

ILLICIT MARKETS- A THREAT TO OUR NATIONAL INTERESTS

THE FMCG-PERSONAL GOODS INDUSTRY



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- Corporate Governance
- Whistleblowing / Vigil Mechanism
- CSR & Sustainability
- Economics & Public Policy

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THE FMCG-PERSONAL GOODS INDUSTRY



Foreword

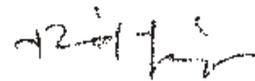


Product counterfeiting puts consumer safety at a great risk. Counterfeit, fake and smuggled goods are no longer just about luxury items. Today, almost all sorts of products are being copied and smuggled, which lead to fatal consequences for the consumers.

FICCI has been at the forefront of advocating policy framework on various aspects affecting the industry. In 2012, a FICCI CASCADE study titled “Socio-Economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Industry Sectors” was released which was the first ever compilation of facts and figures on counterfeiting, smuggling and tax evasion in seven key industry sectors in India. After the earlier comprehensive study, which not only estimated the size of the grey market in the select industry sectors, but also highlighted the losses to the industry in sales and Government in revenue, we have now gone a step further and developed 10 sector specific reports on 'Illicit Markets – A Threat to Our National interests'. This report is specific to the FMCG-personal goods industry and aims at updating the estimates of grey markets in the FMCG personal goods sector, projecting the resultant losses to the industry and assessing its impact on innovation and investment.

I would like to thank and congratulate all the committee members and stakeholders who have contributed towards this project, particularly Thought Arbitrage Research Institute (TARI). It is hoped that this study would provoke further debate on the extent of this problem and ways and means to mitigate the challenge.

I wish FICCI-CASCADE success in its future initiatives.



Dr. A. Didar Singh
Secretary General
FICCI

Chair's Message



I am pleased to present the report on 'Illicit Market: A Threat to Our National Interest' which is specific to the FMCG personal goods industry.

Illicit markets have broad economy-wide effects on trade, foreign investment, employment, innovation, criminality, environment, and most importantly, on the safety of the consumers. Over and above, it also has a negative impact on the brand image and loss of revenue for industry and governments.

In the FMCG personal goods industry, counterfeiters thrive on advanced packaging techniques which are used to bring out fake versions of original products. Apart from counterfeiting, this segment is also vulnerable to pass off brands with similar sounding names, designs and packaging, misleading and cheating the consumers into buying the illicit products.

Given the thrust on "Make in India" products; technology, invention, and innovation will play a key role in India's current economic development. However, lack of Intellectual Property protection will prove to limit innovation. Moreover, fear of lower returns on investments by legitimate manufacturers due to counterfeiting and the growing illicit markets will lead to a negative business sentiment. Besides revenue losses to the industry and tax losses to government, counterfeits in this sector also affect the brand adversely as they are unsafe to use and could adversely impact customer confidence.

This report has estimated the size of the illicit market; its adverse impact on innovation and investment in the FMCG personal goods industry. I am certain that the findings from this report would increase consumer awareness, drive support from policy makers in tax related reforms and step up the industry for greater investment in R&D and encourage innovation.

I hope that this research will be useful for all stakeholders including consumers, industry, policy makers and researchers on the issues in the FMCG personal goods industry, and the challenges ahead if concerted efforts are not taken to curb this twin menace of smuggling and counterfeiting.



Anil Rajput
Chairman
FICCI CASCADE

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Executive Summary



The existence of grey markets is a matter of serious concern for any economy. In a 2012 FICCI CASCADE study titled "Socio-Economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Industry Sectors" the existence of such markets was established by estimating its size in seven key industry sectors and the consequent losses to the industry in sales and the government in revenue for 2008 and 2010. The present study on the FMCG-personal goods sector has been commissioned by FICCI's Committee Against Smuggling and Counterfeiting Activities Destroying the Economy (CASCADE) to update the estimates of grey markets in this sector, and also assess its impact on innovation and investment.

FMCG - PERSONAL GOODS

GREY MARKET
ESTIMATES
INDUSTRY &
GOVERNMENT LOSS

IMPACT ON:

- Innovation
- Investment
- inter-state Tax Arbitrage
- Terrorism

Size of the Illicit Market in the FMCG-Personal Goods Industry

FMCG goods can be broadly classified into three categories: packaged food or food and beverages, personal goods and house care products.

Personal goods comprise essential and non-essential commodities for daily consumption, such as toilet soaps, detergents, shampoos, shaving products, cosmetics, fragrances and other toiletries. These can be segmented into hair care, skin care and oral care products. Hair oils, toothpastes and shampoos have significantly high penetration in both urban and rural markets. The personal care segment accounts for 22% of the entire FMCG market. ¹



The hair care market includes hair oils, shampoos, hair colorants and conditioners, and hair gels. The coconut oil market accounts for 72% share in the hair oil market. The skin care market is at a primary stage in India. With changing lifestyles, increasing disposable income, and greater product choices and availability, people are becoming more alert about personal grooming. The oral care market can be segmented into toothpaste (60%), toothpowder (23%) and toothbrushes (17%).²

Our study shows that the grey market in the FMCG-personal goods sector has gone up. For 2010 it was estimated at 25.9%, and has increased to 31.6% in 2012. The loss to the industry in 2014 has been estimated at ₹ 19,243 crores, up from ₹15,035 crores estimated for 2012.

Industry	Grey Market %age		Loss to Industry (₹ crores)	
	2012	2010	2014	2012
FMCG-Personal Goods	31.6%	25.9%	19,243	15,035

Total loss to the government estimated for 2014, is ₹ 5,954 crores, up from ₹ 4,646 crores in 2012.

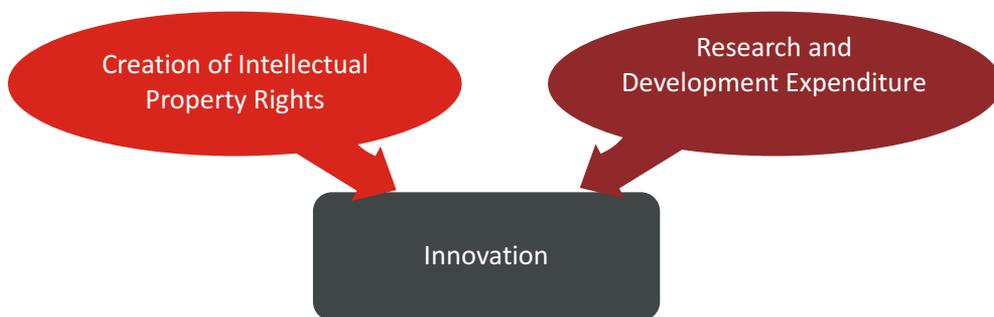
Clearly, despite best efforts, the illicit markets continue to thrive in the FMCG-personal goods segment. It poses serious challenges to various stakeholders: governments lose tax revenues, industries lose sales revenues, and customers knowing or unknowingly lose out on quality products which could often lead to hazardous health and safety consequences. While completely eliminating the existence of illicit markets may not be a realistic proposition, more rigorous efforts need to be made to limit their further growth.

Impact of Illicit Markets on Innovation

Our study relies on the hypothesis that industries characterised by higher level of illicit markets invest lesser on innovation, as there are no financial incentive to do so.

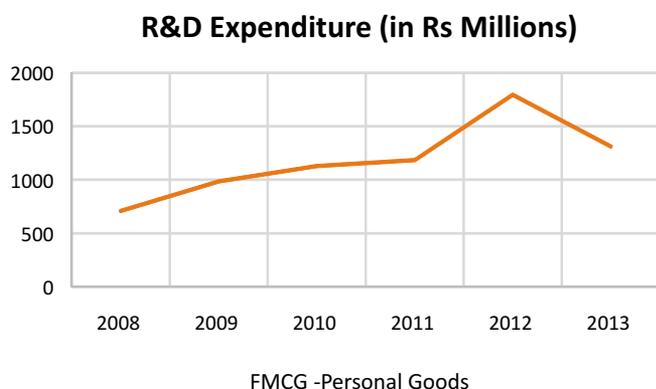
If organisations can imitate (counterfeit) an innovation at a cost that is substantially below the cost to the innovator, it reduces or even completely eliminates the incentive for innovation.

We examined two proxies to measure the impact of illicit markets on innovation.



CSIR (which holds the largest number of patents in India) has not filed any patents for the personal goods sector. The absence of patents may be due to the fact that multinationals are using patents filed abroad. It can also be attributed to the domination of the sector by small and cottage industries which depend more on traditional knowledge and use trade secrets, to drive their market. This, coupled with the high costs and complexity of the patent system tend to drive such units away from patenting their innovations.

Analysis of the second proxy used, the ratio of research and development expenditure to operating expenditure found that in this sector there is a low level of investment in R&D, with an average ratio of 0.59% during the five year period 2008 to 2013.

