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In the Shadow of the China–Australia FTA Negotiations:  
What Australian Business Thinks about IP

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of Applied Economic and Social Research

# **In the Shadow of the China–Australia FTA Negotiations: What Australian Business Thinks about IP\***

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## ABSTRACT

This study collated responses from a survey of over 2,100 businesses across Australia to assess the extent of both their business dealings with China and their commercial interest in IP. The survey results reveal that among Australian businesses which have direct business dealings with China, IP issues (registration, examination and enforcement) are of less concern than Chinese regulations and legal transparency. Among the IP issues covered in the survey, *IP enforcement* poses the greatest problem for Australian businesses.

## 1. INTRODUCTION

Since early 2005, Australia and China have been negotiating a Free Trade Agreement (FTA) which includes a minor but important chapter on Intellectual Property (IP). Achieving a workable and mutually beneficial agreement, however, requires knowledge of both the scale and nature of IP-related issues of concern in the tradable sector, since trade-offs for both countries are involved. However representative data necessary for assessing the benefits and costs of various options, in order to arrive at reasonable trade-offs, are often non-existent. In order to remedy this deficit, this study collated responses from a survey of over 2,100 businesses across Australia to assess the extent of both their business dealings with China and their commercial interest in IP. The survey provides information on the importance of IP across industries, as well as the relative importance of IP for the success of their Chinese business dealings. This information provides some insight into the priority that IP issues should be given in FTA negotiations, vis-à-vis other business concerns such as the transparency of regulations, taxation and conditions for employing professional and skilled staff.

The specific questions this paper addresses include:

1. How important are IP issues in China for Australian businesses? In other words, what priority should IP issues be given compared with other concerns of business, such as the transparency of regulation, taxation and skilled labour supply?
2. What are the particular relevant IP issues for Australian businesses in China? That is, what aspects of the IP system are most problematic: legal standards for protection, the mechanisms for enforcement, or the granting processes?
3. Which of these IP issues are important for what industries? How do the different areas of IP, patents, trade mark and designs, rank in importance?

Information about these issues is relevant to the ongoing Australia–China FTA negotiation, which covers not only trade in goods but also trade in services, and issues related to foreign direct investment and IP. While, in general, negotiations on these different topics occur simultaneously and separately, in the end ‘horse-trading’ across sectors is inevitable. Traditionally governments have relied on industry

submissions and anecdotal evidence to prioritise issues and guide them on trade-offs in their policy making. Unfortunately, however, this information has an unknowable level of generalisability by its very nature—it is not possible to know whether the views expressed in these reports and submissions are exceptional, or represent a general consensus. This paper attempts to expand on the available information in this regard.

The remainder of the paper is structured as follows. The next section provides a brief review of related literature. Section 3 presents the findings from the survey of Australian businesses. Section 4 discusses the rationale for FTAs, in particular the logic and history of including IP rights in FTA negotiations. Section 5 concludes with some implications for the FTA negotiations.

## **2. RELATED LITERATURE**

There is a small but growing literature which examines the impact of strengthening IP rights on trade and development. Much of this literature is focused on whether it is in developing countries' economic interests to raise IP standards (e.g., Maskus, 2000; Drahos, 2001). There is only limited academic literature on whether IP for a particular country (in this case Australia) is important to its trade relations with another country (in this case China). The approach of this paper is similar to that in Mansfield (1994), who surveyed 100 US firms in six industries, asking questions about whether the strength or weakness of IP rights protection had had a substantial effect on the kinds of technology transferred by firms to that country. However, Mansfield has been criticised for failing to ask about different categories of IP rights, and for not disaggregating amongst the kinds of activities undertaken by the firm in the target country (Heald, 2003).

Submissions made by industry in the context of trade negotiations represent a significant source of information for trade negotiators and a number of these submissions made in the course of the Australia-China negotiations are available on government websites. Such information, however, tends to be anecdotal, reporting particular incidents without reference to the broader context. Moreover, such submissions are most likely to come from representative bodies and industry participants with the

strongest interest in such issues. It is not clear, *a priori*, how important these issues are for the Australian economy as a whole.

Among the studies put forward by the interest groups is a broadly-based survey of 700 Australian manufacturers undertaken by the Australian Industry Group (AiG) in the June quarter of 2006 (AiG, 2006). This survey found that one in 16 manufacturing enterprises had a Chinese operation, either as a foreign-owned company or a joint venture partnership. Most enterprises see substantial growth opportunities arising from engagement with China, including increasing exports to China, making more use of Chinese inputs in domestic production, selling Chinese completed products in the Australian market and establishing Chinese operations. However, the lack of IP protection was of the ‘greatest concern’ to Australian enterprises exporting to and investing in China, and for companies supplying the Australian and other markets. Almost half of the firms (49 per cent) exporting to China identified shortcomings in IP protection as the issue of most concern, amongst all non-tariff barriers to trade in China. A lack of transparency in legal and financial systems was the second most important barrier (reported by 44 per cent of exporting enterprises); and inconsistent interpretations of the law were also an issue (for 38 per cent of enterprises). Many enterprises from the survey (no proportion specified) see enforcement of IP rights in China as futile, and intentionally withhold innovative designs or products from the Chinese market. Meanwhile, 52 per cent of enterprises with business dealings with China stated that IP infringements did not prevent investment in China.

This study by the AiG has several benefits, in that it compares the importance of a range of issues (for example, it ranks and compares IP and regulatory transparency), and it looks at the intended activities of firms in addition to their current activities. However, the AiG sample is not representative of the whole economy and hence it’s unclear if the results can be generalised to all Australian businesses.

Looking further afield, the availability of data from Europe and the United States on businesses’ IP experiences with China is sparse. The US Government has their own processes for assessing the impact of ‘trade barriers’ on their nationals in third countries, although none of these involve the use of representative surveys. The US Trade Representative examines and reports to Congress on the effectiveness of IP protection in other countries annually through the ‘Special 301’ process (*Trade Act of*

1974, §182; 19 U.S.C. §2242, see USTR (2006a)). This provides a yearly report on IP-related issues of relevance to US companies in China. In addition, the USTR has in recent times completed a ‘Top to Bottom Review’ of the US–China trade relationship (USTR [2006b]) and an out-of-cycle review of China’s IP laws (2005), as well as an annual report on China’s compliance with World Trade Organization (WTO) rules (US–China Relations Act of 2000 §421; 22 U.S.C. §6951). These reports provide a full description of the legal framework in China, and enforcement and other IP issues experienced in China. They therefore assist in identifying particular IP issues that may be experienced by Australian businesses. They are, however, of limited use in answering the research questions above, given that they examined the overall US–China trade relationship sector-by-sector, without any ranking of the importance of the various issues.

