to maintain stability. Needless to say, avoiding social unrest appears high on the priority list of the ruling party and as a consequence IP offenses are often met with leniency, particularly if they do not do too much damage to China's image in the international community. Or as Raustiala & Sprigman (2014, p. 3) observe:

[A] tolerance for counterfeits can serve important social and political goals, goals that may outweigh whatever harms may stem from counterfeits – especially considering that most of that harm, at present and for the foreseeable future, falls on foreign manufacturers’.

That is a bleak forecast for foreign manufacturers, but the prospects are even worse for the Chinese economy in the long run. China's economic boom in the last three decades can largely be attributed to productivity growth, and in a lesser degree to human capital and increases in labor participation (Zhu, 2012, p. 104). While there is still enough room for increases in productivity, China's global advantage as a world manufacturer has been undermined by its own economic success.

In fact, Foreign Direct Investment (FDI) has been in decline since the onset of the recent financial crisis, due to rising wages and lax and unfair law enforcement in China. Foreign firms are rapidly outsourcing their production to other countries, such as Vietnam and Indonesia (The Wall Street Journal, 2014). This should be a wake-up call for serious reforms in China's economic policy and IP enforcement. For the local market, *Shanzhai* might serve its purpose as a social and political tool, but it cannot be considered “a sustainable model” (Hennessey, 2012, pp. 630–631). Similarly, the lack of innovative culture and emphasis on mirroring western ideas does not create desirable products for international markets (Keane & Zhao, 2012).

4. CHINA'S CULTURE, CREATIVE INDUSTRIES, AND SHANZHAI

China's Cultural and Creative Industries (CCIs) are basically in an immature stage, for prior to 1978 there was virtually nothing in this respect. However, particularly in the 21st century, creative workers have become key components in the reforms for a “National Cultural Strategy”, as the next step in China's economic development. By promoting CCIs, the aim is to achieve a “higher value model for economic growth, driven by the market, product quality and innovation” (Walker & Xiang, 2013, pp. 2–5). Evidence for this strategy has materialized in the creative clusters that have sprung up all across the country. Examples

include Beijing's Zhongguancun Haidian Park⁵, which functions as China's Silicon Valley, the famous 798 Dashanzi Artist District⁶, and the Songzhuang Creative Arts and Cartoon Cluster⁷ (Keane, 2009).

Notwithstanding the good intentions of these creative clusters, they are magnets for *Shanzhai* manufacturers, becoming "imitation clusters", rather than "innovation clusters" (Hennessey, 2012, pp. 628–629). This issue boils down to the dualistic nature of the clusters which pits the pragmatic goal of "attracting business" against the long-term goal of "attracting creativity and innovation". Chinese businesses are eager to cash in on their advantages, such as low rents and tax cuts offered by the municipalities that oversee the clusters, but how a cluster is to foster creativity and innovation remains obscure and therefore ultimately questionable. In reality, such clusters exist because "a veneer of academic respectability is attached to a range of activities that absorb a high level of state investment without much visible indication of creativity" (Keane & Zhao, 2012, pp. 220–221).

Despite these depressing remarks, it must be said that the Chinese Information and Communications Technology (ICT) industries have fared well under clustering. For example, Guangdong Province has concentrated its ICT industry in Shenzhen and Dongguan, and brought forth successful players such as Xiaomi and Huawei, who can compete in international markets (Wang & Lin, 2008). Xiaomi became the third largest smart phone manufacturer in 2014. This firm may not ring a bell in the West, because it has not marketed its products outside Asia, but its shipments already account for 6% of the global market, surpassed only by Samsung (25%) and Apple (12%). Moreover, Xiaomi's profits have risen to 566 million USD, exhibiting favorable prospects for continued growth (Cook, 2014).

Ironically, Xiaomi and Huawei both have their roots in the *Shanzhai* industry, albeit in different degrees. Huawei was founded in 1987 by civil engineer Ren Zhengfei and started out as a specialist in network technology. Today its low budget smart phones flood the markets in developed countries, but what is most striking is their push for high-end design and high-end technology via massive R&D spending and labor force allocation. Close to half of its employees are assigned to the development of innovative products, while R&D spending for 2013 accounted for 13.7% of total revenue. Between 2003 and 2005, Huawei was embroiled in a copyright infringement and technology theft case with US based Cisco Systems (Greene & Cheng, 2012).