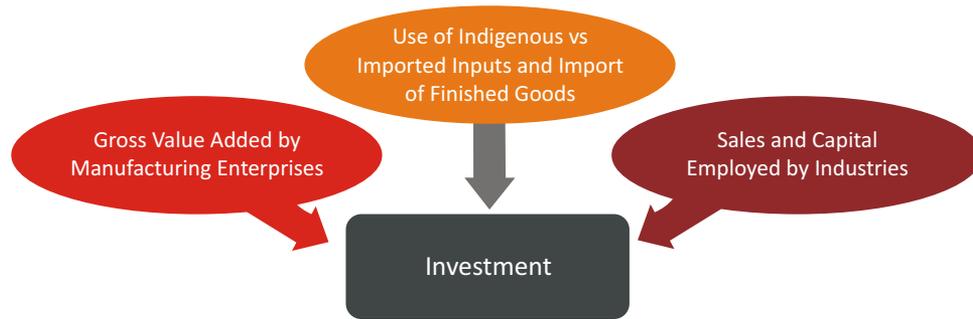


R&D expenditure has remained fairly stagnant with a sudden increase in 2012, falling back to previous levels in 2013.

The grey market has a substantial presence in this sector and has also shown a significant increase, growing from 25.9% in 2010 to 31.6% in 2012. Our study shows that this sector is spending very little on innovation. The lack of new copyrights, trademarks or patents in this industry, could be attributed to the fear of lower returns on investments by legitimate manufacturers due to counterfeiting and the growing illicit markets.

Impact of Illicit Markets on Investments

This section has analysed the level of investments, particularly the level of domestic investment by Indian companies' in the country, and whether the presence of illicit markets has a bearing on investments. A relationship between illicit markets and its impact on investments is understandably difficult to establish, if at all it exists, especially in the absence of data on the presence of illicit markets. To study the impact illicit markets on investment we used the following proxies:



The FMCG-personal goods sector throws up some interesting results.

GVA in this sector has increased, doubling over the period from 2008 to 2012. The sector also shows a marked preference for indigenous inputs/raw materials which is good as it saves cost and adds value in the manufacturing process. These are positive signs for the industry.

The proportion of imported inputs however has not fallen significantly remaining stagnant over the years, implying that industry still relies to some extent on imports. The ratio of imported finished goods over total production also, though low, has increased from 2.6% in 2008 to 3.29% in 2012. The significantly large and increasing illicit markets could be a contributing factor.

The ratio of sales to average capital employed has remained fairly steady over the last few years, indicating that there has been no dramatic increase in investments against which higher sales can be expected in the coming years.

Illicit markets, particularly counterfeiting and smuggling at significantly lower prices than legitimate products, deprives legitimate businesses of profits, employment and contribution to the overall economy. It acts as a disincentive for companies to invest resources for R&D, a critical element for innovation and growth.

The continued dependence of this sector on imported inputs and finished products shows that businesses are yet to fully develop their own technology which would enhance business efficiency and reduce production costs.

The huge increase in the grey market size is clearly driving the sector away from making patient long term investments to generate revenue from the capital base for fear of loss of investment.

Given the rising disposable income levels, which will drive consumption coupled with a young demographic profile, a lack of continued investments by legitimate businesses in India will keep fanning the illicit markets. However, the industry in the past 5 years has shown a higher localisation of inputs, which signifies that efforts are being made to bring down dependencies and increased costs related to such imports and create a higher gross value added in India.

Illicit Markets, Terror Organisations and Criminal Networks

While statistical data is available for the number of terrorist attacks that have taken place in India, it is difficult to directly correlate it to the grey market data in the absence of sufficient information and research, which are lacking at present, especially in the Indian context.

Furthermore, despite the existence of requisite laws in India and arrests of suspected criminals by the police, the scale of illicit markets is huge and the criminal networks and illicit markets organisations continue to thrive. Clearly, the existing laws and police operations are not resulting in the desired outcome and do not act as a deterrent. This could be due to the low conviction rates in India.

The lack of adequate data based on search and seizure in India makes it difficult to link the increase in illicit markets to terror funding. Establishment and determination of the extent of such a link calls for strategic intelligence gathering and preparation of robust databases, which are clearly missing at present. Given the security implications, if not outright financial considerations, there is little to argue against carrying out such exercises. This would be the first step to contain counterfeiting and its corollary, terror and ensure that genuine business interests do not suffer.

Conclusion & Way Forward

Our study shows that there is not only a significant presence of illicit market in the FMCG-personal goods sector, it is also growing. The study also shows that the illicit market impacts innovation and investment adversely. None of these is good for any of the stakeholders concerned - businesses, governments or consumers.

Illicit markets also undermine employment and raise prices of products as companies increase security systems to counter organised criminal activities. Fake and spurious goods can also have serious health and safety implications.

As a first step stakeholders must work in tandem to improve information sharing which will enable collation of credible statistics. Credible statistics will help to draw up and implement action plans that could undermine the activities of the perpetrators of this crime. Quality information would provide a solid basis for establishing the scope of illicit markets and form a key input in assessing the magnitude and effect of illicit markets.

The growth of illicit markets needs to be curbed to encourage innovation and investment which are keys to economic growth and sustainability of business. India can ill-afford to ignore either as it attempts to better the living conditions of its growing population and move up in the value chain in the world economy.

To encourage innovation and investment the overall business environment needs to be improved. Patenting procedures need simplification and industry incentivised to file more

patents. A stronger regulatory mechanism with trained manpower and funds which India poorly lacks is also vital, along with greater coordination between multiple agencies.

Consumer awareness, better collaboration between the industry and academia and simplification of the tax regime are some other measures that are equally important. So is the proposed unified tax regime, Goods and Service Tax (GST), which would address some of the tax anomalies, simplify tax structures, reduce tax cascading and remove incentives for imports in the FMCG-personal goods sector.

Illicit markets as a source of terror funding is also a matter of grave concern. If the threat of terrorism is to be nipped, access to funding has to be choked. Many countries do not possess the legal and operational wherewithal and technical expertise needed to zero in on terrorist financing sources and initiate prosecution. India is no different.

It is imperative therefore to build a framework for prevention of terrorist financing which tracks financing hubs and also acts as a deterrent to ultimately bring down the threat of terrorism. Such a framework will include training and capacity building among enforcement agencies, use of technology to detect and track sources of finance and increasing consumer awareness to empower consumers to take more informed decisions.

For sustainable economic growth, investment and innovation are a pre-requisite. According to a recent Dun & Bradstreet report,³ rising income levels coupled with increase in the young working-age population will lead private final consumption expenditure to grow steadily over the years, averaging around 7.0% during FY15-FY20. The growing illicit markets however vitiate the environment and restrain such growth, reducing business efficiency, profitability and overall development. To curb this growth collaborative efforts are required from all the stakeholders.

SUMMARY OF CONCLUSIONS

- The grey market percentage in the FMCG-personal goods industry has increased from 25.9% in 2010 to 31.6% in 2012.
- Loss to the industry has increased in 2014 in comparison with 2012 from ₹ 19,243 crores to ₹ 15,035 crores, attributable to the increase in the industry size as well as grey market percentage.
- Total loss to the government estimated for 2014, is ₹ 5,954 crores, up from ₹ 4,646 crores in 2012.
- There is no significant innovation activity in this industry as is evident from:
 - Non-existent patent applications.
 - The low and fairly stagnant ratio of R&D expenditure to total operating expenditure which stood at an average of 0.59% during 2008-2013.

The lack of new copyrights, trademarks or patents in this industry and low level of R&D expenditure could be attributed to the fear of lower returns on investments by legitimate manufacturers due to counterfeiting and the growing illicit markets.

- The 3 proxies studied for evaluation of the impact of illicit markets on investment activity, throw up some interesting results for the FMCG-personal goods sector.
- GVA in this sector has doubled over the period from 2008 to 2012.
- The sector also shows a marked preference for indigenous inputs/raw materials which is good as it saves cost and adds value in the manufacturing process.

These are positive signs for the industry. However:

- The proportion of imported inputs has not fallen significantly, remaining stagnant over the years.
- The ratio of imported finished goods over total production also, though low, has increased.

This implies that industry still relies to some extent on imports as it is yet to fully develop its own technology which would enhance business efficiency and reduce production costs. The significantly large and increasing illicit markets could be a contributing factor.

- Sales to average capital employed has remained fairly steady over the last few years, indicating that there has been no dramatic increase in investments against which higher sales can be expected in the coming years.
- With regard to terror organisations and criminal networks, the lack of adequate data based on search and seizure in India makes it difficult to link the increase in illicit markets to terror funding. Establishment and determination of the extent of such a link calls for strategic intelligence gathering and preparation of robust databases, which are clearly missing at present.