The American Chamber of Commerce (AmCham)<sup>1</sup> also conducts an annual survey, of its approximately 2,100 members, about the business environment in China. The most recent resulting ‘White Paper’ reports the responses of ‘over 200 respondents’ (AmCham, 2006). Information from the survey is presented in two ways: at a general level by issue, and in detailed albeit largely anecdotal form by industry sector. The questions presented at least in the final report are pitched at a general level: whether the IP situation has ‘deteriorated’ or ‘improved’; whether there are more or fewer counterfeits; and whether members are satisfied with the cooperation from Chinese officials. The White Paper is useful in identifying particular matters of concern, and even regions or industries which IP disputes affect but, for obvious reasons, it provides no information when it comes to Australian interests in the area.

Information from Europe is even more limited. An ‘Enforcement Survey’, conducted in 2006 received 290 responses of which only 45 dealt with trade conditions in China (European Commission, 2006). Statistics on counterfeit goods seized at the European Union (EU) border are available but there is no evidence that these data are representative. In 2004, for example, 54 per cent of goods seized at EU borders came from mainland China, which is disproportionately greater than its overall share of imports of 19 per cent (European Commission, 2006). However, since it is probable that shipments from this

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<sup>1</sup> AmCham members are individuals (as individuals and as representatives of companies) doing business in China.

known source of counterfeit goods are more heavily scrutinised, we cannot be confident that this estimate is unbiased.

### 3. AUSTRALIAN SURVEY FINDINGS

#### 3.1 Profile of respondents

During June and July of 2006 a stratified-sample, telephone survey of 5,330 enterprises was conducted to find out how many Australian-located enterprises<sup>2</sup> do business with China, and for these, the importance of IP issues. From the 5,330 enterprises that were approached 2,125 gave valid responses, implying an overall response rate of 39.9 per cent. Of these 2,125 enterprises 396, or 18.6 per cent, indicated that they had had business dealings with China over the previous 12 months (see Table 1). Enterprises were classified as ‘doing business with China’ if they had (i) exported to China, (ii) licensed technologies or brands to Chinese businesses, (iii) outsourced manufacturing to China, (iv) provided fee-based consultancy services to exporters who deal with China, (v) owned production facilities in China, or (vi) set up offices or distribution outlets in China. However, after respondents were weighted by enterprise population (frequency) weights, this percentage fell to 9.0 reflecting the fact that the survey over-sampled large manufacturing businesses.<sup>3 4</sup>

This 9.0 per cent estimate assumes that each enterprise receives an equal weight in the calculation—that is, that the response of a corner milk bar, for example, has the same weight in the estimate as BHP Billiton. However, it makes more intuitive and economic sense to re-weight enterprises according to their importance to the economy. If, for example, we weight enterprises by their annual turnover (using the midpoints of the turnover ranges shown in Table A6 and using only the companies for which turnover data are available), we find that the total turnover of the companies doing business with China is 40.8 per

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<sup>2</sup> This includes both foreign and Australian-owned enterprises.

<sup>3</sup> Population weights compensate for differences in the sampling percentage in each category and response rates in each category. See the Appendix for further details.

<sup>4</sup> We remind readers that as all our data have been drawn from a sample, our estimates are subject to a certain level of sampling error. While we cite point estimates, such as the 9.0 per cent given above, the true figure will vary from 9.0 by an amount that depends upon this sampling error which has yet to be calculated.



cent of all turnover in the economy. This difference arises because large enterprises are considerably more likely to deal with China than SMEs. Alternatively, if we weight each responding enterprise by employment, the percentage dealing with China is 18.4. This figure is lower than the turnover-weighted figure because enterprises that deal with China are not only larger than average, but they are also more capital intensive. Because we believe that it makes most sense to weight responses by annual turnover, most of the remaining data will be presented in a turnover-weighted format.

**Table 1. Enterprises currently doing business with China**

	No. of enterprises	% of enterprises
<b>Enterprises doing business with China</b>		
Unweighted survey counts <sup>a</sup>	396	18.6
Population counts <sup>a</sup>	74,801	9.0
Population counts weighted by annual turnover <sup>a</sup>	74,801	40.8
Population counts weighted by employment <sup>a</sup>	74,801	18.4
<b>Enterprises not doing business but planning to do business with China in next</b>		
Population counts weighted by annual turnover	82,907	18.3
<b>Total ABS population of enterprises<sup>b</sup></b>	<b>837,078</b>	<b>100.0</b>

Notes: a Intellectual Property Research Institute of Australia China FTA Survey, 2006. b ABS cat. no. 8161.0.55.001 Australian Bureau of Statistics Business Register, Counts of Businesses, Table 1. ABSBR, Counts of Businesses, June 2004

In addition to this 40.8 per cent of enterprises which are currently dealing with China (weighted by annual turnover), a further 18.3 per cent indicated that they planned in the next two years to partake in at least one of the six following activities: exporting, licensing technologies, outsourcing manufacturing, providing fee-based consultancy services or establishing production facilities, offices or distribution outlets.

### 3.2 Profile of enterprises currently dealing with China

In this Section we present the characteristics of enterprises which claim to be currently dealing with China. Table 2 shows the industry breakdown according to whether the enterprise is currently dealing with China or not dealing with China. As can be seen, the manufacturing sector accounts for 45.2 per cent of companies that are doing business with China, which far exceeds the next two most represented sectors, namely wholesale trade (19.6 per cent) and property and business services (8.0 per cent). While

manufacturing dominates the industries dealing with China, it does not have the highest ratio of enterprises which deal, vis-à-vis not deal, with China. This accolade goes to education, followed by communications and agriculture.