Xiaomi was established in 2010, much later than Huawei. However, in similar fashion, the firm has had a hard time shedding its *Shanzhai* image, mostly because they shamelessly mimic global competitor Apple. Xiaomi's handsets are designed after Apple's iPhone, have similar functions and cost far less. In addition to the design and functions, copying has even extended to the CEO of Xiaomi, Lei Jun, who at a product launch in July 2014 appeared on stage as a *Shanzhai* Steve Jobs. Despite the *Shanzhai*-look, Xiaomi is run differently from Apple. It gives its customers input into the design process and software development. Hence, Xiaomi is becoming an "imitator-innovator" (Raustiala & Sprigman, 2014).

On the brink of imitation to innovation, China's ICT sector is booking national and international success with Xiaomi, Huawei and others. Nevertheless, if China is to fulfill its dream of successfully transforming its economy to become more sustainable and globally competitive, respect for IPR, enforcement and improvement of existing IP laws in the creative industries cannot be disregarded. Evidence from academic research highlights this issue. A weak IP system results in low-

er R&D investment and a negative view of R&D spillover, which in turn considerably undermines innovation and growth. When stronger property rights are promoted, the benefits of R&D spillover outweigh the gains from imitation (Branstetter & Saggi, 2011; Fan, Gillan, & Yu, 2013).

Due to the semi-federal nature of China's administrative system, local governments have in varying degrees reigned over implementation and enforcement of IP laws. Comparison of provinces within China shows differences between weak and strong IPR regions and illustrates the effect of strong IPR enforcement. In particular for the ICT industry, “[h]igh-tech firms in provinces with better IP rights enforcement have greater access to external debt. They invest more funding in R&D and have better tangible results—more patents and new product sales” (Ang, Cheng, & Wu, 2014, p. 347). Finally, it must be emphasized that strengthening of IPR can lead to “a positive and significant effect in attracting FDI” and consequently fosters “technology transfer” (Awokuse & Yin, 2010, p. 224; Branstetter & Saggi, 2011). That is exactly the kind of foreign influence the Chinese government has an appetite for.

5. CONCLUSIONS

As I argued in this paper, *Shanzhai*, the Chinese version of counterfeiting, has an irresistible appeal for businesses in China, due to the rise of consumer culture on the one hand and the existence of a failing IP protection system on the other. Above all, imitation and low-cost production have been profitable strategies that enable China to become second only to the US as the largest global economy. Within China, the *Shanzhai*-economy fulfills the consumer demand for affordable status products, with an emphasis on luxury goods. International and local brands see their products and services being copied and then sold throughout the country, sometimes even in

respectable stores. This practice ultimately leads to consumer confusion, with whole industry clusters dedicated to knockoffs and unscrupulous business conduct.

The Chinese government has ratified various agreements and treaties to address these practices, but in general the enforcement of IP laws has been inadequate for decades. A weak administration, non-interest in enforcement, and leniency towards counterfeiting as a way to maintain social stability are cited as reasons. Moreover, international complaints on IPR violations are often brushed off with the reply that China is a developing country and cannot do better. However, the financial crisis of 2008-2009 reduced consumer spending in Europe and the US, leading to a fall in exports from China and a shrinking market for second-best Chinese products. To tackle this issue, Beijing unfolded its plan to move from imitation to innovation and transform the local economy.

Against this transforming economic background, I asked whether IPR is truly necessary for a healthy creative market in China. Why not continue on the *Shanzhai*-route? As evidenced, the Chinese ICT sector has been doing quite well with manufacturers Xiaomi, Huawei, and Lenovo growing out of the *Shanzhai*-industry into respectable local brands and even moving into global markets. Nonetheless, these successful examples are exceptions, mere drops in the ocean of the *Shanzhai*-economy. Even when one acknowledges the success of the Chinese ICT sector, the ideal of transforming to a creative and innovative economy remains far-fetched. The challenges that lie ahead are not limited to IPR, but also involve such changes as the rigid education system, where creativity is not fostered.

This time, Beijing's promises to respect and enforce IP laws come not as a soothing response to

international complaints about IPR violation, but as a remedy for the falling export numbers and moderate economic growth. Perhaps this urgency can make the difference over past negligence. In my opinion, there is no alternative for the Chinese government except enforcement of IP laws. Chinese businesses must abandon the *Shanzhai*-route, because these second-best Chinese exports find no demand on the world markets. Similarly, from a national perspective, the demand for status goods will remain high, but consumption will not be effectively stimulated if customers prefer faulty low-priced knockoffs over better quality brands.

In sum, this double-edged dilemma shows that *Shanzhai* is not a sustainable business model for China's future development. The Chinese creative industry can benefit from protection by IPR and in turn support its economic transition from imitation to innovation. The challenges for achieving this goal are tough, but unavoidable.

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