To sum up, for sustainable economic growth, investment and innovation are a pre-requisite. The growing illicit markets however vitiate the environment and restrain such growth, reducing business efficiency, profitability and overall development. To curb this menace therefore, collaborative efforts from all the stakeholders are required - industry, government (state, central and international) and consumers.



Objective of the Study



The existence of grey markets is a matter of serious concern for any economy, more so in India where rapid technological advancement and economic liberalisation seem to have made it easier to spawn a parallel economy out of counterfeit products.

A 2012 FICCI CASCADE study titled "Socio-Economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Industry Sectors" estimated the size of such markets in seven key industry sectors and the consequent losses to the industry in sales and the government in revenue for 2008 and 2010. The present study, commissioned by FICCI's Committee Against Smuggling and Counterfeiting Activities Destroying the Economy (CASCADE), aims at updating the estimates of grey markets in selected sectors, projecting the resultant losses to the industry and government, and assessing their impact on innovation and investment. This report is specific to the FMCG-personal goods industry.

FMCG - PERSONAL GOODS

GREY MARKET
ESTIMATES
INDUSTRY &
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IMPACT ON:

- Innovation
- Investment
- Inter-state Tax Arbitrage
- Terrorism

Grey market percentages are currently ascertainable for 2012, as reliable government data from the Ministry of Statistics and Planning Implementation (MoSPI) of the Government of

India is available for 2012. This data includes the Annual Survey of Industries (ASI) for 2012 which provides data on factory production across the country and National Sample Survey Organisation's National Sample Survey (NSS) 68th round, which provides household consumption data across the country for 2012.

Loss to the industries concerned in 2013-14 has then been ascertained by extrapolating the industry size determined for 2011-12 based on assumptions about the growth of the industry over the two year period of 2012-13 and 2013-14. These assumptions are obtained from industry reports and discussions with industry experts. Assuming that the grey market percentage remains constant over this two year period, it is applied to the market size so estimated for each industry to arrive at the loss to the industry for 2013-14.

As indicated in several studies including the 2012 FICCI CASCADE study, estimating the extent of counterfeiting and piracy and the harm these activities cause is extremely challenging. Illegal businesses operate outside the law and do not report their activities to any government agency. Hence, measuring their size must be done using indirect methods.⁴

Industry Coverage

Taking off from the 2012 FICCI CASCADE study, the present study quantifies the extent of grey markets and estimates losses due to operation of the illicit markets in the FMCG-personal goods sector. It also looks at various other aspects of business, and the impact illicit markets have on innovation, investment, and consumers and other stakeholders, etc. in this sector.

This study is perhaps the first quantitative study in India on the impact of illicit markets on various economic aspects. Depending on the quality and credibility of data available, the study has quantified different types of impact on various sectors using latest Government of India data on consumption and production, which is available for 2012 (released in 2014).

Literature Review



We have reviewed past studies and published research on the subject of grey markets including counterfeiting, smuggling and tax evaded goods and their impact on innovation, investment, tax arbitrage and funding terrorist activity.

This review included global studies commissioned by public institutions and agencies of repute, industry associations working on anti-counterfeiting endeavours, academia and major corporates. Such works were reviewed to analyse the scope of research, methodology adopted, analysis techniques and results.

Extracts from some of the significant reports are reproduced in Annexure I to give a broad understanding of global thinking on the subject.

FMCG-Personal Goods - Industry Profile in India



FMCG is one of the faster moving sectors of the economy and is expected to grow at a compounded annual growth rate (CAGR) of 14.7% to \$ 110.4 billion during 2012-2020, according to India Brand Equity Foundation (IBEF) of the Ministry of Commerce and Industry, Government of India. It can be broadly classified into three categories: packaged food or food and beverages, personal goods and house care products.

Personal goods comprise essential and non-essential commodities for daily consumption, such as toilet soaps, detergents, shampoos, shaving products, cosmetics, fragrances and other toiletries. These can be segmented into hair care, skin care and oral care products. Hair oils, toothpastes and shampoos have significantly high penetration in both urban and rural markets. The personal care segment accounts for 22% of the entire FMCG market.⁵

The hair care market includes hair oils, shampoos, hair colorants and conditioners, and hair gels. The coconut oil market accounts for 72% share in the hair oil market. The skin care market is at a primary stage in India. With changing lifestyles, increasing disposable income, and greater product choices and availability, people are becoming more alert about personal grooming. The oral care market can be segmented into toothpaste (60%), toothpowder (23%) and toothbrushes (17%).⁶

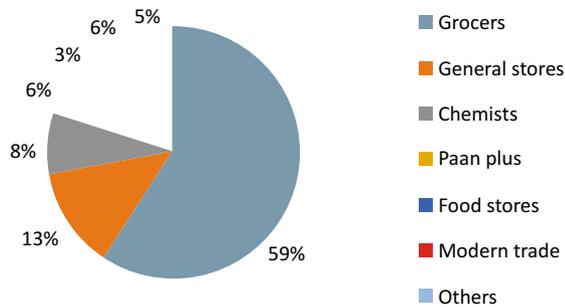
A large population base, demographic changes (median age of 27 years), rapid urbanisation (from 285 million in 2001 to 377 million in 2011), growing income levels and sociological factors are driving growth of personal and beauty care products in an unprecedented way. The rise of the 'metro-sexual' male has also led to creation of a new category of cosmetics for males, which was once considered the sole preserve of women. Aspirational and upwardly mobile Indians are now craving more for luxury and premium brands.

Industry structure

At the very top, the sector is dominated by foreign-owned and multinational companies. The next level comprises of hundreds of small and medium companies, which is followed by a large unorganized sector comprising of hundreds of micro/cottage scale enterprises spread across the country that thrive on products based on traditional and local recipes. Thus, the industry comprises of both organised and unorganised sectors.

Distribution channels are similarly characterised by a large chunk which is in the organised sector but a larger section in the unorganised sector. Nearly 7.8 million retail outlets sell FMCG goods. While the economic growth of the past decades has witnessed growth of supermarkets and malls, spreading fast to semi-urban areas, there is an equally strong presence of the unorganised sector taking care of a larger swathe of semi-urban and rural areas. The local 'kirana' shops (grocers) dominate retail sellers, accounting for about 59% of sale.

Sales channel break-down (2010)

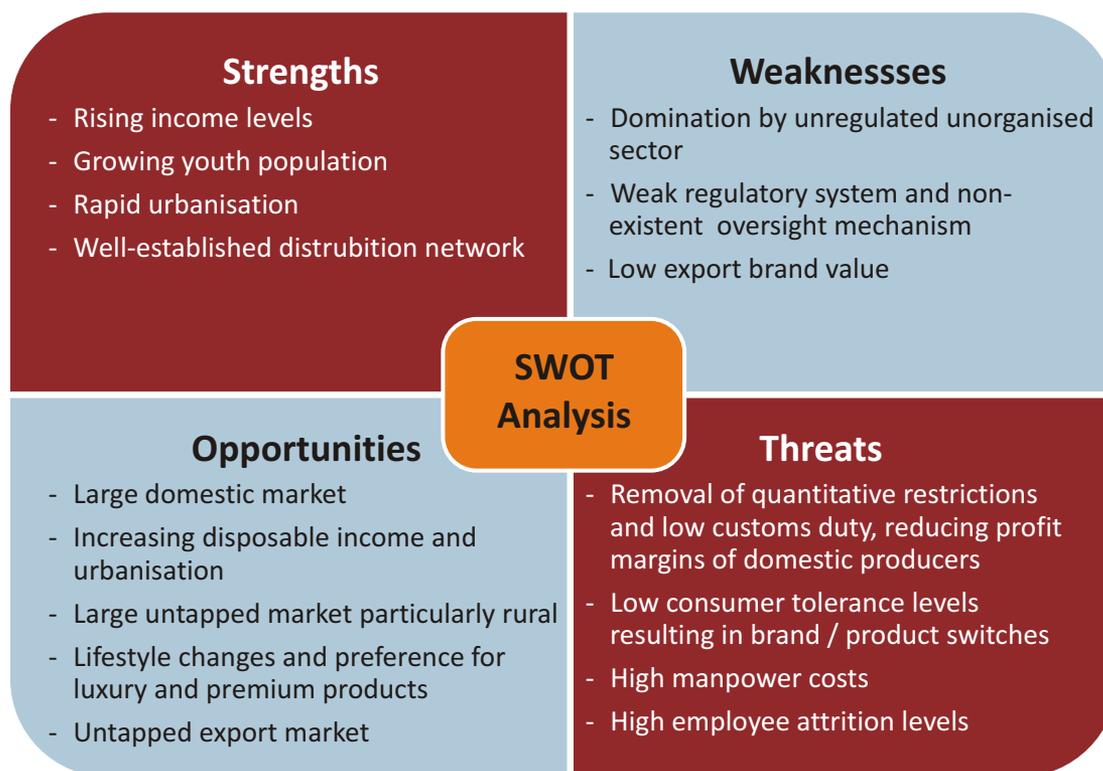


Ancillary industries

Many large personal goods manufacturers are known to outsource their products, packaging materials and chemicals as inputs, spawning a large number of ancillary units. Some estimates suggest that about 9-10% production is outsourced to contract manufacturing units. An entire packaging industry has grown around these companies. Besides, these products have helped set-up a huge country-wide distribution network, including kirana (grocery) stores specially dealing with such products.