**Table 2. Industry distribution of enterprises by whether they have business dealings with China**

	Deal with China %	No dealings %	Ratio of column 2 to 3
A/ Agriculture, forestry & fishing	2.6	0.8	76.5
B/ Mining	6.1	3.0	67.0
C/ Manufacturing	45.2	17.5	72.1
D/ Electricity, gas & water supply	0.1	4.6	2.1
E/ Construction	3.6	5.5	39.6
F/ Wholesale Trade	19.6	19.4	50.3
G/ Retail Trade	1.6	9.3	14.7
H/ Accommodation, cafes & restaurants	0.1	0.1	50.0
I/ Transport and storage	4.2	7.5	35.9
J/ Communication Services	0.6	0.1	85.7
K/ Finance and Insurance	2.5	12.9	16.2
L/ Property & business services	8.0	8.1	49.7
N/ Education	4.5	0.2	95.7
O/ Health & community services	0.0	3.2	0.0
P/ Cultural and recreation services	0.6	2.4	20.0
Q/ Personal and other services	0.0	1.0	0.0
Total	100.0	100.0	

Note: Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia China FTA Survey, 2006.

The propensity to deal with China is also a characteristic of large enterprises, as defined by both employment and annual turnover. As shown in Table 3, 46.1 of the large enterprises reported dealing with China, compared with 27.5 per cent of SMEs.<sup>5</sup> These differences partly arise from the fact that large enterprises do more of almost all activities by virtue of their size, but it also probably reflects the logistical, language and other complexities involved in undertaking such activities.

**Table 3. Enterprises doing business with China by size of enterprise**

	Deal with China %	No dealings %	Total %
SMEs	27.5	72.5	100
Large enterprises	46.1	53.9	100
Total	40.8	59.2	100

Note: An SME is defined as employing less than 200 people. A large enterprise is defined as employing 200 people or more. Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

<sup>5</sup> These differences are also echoed in Table A6 where we classify enterprises according to annual turnover.

A breakdown of the activities according to the type of business engagement is shown in Table 4. About a quarter of the enterprises that are doing business with China are exporting, and about one in five have offices or distribution outlets in China. Meanwhile, about one in nine have outsourced manufacturing operations to China and slightly more have established production facilities there. Licensing and providing consultancy services to exporters dealing with China were the least common activities.

**Table 4. Enterprises doing business with China by type of activity**

<b>Type of activity</b>	<b>% of enterprises</b>
Export to China	24.7
License technologies	7.7
Outsource manufacturing	11.4
Provide fee-based consultancy	6.7
Production facilities in China	11.8
Offices or distribution facilities in China	19.3
Total (any of the above)	40.8
Total enterprises in Australia	100.0

Note: The column does not add to the total because some companies undertake more than one activity. Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

In an attempt to gauge the importance of the Chinese market to exporters, China-exporting enterprises in the survey were asked about the magnitude of their sales to China. Table 5 shows that for around three-quarters of these enterprises, exporting to China accounts for less than 10 per cent of their total turnover. For another 13.1 per cent of enterprises, sales to China represent between 10 and 50 per cent of total turnover. Notwithstanding these proportions, a significant number of exporting enterprises, almost 33.8 per cent, said that China is one of their top three export markets.

**Table 5. Importance of the Chinese market to exporting enterprises**

Exports to China as per cent of total turnover	% of Enterprises
Less than 10 per cent	77.6
10–50 per cent	13.1
Greater than 50 per cent	5.2
Don't know	4.2
Total enterprises exporting to China	100.0
China in enterprises' top 3 markets	33.8

Note: Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

To gauge the financial importance of licensing, outsourcing and consulting, we sought the qualitative responses 'not important', 'somewhat important' and 'very important' to questions. According to the evidence in Table 6, around a third of enterprises engaging in these activities regarded licensing and consulting in the Chinese market as very important. In the case of enterprises that are outsourcing to China, 47.1 per cent of enterprises regarded their business in China as a very important priority. In all cases a further significant proportion of firms regarded their business in China as somewhat important.

**Table 6. Importance of China to companies that are licensing, outsourcing and consulting**

	% of enterprises		
	Licensing	Outsourcing	Consulting
Not important	32.3	11.7	31.0
Somewhat important	38.6	41.2	41.6
Very important	29.1	47.1	27.4
Total enterprises licensing, outsourcing or consulting	100.0	100.0	100.0

Note: Enterprises were asked to rate their activities in China in terms of whether they are an important priority or not in their overseas operations. Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

In order to gain some perspective of how important IP rights were in the broader scheme of business concerns, we also asked enterprises that are currently dealing with China to rate the importance of some specific aspects of the Chinese business environment on a scale of one (not important) to seven (very important); the results are shown in Table 7 below. Since we were not asking respondents to rank these attributes but to rate them, it did not matter that they were by definition not mutually exclusive. This question was not about problems with the Chinese environment nor about the most desirable aspects of the Chinese environment. It was simply about what type of issues matter.

We nominated six business environment aspects: Chinese regulations, Tax system, IP rights, Legal transparency, Infrastructure and Skilled workers. Our survey revealed that all six aspects were considered to be important by the majority of enterprises. However, Chinese regulations followed by legal transparency were judged to be most important, with an average importance ranking of over 5. IP rights and infrastructure were rated in the middle, ahead of the tax system and the availability of skilled workers.<sup>6</sup>

**Table 7. Importance of Chinese business environment for enterprises which currently deal with China**

Aspects of the business environment	Mean importance rating by enterprises	Percentage of firms with a rating of $\geq 4$	Sample number with a rating of $\geq 4$
Chinese regulations	5.6	87.3	313
Tax system	3.9	57.9	192
IP rights	4.7	71.1	260
Legal transparency	5.3	85.2	295
Infrastructure	4.8	81.6	290
Skilled workers	4.4	67.3	261
Sample size dealing with China=396			

Note: Enterprises are asked to rate aspects of the business environment affecting their activities in China on a scale of 1 (not important) to 7 (very important). Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

### 3.3 Enterprises dealing with China which consider IP important

The remaining part of the survey focused only on those (260) enterprises, identified in Table 7, which had responded that IP rights rated at least 4 out of 7 in importance. This was equivalent to 71.1 per cent of all businesses which had dealings with China (weighted by turnover). To begin with we questioned IP-interested enterprises about their prior experience with infringement in China. Specifically, firms were asked whether they had detected infringements by Chinese exports over the previous two years, as well as whether they had applied for patents or trade marks in China in the previous two years. The results are presented in Table 8 below. The most significant infringement of intellectual property identified by these firms was in regard to designs, with 6.1 per cent of enterprises highlighting this area of infringement by

<sup>6</sup> In this respect, the results of our survey differ from those produced by the Australian Industry Group (above page 5). In the AiG study, IP was rated the *most* important non-tariff barrier to trade, above concerns such as transparency of legal and

Chinese exports. However, reports of infringements relating to patents and trade marks were only marginally lower than for designs—5.4 per cent of the firms said they were aware that Chinese exports had infringed their intellectual property in the form of patents, and 5.2 per cent said their trade marks had been infringed. A total of 9.1 per cent of firms had had one or more infringement experiences. Of those enterprises that were IP-interested, 11.6 per cent of enterprises had applied for patents or trade marks in China in the two years prior to the survey.

**Table 8. Enterprises with past IP experience in relation to China, Enterprises which consider IP important**

Type of IP experience (last 12 months)	% of enterprises
Patents infringed by Chinese exports	5.4
Trade marks infringed by Chinese exports	5.2
Designs infringed by Chinese exports	6.1
Total (any of the above)	9.1
Applied for patent or trade mark in China in last 2 years	11.6
Total enterprises which considered IP important	100.0
Sample size	260

Note: The column does not add to the total because some companies undertake more than one activity. Enterprises weighted by annual turnover.  
Sources: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

Those enterprises which claimed a high interest in IP rights were also asked three further questions relating to the impact of enforcement difficulties, specifically: how often their IP rights in exports had been infringed; the impact of infringement on profits; and how often they had sought to enforce their rights. The mean rankings in regard to these questions were relatively low. As shown in Table 9, 78.3 per cent reported either no, or infrequent, infringement and only 1.6 per cent reported very frequent infringement. The impact on profits was also small. 89.4 per cent of enterprises reported that the effect on profits was not important and a further 10.2 reported that it was somewhat important. Only 0.4 per cent reported that it was very important.

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financial systems.

**Table 9. Importance/ frequency of IP infringement, Enterprises which consider IP important**

Rating	% of enterprises		
	Frequency IP rights in relation to exports infringed	Impact of this infringement on profits in last year	How often do enterprises try to enforce IP rights
Not important/frequently	78.3	89.4	88.8
Somewhat important/frequently	20.1	10.2	10.0
Very important/frequently	1.6	0.4	1.2
Total enterprises which considered IP important	100.0	100.0	100.0
Sample size	<b>224</b>	<b>260</b>	<b>260</b>

Note: Follows on from responses in Table 8 regarding IP rights. IP important if awarded 4 or above on a scale of 1 (not important) to 7 (extremely important). Enterprises weighted by annual turnover. The difference in sample size numbers reflects non-response by some respondents.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

Only 46 enterprises in our sample had attempted to enforce IP rights through the Chinese legal system. Of these, 42.7 per cent indicated that they were never or rarely successful, 28.4 per cent had been somewhat successful and 28.9 per cent had been frequently successful (see Table 10). These figures should be kept in perspective. Studies of enforcement in Australian courts have shown success rates of 56 per cent in patents (Weatherall and Jensen, 2005) and 62 per cent in trade mark (Bosland, Weatherall and Jensen, 2006). The combined ‘somewhat’ and ‘very’ successful rates in Chinese courts is 57.3 per cent.

**Table 10. Success in enforcing IP rights through Chinese legal system, Enterprises which has attempted to inform IP rights**

Rating	Success in enforcing IP rights through Chinese legal system
Never or rarely successful	42.7
Somewhat successful	28.4
Very successful	28.9
Total enterprises that tried to enforce IP rights in China	100.0
Sample size	46

Note: Follows on from responses in Table 9. Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

Respondents were subsequently asked to indicate which of the methods of response listed in Table 11 they had engaged in response to IP challenges. As can be seen, by far the most prevalent response was to do nothing, nominated by 50.6 per cent of enterprises for which IP rights are important. This figure is not

inconsistent with the findings from the AiG survey AiG (2006) which reported that ‘many’ (no proportion specified) businesses thought enforcement was futile and that IP issues were not preventing investment in China for 52 per cent of respondents. In our survey, the three next most common responses were that they used different brands and labels for China (15.6 per cent), had lobbied the Australian government (13.4 per cent) or had lobbied the Chinese government (12.8 per cent). Only 6.6 per cent reduced exports of the affected goods.

**Table 11. Enterprise responses to IP challenges, Enterprises which consider IP important**

<b>Activities</b>	<b>Ways in which enterprises have responded to IP challenges</b>
Lobbied the Chinese government	12.8
Made deals with infringers	8.0
Lobbied the Australian government	13.4
Reduced exports of affected products	6.6
Used different brands/labels for China	15.6
Enforced property rights in third markets	7.9
Done nothing	50.6
Total enterprises which considered IP important	100.0
Sample size	260

Note: Enterprises weighted by annual turnover.  
Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.

Finally, when all enterprises doing business with China and/or planning to do business with China were asked to rate how much they valued action by the Australian government to address IP problems issues, the top priority was to encourage China to increase enforcement of IP rights, as shown in Table 12.

**Table 12. Importance of Australian government assistance for those dealing or planning to deal with China**

<b>Types of assistance</b>	<b>Mean importance rating by enterprise</b>
Seek stronger IP laws in China	5.0
Encourage China to enforce IP more	5.2
Assist companies with specific infringement complaints	4.8
Establish better bi-lateral cooperation in law enforcement	5.1

Note: Respondents were asked to rank questions on a scale of 1 (not important) to 7 (extremely important). Enterprises weighted by annual turnover.  
Source: Intellectual Property Research Institute of Australia, China FTA Survey, 2006.