SWOT Analysis

With rising income and aspirations of the new generation, consumption of personal care items has seen a dramatic rise, in which media, particularly the electronic media, has played a big role. Leading firms spend almost 10% of their turnover on advertising and brand promotion. They also focus a great deal on new product launches. The growth is remarkable in semi-urban and rural areas. Though it accounts for nearly a third of the market, it is expected to outstrip urban areas in the next few years.



Government Policy

The government has taken and proposes to take several tax measures to boost the personal goods market. Quantitative restrictions have been removed, making it easy for importing as much as the business demands. Customs duty has been lowered to help imports further. In 2013, 51% FDI was allowed in multi-brand retail, which will boost organised retail market. Barring some, no industrial licenses are required for manufacturing FMCG products.

Higher tax also promotes spurious/ counterfeit products and smuggling. Coupled with lower excise, higher local taxes make imports cheap and domestic products expensive.

The proposed new Goods and Services Tax (GST) which is expected to be implemented soon would integrate multiple indirect taxes under a unified tax system. This will help business in many ways by simplifying the tax regime. It will lead to a re-evaluation of procurement and distribution arrangements, removal of excise duty on products would result in cash flow improvements and elimination of tax cascading to lower input costs and improve profitability.



Counterfeiting in the FMCG-Personal Goods Industry



Counterfeit products are mixed with genuine products and sold to unsuspecting customers. These could be contrabands or look-alikes passed off as original products. Established brands and premium products are often the biggest sufferers as look-alikes are available at cheaper prices and passed off as original often by misspelling the trademark. Like, Sunsilik instead of Sunsilk or Climic Plus for Clinic Plus.

Besides revenue losses, counterfeits affect the brand adversely as they are unsafe or adulterated and could hit customer confidence as the fake products do not give the results promised by the brand. In a 2013 study, AC Nielsen estimates that 30% of FMCG business is lost to fake products, and 80% of the consumers who purchased these products believed that they had bought originals.⁷

A large unorganised sector, lax regulatory regime and access to advanced technology have made it easier to produce fakes and flood the market.

Many leading business houses and industry bodies have taken initiatives in the recent years to check counterfeit products, which includes consumer awareness, detection and raids with the help of enforcement agencies and other legal actions. All segments, be it hair care, skin care and oral care, are vulnerable to counterfeiting. All the stakeholders - manufacturers, government and consumers - need to work closely to check the menace.

Factors Driving Illicit Trade in FMCG- Personal Goods



A huge disparity in income and standards of living, coupled with weak regulatory mechanisms, produce an environment conducive for illicit markets to flourish in India. The case is no different for the FMCG-personal goods industry. Some of the driving factors are:

- A large unorganized sector.
- Weak regulatory and implementation mechanism.
- High price of branded and premium products.
- Huge income disparities creating a market for cheap alternatives to branded and premium products.

Size of the Illicit Market in the FMCG-Personal Goods Industry



Data Sources

In order to calculate the grey market percentage for 2011-12, the gap between supply and demand will be derived. Listed below are the various sources of information that have been used to arrive at these numbers.

This study has used a combination of data analytics on Government of India statistics, corporate information from data aggregators and industry validations to estimate the extent and level of grey market operations. The key data sources are the Annual Survey of Industries (ASI) and National Sample Survey (NSS) published by the Ministry of Statistics and Programme Implementation (MoSPI) of the Government of India. This has been supplemented with data from the Directorate General of Commercial Intelligence (DGCIS) under the Ministry of Commerce and Industries, Ministry of Micro, Small and Medium Enterprises (MSME) and information extracted from PROWESS database for companies.

Supply Side Estimation

ASI - Gross Sales Value: The Central Statistical Organisation (CSO) of the MoSPI collects national data on manufacturing activity for each district (rural and urban) to compile the ASI statistics. Gross Sales Value (GSV) in ASI data includes product cost, excise duty, sales tax and other distribution expenses.

GSV data of selected products identified for domestic sales was for 2012 as well. The data (after taking the multiplier effect as suggested by CSO) covered the ASI survey for the financial year 2011-12. 13.33 lakh data points were analysed. Data was extracted from Block A and Block J. Details are provided below.

Table: ASI Data Points Analysed

Particulars	Description of data series	Data Points evaluated
Annual Survey of Industries 2011-2012	Factory wise details of manufacturing activities pan India for the period April, 2011 to March 2012.	Block A and Block J, gross sales value, multiplier, NPCMS Code etc.

ASI 2011-2012 has changed its coding structure and now uses the NPCMS code structure for product classification and industry grouping which is a 7-digit classification. The previous FICCI CASCADE study used ASICC code classification (5-digit) to determine the product classification under various industry heads.

In order to maintain consistency and comparability with the previous FICCI CASCADE study results, a similar product classification has to be followed under the NPCMS code structure. Hence NPCMS codes have been mapped with ASICC codes and then allocated to the industry sector. Additional NPCMS codes identified post mapping with ASICC codes have been further deciphered to allocate to the industry sector concerned.

Annual Production Amounts of MSME: ASI data captures production of units registered under the Factories Act. Broadly according to the Factories Act, 1949, a factory means any premises where ten or more people are working where manufacturing process is carried on with the aid of power or otherwise where twenty or more workers are working.

There are also a large number of micro, small and medium enterprises (MSME) in the sectors covered in this study. As per the MSME Development Act, a micro enterprise is one where investment in plant and machinery does not exceed ₹ 25 lakh, while in a small enterprise the limit is between ₹ 25 lakh to ₹ 5 crore and medium enterprises are those which have investment values between ₹ 5 crore to ₹ 10 crore.

Comparing these definitions it can be assumed that small and medium enterprises would have been covered by ASI. Accordingly annual production of micro enterprises that are engaged in manufacturing activities has been extracted from the MSME annual production.

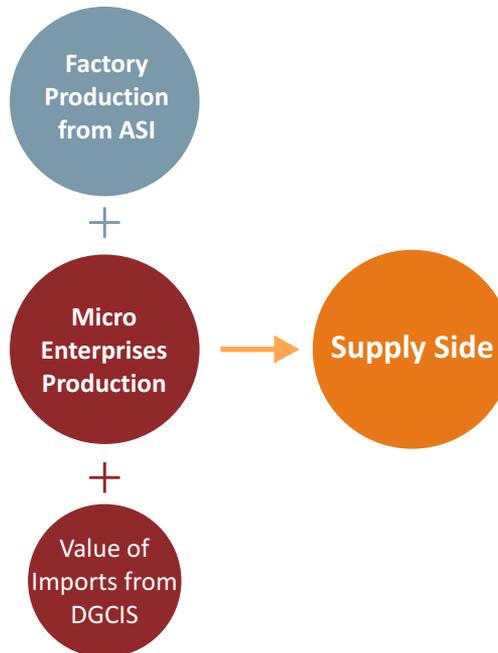
Of the total 24.01 lakh units surveyed in 2006-2007 as a part of the MSME Census, only 22.48 lakhs were found relevant to MSME of which 15.64 lakh units were found working, 4.96 lakh units were closed and 1.88 lakh units were not traceable. The survey results give details of the registered units, segregate such units into micro, small and medium enterprises and map their products into National Industry Code (NIC) classification.

In this study, the value of the goods manufactured from registered micro enterprises and supplied to the selected industry sector has been estimated by taking inputs from MSME

Census of 2006-2007 and the Annual Report of the Ministry of MSME for the year 2011-2012. These estimates supplemented the GSV obtained from ASI data.

Value of Goods Imported: The value of goods imported into the country has been taken from data published by the Directorate General of Commercial Intelligence and Statistics (DGCIS) under Ministry of Commerce and Industry. For this study, we have used the eight digit code classification import data for the year 2011-2012. Import value data was extracted to supplement the production figures obtained from factories and micro-enterprises to arrive at the total of the supply side for domestic consumption.

ASI 2012 uses NPCMS code classification whereas import data uses ITC HS codes. Import data follows the harmonic system code for classification and for 2010-2011 a total of 10,032 codes were scrutinised up to an 8 digit level. MSME data is based on the 2 digit classification of NIC 2004.