#### 4. IMPLICATIONS FOR AUSTRALIA–CHINA FTA NEGOTIATIONS

*What is an FTA?*

An FTA is an agreement between two or more countries to eliminate tariff and non-tariff barriers—such as preferences, standards and quotas—that hinder the free flow of goods and services between them. From an economic perspective, the aim of such agreements is to restructure production so that the combined area reaps not only the static gains reflecting comparative advantage, but also the dynamic gains resulting from specialisation and the division of labour, such as improved technologies. The more complementary are the production systems of participating countries, the greater are the expected gains.

Economic theory suggests that the net outcome of the complete removal of trade barriers will be an increase in income and ultimately wealth. However, these gains from trade refer only to aggregate income and wealth and the message is more mixed in relation to their distribution. In reality there may be significant losers, in particular among those employed in previously protected industries, unless they are compensated by the gainers through government-induced transfers so as to leave them at least no worse off than in the pre-liberalisation situation. There remains a popular expectation that there will be a net economic gain for a country that joins an FTA and a net economic loss for a country which is excluded.<sup>7,8</sup> However, there is no agreement amongst economists that: (i) the proliferation of FTAs since 2000 will yield net gains to the global economy; or (ii) a country will actually experience a net economic gain from joining an FTA.<sup>9</sup>

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<sup>7</sup> Economists have traditionally categorised FTAs into: (i) a free trade area in which each member retains its pre-agreement tariff rates against non-members but removes its tariffs preferentially on imports from members; (ii) a customs union in which a common external tariff is imposed by each member on each given tariff line on imports from non-members but tariffs are removed preferentially on imports from members; (iii) a common market which is a customs union with internal free trade in factors of production as well as in goods; and (iv) an economic union which is a common market with a common currency and co-ordinated macroeconomic policies. Most modern FTAs take the form of free trade areas, although not all internal trade is free. They also depart from the traditional typology by involving not only trade in goods and factors of production but also services, investment and intellectual property.

<sup>8</sup> There are two important results in the theory of FTAs. The first, due to Kemp and Wan (1976), established the conditions under which a customs union would not harm non-member countries. The second, due to Panagariya and Krishna (2002), established parallel conditions under which a free trade area would not harm non-members.

<sup>9</sup> A country may lose from membership of an FTA because of trade diversion, but also because of the additional costs of administering customs procedures associated with rules of origin and because exporting firms may not find it profitable to seek the preferential rates for its exports to member countries again because of rules of origin. These administrative costs can

Despite the rhetoric which usually surrounds FTA negotiations, few FTAs are actually designed to eliminate all trade barriers. Most recent FTAs have excluded sensitive sectors and/or have reduced selected trade barriers over lengthy periods. Accordingly, there is considerable scope for parties to debate over which set of barriers will be the subject of negotiations and which will not. FTAs are typically negotiated between two or more countries through a series of negotiating ‘rounds’ during which trade officials meet, initially to discuss the scope of the agreement and later, to discuss specific proposed text. Usually, different topics and sectors will be dealt with in separate ‘working groups’ involving trade negotiators with expertise in that area, with an overview perspective maintained by lead negotiators. Negotiations are often preceded and accompanied by consultation between trade negotiators and industry representatives in order to identify current trade issues. Parties will have different priorities dictated by national interests. One country may be seeking access to services markets, while another may be seeking a reduction in tariffs for resources. While in general negotiations on different topics occur simultaneously and separately, in the end 'horse-trading' across sectors is inevitable.

*Do FTAs include commitments on IP?*

The inclusion of IP in FTAs, while increasingly common in agreements involving a developed country, is contentious. A number of critics (for example, Drahos [2001]) have argued that developed countries are seeking to secure increased protection that they are unable to achieve in the WTO. On the other hand, for countries which have an interest in the protection of IP, it is also argued that FTAs that cover IP can enhance the rights and obligations available under the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)<sup>10</sup> by increasing protection and/or securing better enforcement. The rationale for linking IP and trade is that without some IP protection in the markets of trading partners, the technologically-advanced country will find itself competing with counterfeits and copies made by manufacturers in the second country which have not had to face the (sunk) costs of research and development. Compared with a ‘full IP protection’ situation, these counterfeits reduce the original manufacturers’ ability to achieve economies of scale and dull their incentives to reinvest in further research and development.

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be substantial especially if the country is a hub, i.e. a country that is a member of an FTA and that FTA has different rules of origin. For a recent discussion of rules of origin, see Lloyd and MacLaren (2006).

In addition to the debate as to whether FTAs should include provisions dealing with IP, there is a wide variety in the scope of such provisions, and the level of detail in IP provisions may vary significantly. For example, provisions mandating cooperation between customs authorities could be drafted at a very high level of generality (simply committing to ‘cooperation and dialogue’) – making it easy to commit to but difficult to enforce – or it could descend to detail IP standards and the on process for customs enforcement.<sup>11</sup>

There are practical and legal limits to changing the level of protection (for example, extending copyright to the life of the author plus seventy years) on a preferential basis. In relation to matters of ‘the protection of intellectual property’, a term defined, in TRIPS, to ‘matters affecting the availability, acquisition, scope, maintenance and enforcement of intellectual property rights’ (TRIPS, Article 4), there is no FTA exception from the obligation to confer Most Favoured Nation (MFN)<sup>12</sup> status on nationals of all WTO

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<sup>10</sup> One of the WTO agreements with which all WTO Members must comply.

<sup>11</sup> Experience from existing agreements suggests that there are six possible levels of IP harmonisation.

(1) Provisions requiring adherence to international treaties or optional protocols, or affirming, in general terms that the parties undertake to provide effective protection for IP rights.

(2) Provisions which repeat provisions from TRIPS or other multilateral treaties dealing with the subject matters protected by IP, and/or the rights which attach to the IP subject matters.

(3) Provisions mandating higher legal standards regarding subject matters and rights than those found in the TRIPS Agreement (‘TRIPS-plus’).

(4) Provisions mandating cooperation between customs authorities in order to reduce cross-border trafficking in counterfeit goods.

(5) Provisions mandating cooperation between granting authorities (through, for example, staff exchanges) and good faith efforts to promote harmonisation of IP laws.

(6) Provisions requiring the establishment of mechanisms to assist with enforcement: for example, bodies or officials tasked with assisting foreign IP owners to pursue enforcement.