Consumption/Demand Estimation

The National Sample Survey Organisation (NSSO) of MoSPI conducts a survey on household consumer expenditure and employment and unemployment covering the entire country. This survey is one of the largest sample surveys of its kind and collects data on household characteristics such as household size, principal and secondary occupation, household type, land ownership/ possessed/ leased, land cultivated, land irrigated, primary source of energy, household ownership, etc.

For this study, data was analysed from NSS's 68th round survey, covering the period July 2011 to June 2012. Consumption expenditure data for the last 30 days / 365 days (as the case may be) for the country, was arrived at after giving effect to the multiplier suggested by NSSO. Approximately 123.35 lakh data points were analysed for NSS 68th round where the codes were assigned to the respective industry sectors and then mapped to find the related consumption values. The blocks and codes of NSS 68 from which data was extracted for this study are given in the table below.

Table: NSS Data Points Analysed

Particulars	Description of data series	Data Points evaluated
National Sample Survey (Round 68)	Household consumer expenditure for the period July 2011 to June 2012.	Block 5, 9, 10, 11 and 12; Item code, sub sample code, consumption value, multiplier, weight to be applied, NSS/NSC code.

Estimating the Illicit Markets-Methodology

We have ascertained the grey market percentage for 2012 using the following formula:

$$\text{Grey Market \%age} = \frac{\text{Total Consumption} - \text{Total Supply} \times 100}{\text{Total Consumption}}$$

The difference between total consumption and total supply can primarily be attributed to:

- Goods produced or imported and sold in the country by evading taxes.
- Sale of domestically produced counterfeited (either deceptive or non-deceptive) goods.

FMCG - Personal goods: Data Analytics

The grey market percentage in the FMCG personal goods sector in 2011-12 has been calculated in the following manner:

Consumption expenditure was extracted from NSS for codes relating to FMCG-personal goods.

Total consumption expenditure arrived at, therefore, for 2012 is ₹ 78,343 crores.

For the supply side we have considered domestic production as per ASI 2012, imports as per DGCIS and production by micro enterprises as per the MSME report.

ASI 2012 factory production of FMCG personal care goods covering 74 codes amounts to ₹ 48,595 crores.

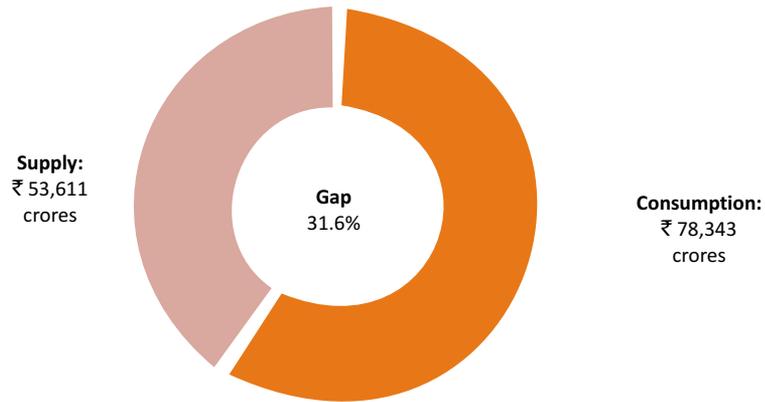
Imports as per DGCIS have been considered only for products which are in finished or ready to use (or consume) state for business to consumer purposes.



For production of FMCG personal goods by micro enterprises we have considered only codes of chemical and chemical products. On a conservative basis and based on consultations with industry experts we have assumed that 35% of micro industries sector production under this code has been supplied to FMCG (personal care products).

The resultant total supply of FMCG personal goods products in the country for 2011-12 is ₹ 53,611 crore.

FMCG-Personal Goods Supply vs Consumption Gap 2012



The grey market percentage in the personal care segment has thus been arrived at 31.6% due to an excess of total consumption over supply of ₹ 24,732 crores. This may be in the form of sale of counterfeited products, smuggled goods, or tax evaded goods.

Summary

The results of the analysis are summarised below:

₹crores

Industry	2012		Grey Market		
	Total Supply*	Total Consumption*	2012		2010
			Total Loss	%age	%age
FMCG-Personal Goods	53,611	78,343	24,732	31.6%	25.9%

(*Based on NSSO/ASI/DGCIS data for 2012)

The grey market in the FMCG-personal goods segment increased. In fact while this sector had the third largest grey market size estimated in the 2012 FICCI CASCADE study, the increase in size has brought it to second position based on latest available data.

Impact of Illicit Market-Estimating Loss to the FMCG-Personal Goods Industry



For the purpose of arriving at the loss to the industry in 2013-14, we have assumed that grey market percentages estimated earlier, will remain constant over 2012-13 and 2013-14. Industry size for 2013-14 has been arrived for the sector with reference to expected and actual growth rates for the past two years provided by industry reports or analysts. These growth rates have been used to extrapolate the industry size established for 2011-12 to 2013-14. Industry size for 2011-12 is taken as the domestic factory production of the industry, ascertained from ASI 2012 data.

Thus loss to the industry (purely in terms of sales) has been established as follows:

$$\text{Estimated Loss of Sales to Industry} = \text{Size of Industry in 2013-14} \times \text{Grey Market Percentage (2011-12)}$$

Estimating the Loss for 2013-14

According to a PwC report titled "The Indian FMCG sector-The innovation imperative"⁸ the industry is set to grow by approximately 11% from 2011-12 to 2012-13 and by approximately 10% from 2012-13 to 2013-14. A 2010, Booz & Company-CII report titled "FMCG Roadmap to 2020"⁹ states that the FMCG industry will grow at a base rate of at least 12 per cent annually to become an ₹ 4000 billion industry by 2020, while a 17% growth is estimated for the next decade if some of the factors play out favourably within an environment of enabling policy and easing of supply constraints.

Fig: Estimated Loss to FMCG-Personal Goods Industry in 2013-14

$$\text{Estimated Size of Industry in 2013-14} \times \text{Grey Market Percentage (2011-12)} = \text{Estimated Loss of Sales to Industry}$$

$$60,957 \text{ crores} \times 31.6\% = ₹ 19,243 \text{ crores}$$



Based on these estimates, we have considered, on a conservative basis that the FMCG-personal goods industry has grown by approximately 12% from 2011-12 to 2012-13 and 2012-13 to 2013-14. Accordingly, the market has been estimated at ₹ 60,957 crores for 2013-14. Applying the grey market percentage calculated for the industry (i.e. 31.6%) to this market size, **the grey market for 2013-14 is estimated to be approximately ₹ 19,243 crores.**

The result shows that there is an increase in loss of sales due to the operation of illicit markets. It is clear from this that despite best efforts to curb smuggling and counterfeiting, the illicit market continues to thrive in the FMCG-personal goods segment. This poses serious challenges to various stakeholders. Governments lose tax revenues, industries lose sales revenues, and customers lose out on good quality products which could often lead to hazardous health and safety consequences. While completely eliminating the existence of illicit markets may not be a feasible proposition, more rigorous efforts need to be established to limit their further growth. This would include, among other things, cooperation amongst these stakeholders, streamlining of complex tax structures, introduction and/or enforcement of standard quality parameters for various products of industries, stringent governance practices and enforcement of existing laws.

Fig: Loss of Sales to Industry 2013-14
(in ₹ crores)

Industry Sector	2014	2012
FMCG-Personal goods	19,243	15,035

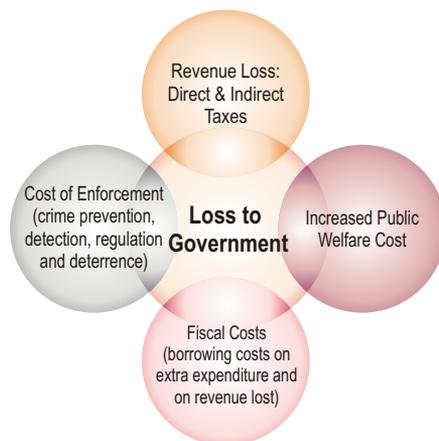
Estimating Illicit Markets - Loss to Government



Apart from resulting in loss to the industry concerned, the operation of the illicit markets results in losses to the government in the form indirect taxes and direct taxes. Illicit markets cause losses to the original right holders in the form of reduced sales, lower profits, brand value, reputation, consumer distrust, etc. Governments lose tax, incur higher expenditure on public welfare, insurance and health services. Ultimately corporates shy away from making investments (as established in an earlier section) due to limited/no protection of rights, resulting in loss of employment opportunities.