The first two categories may be included so that adherence to the multilateral standards can be addressed using the dispute resolution provisions in the FTA. Category 3 is often found in US or EU bilateral agreements in order for these parties to achieve higher protection than that afforded through multilateral negotiation. Categories 4–6, on the other hand, seek to address particular problems arising in trade between the trading partners. They can be designed to adjust dynamically to issues as they arise, for example, by setting up committees, working groups or regular meetings in which problems can be discussed. Provisions in category 4 are relatively common and have a long history; provisions in categories 5 and 6, however, are a more recent phenomenon, arising from the increasing integration of IP systems. Examples of category 6 provisions would be the establishment of an IP Ombudsman within the Chinese embassy in the United States, and the establishment of an IP Working Group as part of the US–China Joint Commission on Commerce and Trade (JCCT) which meets annually to discuss IP issues between the two countries. The EU has a similar EU–China ‘Dialogue on intellectual property rights and geographical indications’. Neither of these bodies was established by an FTA as such, but they provide models for the kind of body an FTA could establish to address, dynamically, IP concerns between the countries. In addition, it is less clear, in law, that MFN obligations would apply provisions in categories 5 and 6.

<sup>12</sup> Most favoured nation (MFN) status does not confer specific advantages on the receiving nation, but means that the nation receiving MFN status will be granted all trade advantages, such as low tariffs, that any third nation receives. In short, having MFN status means that a country will not be treated worse than another country.

members in the TRIPs Agreement. This contrasts with the exceptions provided in the General Agreement on Tariffs and Trade (GATT) and the General Agreement on Trade in Services (GATS). This means that any member of the WTO which concludes an FTA which raises IP standards for nationals of the FTA partner must extend that same treatment to nationals of all other WTO members.<sup>13</sup> This increases the stakes for a country contemplating agreeing to extended IP standards but increases the benefits to other countries not party to the FTA. On the other hand, provisions which establish, for example, specific mechanisms for bilateral cooperation in law enforcement, or consultative mechanisms (such as working groups or annual meetings to discuss IP issues) are not subject to MFN requirements.<sup>14</sup>

The Australian negotiations with China have a number of distinctive features. In negotiating with China, Australia is the *demandeur*, or requesting party, when it comes to IP. This contrasts with the negotiations of the Australia-United States FTA (AUSFTA), where Australia received requests from the United States. Australian IP rules are currently among the most stringent in the world, in part a consequence of the AUSFTA. On the other hand, China only began protecting intellectual property in 1982 and, although it became a party to many of the WIPO treaties in the 1980s and 1990s, it adopted the TRIPS standards only when it acceded to the WTO in 2001.<sup>15</sup> Further, China's past bilateral trade agreements have not dealt with IP or, as in its 2005 agreement with Chile, include only limited provisions on IP. Indeed, China has adopted a general policy in its trade negotiations of making progressive agreements: reaching agreement on some sectors, with undertakings for further negotiations on 'sensitive' areas in the future. Chinese diplomats have expressed a preference for leaving IP out of any agreement.

It is not hard to understand China's perspective. IP legal standards tend to rise with levels of economic development: only as countries develop more innovative capabilities and a capacity to purchase and use

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<sup>13</sup> Under the GATT Art 1, countries are generally obliged to provide MFN status to other contracting parties. GATT Art 1 is however subject to an exception under Art XXIV, which allows the formation of free trade areas and customs unions with mutual, and preferential, lowering of barriers between parties to the free trade area or customs union: Art XXIV.4 and XXIV.5. TRIPS, however, contains an obligation to provide MFN treatment under Article 4 which has no such equivalent free trade area exception. Therefore, 'advantages' offered in relation to the protection of IP must be provided on an MFN basis even where negotiated as part of a free trade agreement (Gervais 2003).

<sup>14</sup> So, for example, the US and EU have both established consultative mechanisms with China in relation to IP; these mechanisms are not open to all WTO members, suggesting an interpretation excluding these mechanisms from the TRIPS requirement of MFN.

new technologies effectively do local economic interests emerge favouring stronger rights (Rapp and Rozek 1992, Maskus 1997). In addition, China has had to make significant changes to its IP systems through WTO accession, and is under continuing pressure from the European Union and the United States to make further changes and to provide practical enforcement outcomes.<sup>16</sup> It may thus be in China's interests to maintain maximum flexibility for future negotiations with those countries.

*Should this FTA include an IP chapter?*

Whether the current Australia–China FTA under negotiation should include an IP chapter, and what any such chapter should include, depends on two factors: first, whether the FTA can improve IP enforcement in China<sup>17</sup> and raise the level of protection, including by addressing specific industry concerns (such as those identified in submissions to DFAT)<sup>18</sup>; and secondly, what price would have to be paid for doing so.

The survey described in this paper sought to provide some perspective on the importance of IP issues in China to Australian businesses. Overall, the figures are not overwhelming. The Chinese market is important to many firms across a range of industries; Australian businesses are also engaging in a range of activities with China, from exporting to outsourcing, licensing, and basing production facilities there. Across the full range of industries, amongst firms doing some form of business with China, IP was rated below both the system of Chinese regulations and legal transparency. While the survey indicates that 71.1 per cent of firms dealing with China considered IP conditions an important aspect of the Chinese business environment, only 10.2 per cent of these enterprises felt infringement had a somewhat important impact on their profits and 0.4 felt it has a very important impact.<sup>19</sup> Overall therefore, we can say that IP

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<sup>15</sup> TRIPS defines minimum standards for many forms of intellectual property regulation including a requirement that WTO Members provide effective IP enforcement procedures.

<sup>16</sup> In April 2007 the United States initiated two WTO dispute proceedings against China over alleged deficiencies in China's IP laws and IP-related market access barriers. (WT/DS362; WT/DS363)

<sup>17</sup> Encouraging China to enforce IP more was identified by respondents as the type of assistance the Australian government could most usefully provide: see Table 12.