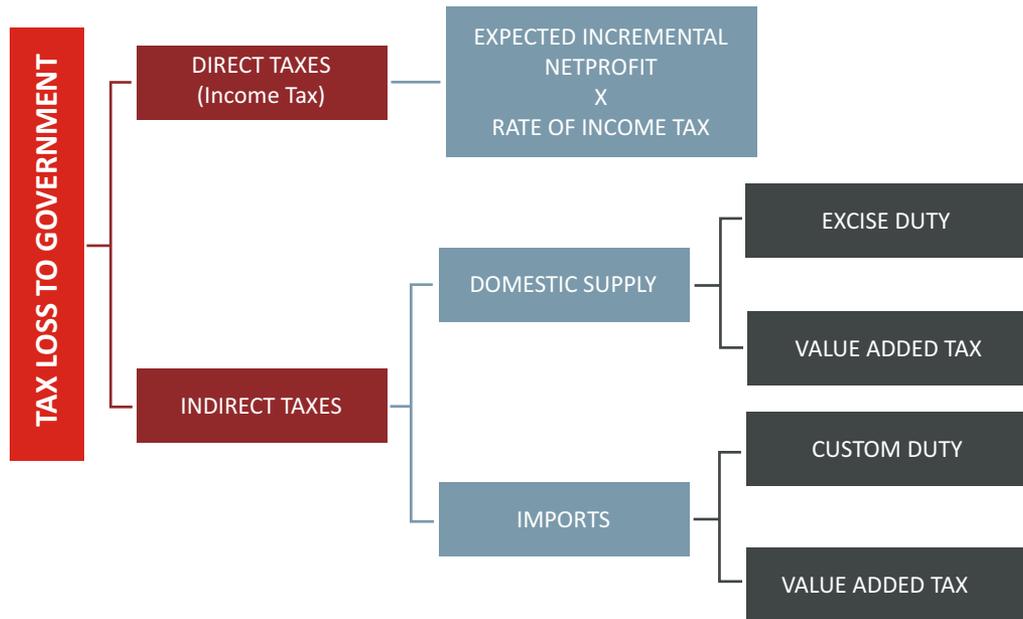
Governments that lose taxes will find it difficult to function and will be unable to provide quality and timely public services. They will be unable to deliver their legislative programmes, provide public goods or redistribute wealth.

This section aims to estimate the loss to the government of India on account of the illicit markets in the FMCG-personal goods industry. It is imperative to develop an estimate of the challenge to the National and State exchequers with the objective of introducing strong regulatory measures.



Methodology

There is very little data on the global economic impact of counterfeiting and the losses to public revenues, employment, investment and innovation.¹⁰ This study aims to project only the consequential tax loss to government on account of counterfeiting and the presence of grey markets in India. As in the 2012 FICCI CASCADE study, the methodology used in this report is derived from the economic model used in the BASCAP report that analyses the negative impact of counterfeiting and piracy on government receipts and expenditures.



The Tax loss to government has been estimated as loss of direct taxes (income tax) and indirect taxes (value added tax, import duty and excise duty).

Revenue Loss to Government = Loss on account of Direct and Indirect taxes in case entire gap is met by the legitimate manufacturers or importers

For calculating the loss in income tax and indirect taxes (excise/customs/VAT), the following approach was followed:

Direct Taxes (Income Tax):

To determine the loss attributable to income taxes, this study analysed annual reports of a sample/representative companies in the industry concerned to determine the weighted average net profit before taxes over sales. This percentage was applied to the sales loss to the industry determined in the previous section (“Size of the Illicit Market in the FMCG-Personal Goods Industry”). The resultant figure is the incremental net profit that would have accrued to

the industry had legitimate industry been able to fulfil sales lost to the grey market. The number so determined is multiplied by the income tax rate to arrive at the income tax forgone by the government. Additional profit will be taxed at the highest income tax slab rate, hence the tax rate considered is 33%.

Income tax lost by the government due to the operation of the illicit markets in the FMCG-personal goods industry is tabulated below

Loss of Direct Tax Revenue to Government (₹ Crores)

Industry Sector	Net Profitability Percentage	Direct Taxes Loss		Change	
		2014	2012	₹ crores	%age
FMCG-Personal Goods	17.5	1,111	867	244	28%

Indirect Taxes (On Domestic Manufacture and Imports):

Loss of indirect taxes to the government on account of illicit markets has already been ascertained. This loss comprises loss on domestic production and loss on imports. The gap in consumption and supply is assumed to be met through legitimate domestic factory and registered MSME production, as well as imports, in the same ratio using 2012 ASI, MSME and DGCIS data.

Indirect tax loss in case of domestic production (ASI & MSME) arises on account of loss of excise duty and VAT. In case of imports the loss arises on import duty (basic and countervailing duty) and VAT.

Based on the principle of conservatism we have considered the following rates of indirect taxes for the FMCG-personal goods industry. The table also shows the proportion of sales loss met by domestic production and imports:

Industry Sector	Loss to Industry met by .. (₹ crores)			Duty Rates (percentage)	
	Total	Domestic Production (ASI + MSME)	Imports	Excise Duty + VAT	Import Duty + VAT
FMCG-Personal Goods	19,243	18,610	633	25	30

These rates of tax were applied to the sales loss to the industry ascertained earlier, to arrive at the loss to the government on account of indirect taxes.

Loss of Indirect Tax Revenue to Government (₹ Crores)

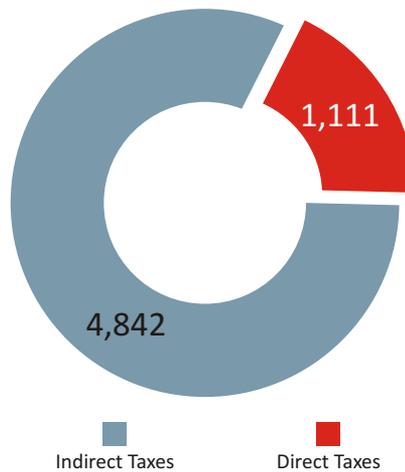
Industry Sector	Excise Duty + VAT	Import Duty + VAT	Total Indirect Taxes Loss - 2014	Total Indirect Taxes Loss - 2012	Change	
					₹ crores	%age
FMCG-Personal Goods	4,653	190	4,842	3,779	1,063	28%

Conclusion:

Thus, the total loss to the government estimated for 2014, on account of the illicit markets in the FMCG-personal goods industry is ₹ 5,954 crores, up from ₹ 4,646 crores in 2012. As stated earlier, it needs to be highlighted, that this loss is only on account of tax revenues. We have not estimated the incremental costs incurred by government on account of welfare measures, enforcement and legislation and interest costs.

Loss of Revenue to Government FMCG-Personal Goods

(in ₹ Crores)



Impact of Illicit Markets on Innovation



This section of the report aims to look at the plausible relationship between illicit markets and innovation. There is ample academic and anecdotal evidence available to demonstrate how illicit markets tend to act as disincentive for businesses to undertake innovation activities such as new product designs, manufacture processes, conducting research and development (R&D) activities etc.

Illicit market broadly includes:

- counterfeit goods (infringement of trademarks),
- pirated goods (infringement of copyright),
- smuggled goods (import or export without paying taxes) and
- tax evaded goods (taxes on both production & distribution of goods)

Innovation entails the process of design, invention, development and/or implementation of new or altered products, services, processes, systems, organisational structures, or business models for the purpose of creating new value for customers and financial returns for the firm.¹¹

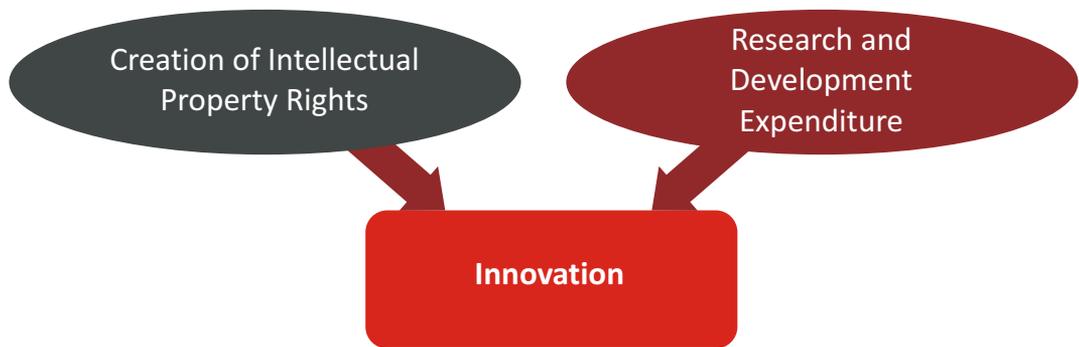
An innovation is the implementation of a new or significant improved product (goods or services), or process, a new marketing method, or a new organisational method in business practices, workplace organisation or external relations.¹² Businesses in their zest for higher profitability look for competitive ways to succeed by developing and incorporating creative and useful innovations into products and services.

Companies are usually unsure about the return on investments made in innovation activities on account of uncertainty about the success of a particular research project and market returns of the outcome products. These risks are grossly accentuated in case these products can be easily

copied to produce imitations whereby the profits of the original innovator get transferred to the counterfeiter.

Researchers use several indicators to measure innovation, such as R&D expenditure, number of patent applications filed, technology development, substitution of imported technology with indigenous technology, etc.

Therefore on the basis of the literature reviewed, and our discussions with subject matter and industry experts, we have identified the following proxies for measuring innovation:



Creation of Intellectual Property Rights

The study entailed assessing the patents filed in India.

Analysis of Creation of Intellectual Property Rights
<ul style="list-style-type: none"> ● Types of IPR's in India - patents, copyrights and trademarks ● Analysis of trends in the number of patents filed/examined/granted over the financial years 2007 to 2012 ● Analysis of fields, sectors and institutions with higher concentration of patents over the financial years 2007 to 2012 ● Data related to patents was collected from the Office of the Controller General of Patents, Designs, Trademarks and Geographical Indication; data pertaining to copyrights, trademarks was not available

A patent is an intellectual property right for inventions and is the grant of exclusive right, for a limited period, provided by the Government to the patentee, in exchange of full disclosure of the invention, for excluding others, from making, using, selling, importing the patented product or process producing that product for those purposes. The Patent Office under the Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, performs the statutory duties related to the grant of patents for new inventions and registration of industrial designs.

For this study we have reviewed the Annual Report of the office of the Controller General of Patents, Designs, Trademarks and Geographical Indication to understand the type and number of patents filed in India.

Patent applications (filed, examined and granted) of the last 5 years show a declining trend in the number of patents granted by the Patent Office. CSIR or the Council of Scientific & Industrial Research (CSIR) has filed the largest number of patents in India and abroad. The top ten industries in which CSIR's patents are in force constitute almost 81% of their patents. **None of these, pertained to the FMCG-personal goods industry.**

According to a Thomson Reuters report, 'Research and Innovation Performance of the G20'¹³ which examines research and patent information to study the scale and impact of innovation in the G20 countries -an average of 5,900 applications are filed in India per annum, which equals that of Australia and UK. Around two-thirds are those of foreign concerns seeking protection in the Indian market. Domestic innovation has remained stable at 29% since 2005. India's contribution to innovation when compared to the rest of the G20 is highly concentrated in agro-chemical and pharma-related technology sectors.

During our study however, **we did not come across information related to patents filed in India under FMCG-personal goods industry.**

Innovations, however, do play a significant role and the personal goods sector has witnessed many innovative measures. These innovations are in the area of product development, packaging and marketing strategies. Introduction of small sachet packets of shampoos, conditioners and detergents for prices as low as ₹ 1 or ₹ 2 was a smart marketing strategy that helped popularise and improve sales of many famous brands even among price and value conscious customers. Today, most popular brands of shampoos, detergents and conditioners are available in small sachets.

Similarly, several innovative measures have been taken to check counterfeiting by using high-tech holograms, bar codes, inherently tamper proof packaging like tin cans, tetra packs sealed hermetically, breakable caps, sealed tubes in which the mouth of tube is sealed and needs to be punctured or broken etc. An entire market has been built around 'natural' or 'organic' products. A wide range of products in the personal care and beauty segment use 'back-to-nature' theme to woo those who prefer such products. Thus, toothpastes with extracts of plants like neem, babool, clove oil and even 'active salt' have gained popularity.

One of the reasons for the low number of patents filed in India may be attributed to the small and medium sized enterprises (SMEs), which prefer to use trade secrets rather than patents as a form of protecting their inventions to stay competitive. This in conjunction with the fact that the Indian manufacturing sector is dominated by the micro, small and medium enterprises (MSME), accounting for nearly 45% of this sector, results in lesser number of patent

applications. The main reasons given by SMEs for shying away from patenting their inventions include high costs and complexity of the patent system. In such a scenario, therefore, the manufacturing sector particularly needs to be given greater incentives in this regard, since it is one of the key drivers of the economy, contributing 8% of the country's GDP and 40% of exports.

Research and Development Expenditure

Research and Development (R&D) expenditure data is often used by researchers as one of the most significant inputs in estimating the level of innovation.

Christopher M. Kalanje, WIPO, has demonstrated the use of expenditure on research, development and information on innovation as indicators of innovation measurement to understand the role of intellectual property in innovation and new product generation.¹⁴

Methodology

Based on various research reports, this study has developed the following approach with the objective of understanding the relationship between the presence of illicit markets and organisations' decisions to undertake expenditure on activities such as research and development.

R&D expenditure is one of the main inputs towards a series of activities resulting in an innovation and has been taken as a proxy for innovation.

Research and Development Expenditure
<ul style="list-style-type: none"> ● Analysis of R&D and operating expenditure for a sample of companies over a period of 6 financial years ● Analysis of ratio of R&D and operating expenditure over a period of 6 financial years for each sector ● Data was extracted from the Prowess database for a sample of public and private companies in India over the sample period

Our sample size comprises the public and private limited companies operating in India. Financial details of these companies have been extracted from the annual reports compiled by the CMIE, Prowess database.

There are a total of 27,650 companies whose information is available in the public domain. These details were examined to ascertain the nature of products/ services produced/ rendered by them. Information relating to the following parameters was extracted for the period 2007-08 to 2012-13:

- Research and development expenditure (both on capital and current account)
- Operating expenditure.¹⁵

Data was collected for this six year period to ensure that a complete economic cycle of low, medium and high level of business activity is captured. More than six lakh data points were analysed to understand the trend of research and development expenditure over the last six years across the selected sectors. Since comparison of absolute amounts of research and development expenditure incurred across various industry sectors will not reveal any meaningful results, the study looked for a suitable representative ratio. Based on the literature review and discussions with subject matter experts, a comparison was made of the percentage of R&D expenditure over operating expenditure for the stated period of six years.

$$\frac{\text{Research and Development Expenditure}^*}{\text{Operating Expenditure}^{**}} \times 100$$

* R&D expenditure includes both capital and revenue expenditure as it appears in the financial statements of the company

** Operating expenditure includes all types of expenditure on raw materials, labour, selling and distribution etc.

Data Analytics Results

The results of our analysis of the percentage of R&D expenditure over total operating expenditure for the FMCG-personal goods sector are presented below:

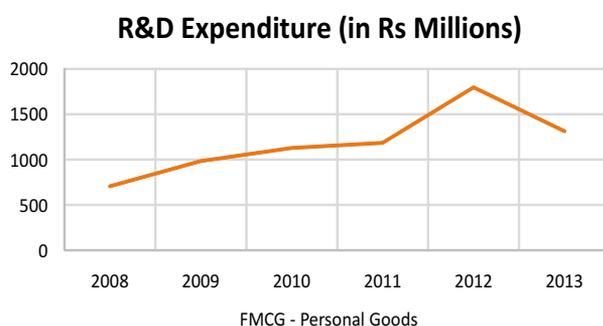
Table: R&D Expenditure as a %age of Operating Expenditure

Industry	2008	2009	2010	2011	2012	2013	Average %age
FMCG - Personal Goods	0.56	0.52	0.64	0.60	0.75	0.47	0.59

Data shows that the FMCG - personal goods sector has significantly low levels of R&D expenditure as a percentage of operating expenditure. The ratio has been fairly stable with a few ups and downs over the period, ultimately settling in 2013 at a level below 2008.

There seems to be no incentive for companies to spend money on research and development. This could be due to the following reasons:

- Lack of patent protection
- Uncertainty of return due to higher risk of counterfeiting, smuggling and piracy



Conclusion

To conclude, we examined two proxies to measure the impact of counterfeiting on innovation in the FMCG-personal goods sectors – creation of intellectual property rights by way of patents and expenditure on research and development. On verifying patents filed by CSIR, which has filed the largest number of patents in India, none was found for the personal goods sector. Since innovation is very much part of the products and processes in the industry, the absence of patents in India may be due to the fact that multinationals are using patents filed abroad. It can also be attributed to the domination of the sector by small and cottage industries which depend more on traditional knowledge and use trade secrets, to drive their market. This, coupled with the high costs and complexity of the patent system tend to drive such units away from patenting their innovations.

The second proxy used was, the ratio of research and development expenditure to operating expenditure. The personal goods sector was found to have a low level of investment in R&D, with an average ratio of 0.59% during the five year period 2008 to 2013.