<sup>18</sup> Available at <http://www.dfat.gov.au/geo/china/fta/submissions/index.html>

<sup>19</sup> Note that the percentages are only for those enterprises doing business with China. Thus the data does not capture those enterprises which would do business with China but for IP concerns. We are unable to comment on whether there is such a group of firms, or their importance to Australian economic interests overall.

enforcement issues were at least ‘somewhat’ important for about 8 per cent of enterprises currently having business dealings with China.<sup>20</sup>

Specific changes to enforcement in China, targeted at very practical enforcement issues (these being identified in the survey as the more pressing issues) are likely to benefit this 8 per cent of Australian enterprises which deal with China. Bilateral cooperation in law enforcement; or the operation of the relevant administrative agencies (such as those for copyright collection); or annual bilateral meetings to discuss enforcement issues; are examples of such specific programs.<sup>21</sup> Such obligations would not be affected by MFN and hence would involve less cost to China. As China develops its own R&D capacity, these measures are also likely to be in the interests of innovative Chinese businesses as well. China’s willingness to establish forums with the EU and USA to discuss cooperation, including on enforcement issues, suggests that a similar outcome is possible in the FTA. So in sum, there is limited but positive scope for Australian enterprises to benefit from the FTA if it provides for more effective enforcement of IP standards in China.

However, determining how much emphasis should be placed on IP issues vis-à-vis other matters in the FTA is not easy. To obtain significant IP provisions within the FTA, Australia might have to sacrifice other negotiating objectives. How much should Australia be willing to give up for IP will depend on the relative importance of IP issues compared with other concerns such as market access (that is, tariffs and tariff quotas) and other trade and investment barriers. Negotiators should accord a lower priority to IP if it is not as important to business as other concerns. While we are unable to assess the strength of concerns such as tariffs, tariff quotas and other trade and investment barriers vis-à-vis IP (because respondents were not asked about these issues), respondents did identify transparency and regulations as being of concern. However, it remains true that, for some Australian enterprises, especially the 0.4 per cent who reported that infringement had a very important impact on profits, enhanced IP enforcement is a critical issue.

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<sup>20</sup>  $\approx 71.1$  per cent of enterprises which deal with China considered IP important (Table 7)  $\times$  (10.2 + 0.4) per cent of these which considered infringement had a somewhat or very important impact on their profits (Table 9).

<sup>21</sup> Interestingly, the idea of having the government assist with *specific* IP disputes in China rated lowest of the assistance industry was interested in: see Table 12 above.

## 5. CONCLUDING REMARKS

This paper reports the results of a survey of more than 2,100 Australian enterprises that have business dealings with China. There is particular emphasis in the survey on the experiences of businesses in their dealings with China and their views about IP issues. The survey results reveal that IP issues (registration, examination and enforcement) are not the single most important concern of Australian businesses; other issues such as Chinese regulations and legal transparency are of greater importance for their Chinese business dealings. Among the IP issues covered in the survey, *IP enforcement* poses the greatest problem for Australian businesses. Significantly, more than half of the businesses facing IP problems in China choose to do nothing about them. This result reinforces the view that IP issues, while problematic for some Australian businesses dealing with China, are not significant enough to outweigh the benefits of doing business with China.

We conclude that there is no evidence to support the idea of nominating IP issues as the highest priority in Australia's FTA negotiations with China, though their ranking relative to other concerns indicates that they are significant for about 8 per cent of Australian enterprises which deal with China. This conclusion would take on more significance if Australia had to concede ground on higher-priority negotiating objectives in order to obtain significant IP provisions in the negotiations.

However, it should be emphasised that the experience of the EU and USA suggests that it may be possible to achieve meaningful commitments from China for consultative mechanisms, including on enforcement. Enhanced enforcement and higher standards are likely to become less problematic for China over time as China develops its own R&D and innovation capacity.

## 6. APPENDIX—SURVEY DESIGN

### 6.1 Sampling Framework

The enterprise survey was based on a stratified random sample drawn from three populations in June 2006: a general sample from the Yellow Pages; a list of all enterprises with turnover greater than \$50m per year from the IBISWorld database; and a list of 216 companies from the Australian Industry Group (AiG) which are ‘known’ to do business or deal with China (‘deal with China’ population). Enterprises were approached by phone and the total interview time was from 5 to 15 minutes.

The percentage of each population surveyed was 0.4 per cent from the general population, 65.3 per cent from the large population and 82.5 from the ‘deal with China’ population. As shown in Table A1, an overall response rate of 39.9 per cent was achieved with sub-group responses ranging from 69.8 per cent for enterprises known to deal with China to 36.7 per cent for the general population. This difference in response rates is not surprising as we expect that firms that are currently doing business with China had a greater incentive to participate.

**Table A1: Sample selected for the enterprise survey**

Strata	(1) Est. population	(2) Sample selected	(3) Sample rate % [=(1)/(2)]	(4) Responses	(5) Response rate % [=(4)/(2)]
General (Yellow pages)	1,034,658	3,956	0.4	1,451	36.7
Large (IBISWorld)	1,831	1,195	65.3	549	45.9
Deal with China (AiG)	216	179	82.9	125	69.8
TOTAL		5,330		2,125	39.9

Note: The definition of an enterprise in the Yellow Pages differs from that of the ABS, IBISWorld and AiG.

Table A2 below shows an industry breakdown (according to ANZSIC classifications) of the firms which participated in the survey, those that refused to participate, as well as total Australian firms. As can be seen, 31.3 per cent of survey participants were from the manufacturing sector, while nationwide manufacturing firms account for 7.4 per cent of firms, according to the ABS Business Register.<sup>22</sup> The next two biggest sectors represented in the survey sample are property and business services (13.0 per



cent of participating companies) and the retail sector (9.7 per cent); both of these sectors are under-represented compared with their national industry share.

Survey refusals shows a similar pattern to that of the survey respondents, with the bulk of the refusals coming from just five industry categories, namely: manufacturing; health and community services; property and business services; construction; and the retail sector. These sectors also tend to be the largest nationwide, although the second largest industry sector nationally—agriculture—was under-represented in both the survey sample and amongst the refusals, probably reflecting the SME company source used in the survey and the nature of the businesses in this sector.

**Table A2. Industry classification of companies**

	Survey Respondents		Survey Refusals		All Australian firms*	
	Number of firms	%	Number of firms	%	Number of firms	%
A/ Agriculture, forestry & fishing	52	2.5	65	2.0	74,111	8.9
B/ Mining	31	1.5	41	1.3	2,731	0.3
C/ Manufacturing	665	31.3	685	21.4	61,888	7.4
D/ Electricity, gas & water supply	13	0.6	19	0.6	599	0.1
E/ Construction	192	9.0	372	11.6	113,426	13.6
F/ Wholesale Trade	133	6.3	156	4.9	46,800	5.6
G/ Retail Trade	206	9.7	369	11.5	126,160	15.1
H/ Accommodation, cafes, restaurants	3	0.1	8	0.3	39,342	4.7
I/ Transport and storage	76	3.6	116	3.6	37,374	4.5
J/ Communication Services	10	0.5	25	0.8	8,089	1.0
K/ Finance and Insurance	74	3.5	151	4.7	51,708	6.2
L/ Property & business services	277	13.0	401	12.5	171,182	20.4
M/ Govt. administration & defence	63	3.0	91	2.8		
N/ Education	31	1.5	51	1.6	6,880	0.8
O/ Health & community services	155	7.3	393	12.3	49,008	5.9
P/ Cultural and recreation services	66	3.1	104	3.2	17,300	2.1
Q/ Personal and other services	78	3.7	155	4.8	30,480	3.6
Total	2,125	100.0	3,205	100.0	837,078	100.0

Sources: Intellectual Property Research Institute of Australia China FTA Survey, 2006; ABS cat. no. 8161.0 (2004).

<sup>22</sup> ABS cat. no. 8161.0.

## 6.2 Respondents by size and industry

According to Table A3, 81.1 of the enterprises participating in the survey were small or medium-sized firms and the remainder were large firms. In both cases the bulk of respondents were from a relatively small number of the 17 industry classifications shown in the table. By far the most represented industry in the survey sample was manufacturing, which accounted for 30.5 per cent and 34.8 per cent respectively of SMEs and large firms participating in the survey. Industry representation was slightly more concentrated amongst large firms (than with the SMEs), with firms in manufacturing and wholesale trade together accounting for almost half of the large firms in the survey sample, and firms from the finance/insurance and property/business services sectors accounting for another 17.2 per cent.

**Table A3. Industry classification of respondent companies—SMEs and large firms**

	SMEs		Large firms	
	Number of firms	%	Number of firms	%
A/ Agriculture, forestry & fishing	47	2.7	5	1.2
B/ Mining	17	1.0	14	3.5
C/ Manufacturing	525	30.5	140	34.8
D/ Electricity, gas & water supply	2	0.1	11	2.7
E/ Construction	180	10.5	12	3.0
F/ Wholesale Trade	80	4.6	53	13.2
G/ Retail Trade	188	10.9	18	4.5
H/ Accommodation, cafes & restaurants	2	0.1	1	0.3
I/ Transport and storage	53	3.1	23	5.7
J/ Communication Services	9	0.5	1	0.3
K/ Finance and Insurance	47	2.7	27	6.7
L/ Property & business services	235	13.6	42	10.5
M/ Govt. administration & defence	44	2.6	19	4.7
N/ Education	20	1.2	11	2.7
O/ Health & community services	140	8.1	15	3.7
P/ Cultural and recreation services	59	3.4	7	1.7
Q/ Personal and other services	75	4.4	3	0.8
Total	1,723	100.0	402	100.0
Row percentage	81.1		18.9	

Sources: Intellectual Property Research Institute of Australia China FTA Survey, 2006.

Amongst the SME sample, four major industry groups in addition to manufacturing were significantly represented—property and business services, retail trade, the construction industry, and the health and community services sector. These four industry groupings accounted for approximately three-quarters of the firms represented in the SME survey sample.

Table A4 presents the percentage of enterprises which reported a general commercial interest in various forms of intellectual property. It shows that 54.2 of all enterprises claimed to have a commercial interest in trade marks, 40.0 per cent in copyright and 38.5 per cent in design. Only 32.1 and 32.7 per cent had commercial interests in of patents and trade secrets respectively.

**Table A4. Enterprises with general commercial interests in IP**

<b>Commercial interest in:</b>	<b>% Enterprises</b>
Patents	32.1
Trade marks	54.2
Copyright	40.0
Design	38.5
Plant breeder's rights	6.7
Trade secrets	32.7
Total (any of the above)	66.4
Total enterprises in Australia	100.0

Note: The columns do not add to the totals because some companies undertake more than one activity. Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia China FTA Survey, 2006.

Table A5 provides an indication of the length of time that enterprises have been doing business with China according to the type of business in which they are engaging. In all cases, except for licensing and outsourcing, the majority of enterprises have been operating in China for at least five years. Table A6 presents the enterprises annual turnover according to whether they do or do not deal with China.

**Table A5: Percentage distribution of when enterprises started business with China by type of activity**

When company began activity:	Exporting	License technologies	Outsource manufacturing	Consultancy services	Production	Offices/ Distribution
> 5 years ago	69.8	41.8	36.8	66.3	52.3	71.3
2–5 years ago	19.7	31.5	34.1	23.7	31.3	15.1
< 2 years ago	9.5	15.0	24.2	1.1	11.8	12.3
Don't know	1.0	11.7	4.9	9.0	4.6	1.3
Total enterprises doing activity	100.0	100.0	100.0	100.0	100.0	100.0

Note: Enterprises weighted by annual turnover.

Source: Intellectual Property Research Institute of Australia China FTA Survey, 2006.

**Table A6. Enterprises doing business with China by annual turnover**

Annual turnover	% of enterprise counts			% enterprises weighted by annual turnover		
	Deal with China	No dealings	Total	Deal with China	No dealings	Total
< A\$1million	5.5	94.5	100	0.0	0.0	100
A\$1m–10 million	10.8	89.2	100	12.7	87.3	100
A\$10m–100 million	16.6	83.4	100	32.7	67.3	100
> A\$100 million	21.1	78.9	100	42.4	57.6	100
Refused/Don't know	8.0	92.0	100	0.0	0.0	100
Total	9.0	91.1	100	40.8	59.2	100

Source: Intellectual Property Research Institute of Australia China FTA Survey, 2006.

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