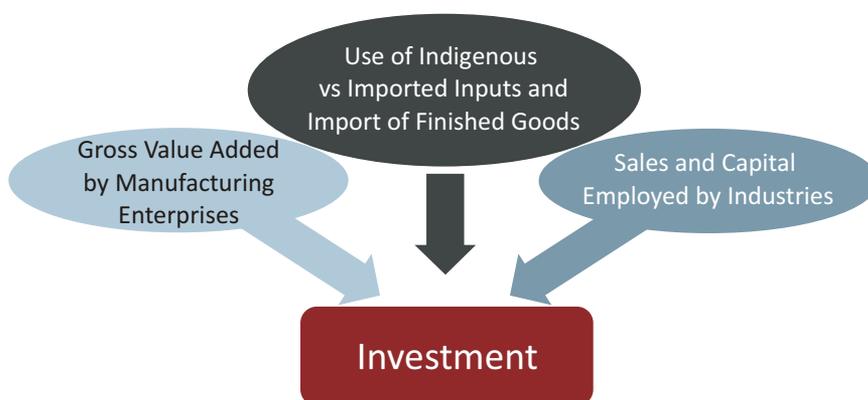
A 2008 OECD study¹⁶ on counterfeiting and piracy states that companies experience a loss of revenues or incentives to invest in R&D for new products and that this could in turn slow down economic growth. Similar conclusions have been reached by a study conducted by GAO¹⁷ on the US economy, which states that counterfeiting and piracy reduce investments in research and development, companies may hire fewer workers, experience lower profitability on account of reduced efficiencies and end up contributing less to overall economic growth.

The grey market, as our study shows has a substantial presence in this sector and has also shown a significant increase, growing from 25.4% in 2010 to 31.6% in 2012. Our study also clearly shows that the FMCG-personal goods sector is spending moderately on innovation. Coupled with the lack of patents, this could be because of the fear of lower returns due to counterfeiting and the growing illicit markets.

Impact of Illicit Markets on Investments



In this section we measure the level of domestic investment in India using three proxies. These proxies will help to understand whether Indian companies are investing in capacity enhancements or process improvements as warranted by increasing consumer demand rather than simply relying on imports of goods. These proxies will also reflect the efficiencies achieved in manufacturing capacity over the period of investment cycle.



Investment is one of the most important drivers of growth in an economy. Among the myriad concerns of domestic and foreign investors wishing to invest in India, the threat of diminished returns as a result of the presence of illicit markets, counterfeiting and smuggling has been a major one. Counterfeiting and smuggling affects all products and sectors in the country. However, some sectors are more prone to the threat of illicit markets than others. It not only raises questions regarding consumer health and safety but also adversely affects legitimate businesses.

Illicit markets, particularly counterfeiting and smuggling, affect the economy and investments in particular in various ways. The presence of counterfeited and smuggled products at



significantly lower prices than the legitimate products rips legitimate businesses of profits. More importantly, it acts as a disincentive for a company to invest resources for research and development, a critical element for innovation which has far-reaching long term implications. This is particularly damaging for a growing or developing economy's transition phase to a knowledge-driven economy. Moreover, in addition to hurting businesses in India, it also results in huge tax losses to the government.

Gross Value Added by Indian Companies

Gross value added is the value of output minus the value of intermediate consumption; it is a measure of the contribution to GDP made by an individual producer, industry or sector. GVA measures the contribution to the economy of each individual producer, industry or sector in an economy. It is also referred to as the productivity metric that measures the difference between output and intermediate consumption. Gross value added provides value for the amount of goods and services that have been produced, less the cost of all inputs and raw materials that are directly attributable to that production.

Thus, the gross value added by the manufacturing sector will measure the extent to which the output sold represents production in the country. It will quantitatively measure how much value addition actually takes place within the country or whether the value addition is taking place abroad. This will help establish whether the manufacturing sector is making enough long term investments for the sector to grow sustainably. It will be an important indicator against which the presence of illicit markets can be measured to understand whether this could be a contributing factor for the sector to be shying away from making enough investments for charting the course for long-term and sustainable growth. Our analysis of GVA will therefore entail:

Gross Value Added : Value added by companies in the manufacturing process

- Analysis of the Gross Value Added, extracted from the ASI data, for the seven key sectors over a period of five financial years, between 2007-2012.
- To measure this, the proxy used is the gross value added as a percentage of total output.
- The movement of the percentage of GVA over total output is shown over the five year period.

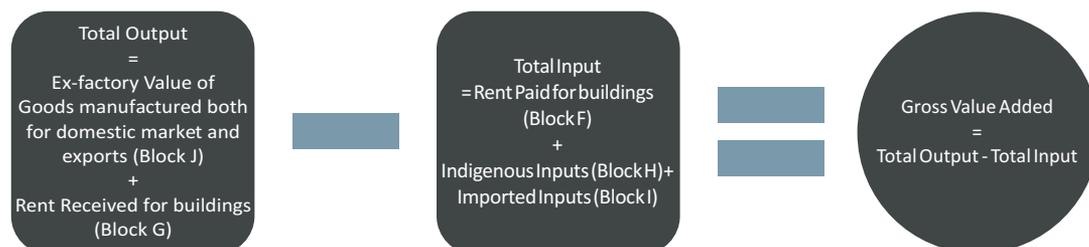
Methodology

The Gross Value Added (GVA) by companies has been calculated by using ASI data for the years 2007-08, 2009-10 and 2011-12. For the purpose of the present study a total of 13.32 lac data points have been analysed covering all sectors under FICCI CASCADE review.

These sample manufacturing units have been further examined in detail to understand the value of gross value added during the manufacturing process. A time series analysis for the

three years 2008, 2010 and 2012 has been done to ascertain whether there is an increasing or decreasing trend towards value addition in the manufacturing process.

The formula for calculating the Gross Value Added¹⁸ is as follows –



Data Analytics Results

GVA is expected to show an increase when there is optimum capacity utilisation or lower input costs. The factors relating to increase in consumer demand or higher rate of profitability may also contribute to increase in GVA.

Percentage of Gross Value Added over Total Output

For the present study, the proxy used to measure the value addition made by companies in the production cycle is the ratio or percentage of the gross value added over total output. The gross value added in absolute rupee terms is not a comparable indicator across all sectors as each sector is at a different tier of output generation, and hence cannot be used as a stand-alone indicator. The total output principally measures an industry's sales or receipts and is dependent on the demand and other pertinent characteristics of a particular industry. To make a like-to-like comparison, it is important to take into account how the industry dynamics for each sector plays out. Hence, the ratio of the gross value added as a percentage of total output is a far more representative figure.

A low percentage of gross value addition to the total output raises questions regarding the degree to which the output sold by the manufacturers represents the actual production within the country. In the present age of globalisation, countries attracting substantial amounts of foreign direct investment often have to grapple with concerns regarding the manufacturers depending on foreign sources for inputs in the manufacturing process which results in increase in imports. This also impedes the development of the indigenous suppliers through backward linkages. Hence, the value addition may actually be taking place abroad from where the inputs are imported. In such a scenario, the domestic manufacturing segment would function merely for final assembly operations.¹⁹ That is clearly not a desirable situation.

For the FMCG-personal goods sector, the gross value added as a percentage of total output for 2008, 2010 and 2012 are:

Sector	2008	2010	2012	Average
FMCG-Personal Goods	11.09	18.04	36.17	21.77

Gross value added as percentage of total output has increased from 11% to 36% between 2008 and 2012.

Gross value added as percentage of total output for the sector has displayed a substantial improvement in the last five years. The industry's preference towards indigenous inputs/ raw materials is driving higher localisation of inputs. The increased use of domestic raw materials not only saves cost for the industry but also enhances the value added in the domestic manufacturing process.

Use of Indigenous and Imported Inputs and Imports of Goods into the Country

The key elements being examined in this study are the impact of illicit markets on investment and innovation, both of which are very closely linked. For analysing both, studying imports of inputs and goods into the country is critical. This section presents the results of the data analysis exercise to show how import of inputs and finished goods plays out with respect to investment and innovation in the country.

India's increasing dependence on imports has been a cause of concern for the government. The current account deficit has been widening and India faced the risk of a credit rating downgrade. The current account deficit, which rose to a high of 6.5% of GDP in 2012-13, has narrowed sharply to 0.9% of GDP in 2013-14 as a result of a decline in the trade deficit as exports picked up and imports moderated.²⁰ Although import of oil and gold are the most significant contributing factor to widening the trade deficit, import of intermediate and semi-finished goods too have a role to play. The latter has far reaching long term implications for the country, which is discussed in this section.

Imports of goods can be broadly classified into the following:

- Inputs to be used in the manufacturing process by Indian companies; and
- Finished goods to be sold directly in the domestic market.

As businesses develop technology through new methods, new production techniques and introduce new inventions to the production process, there is a replacement of imported technology with indigenous technology. The level of sophistication in domestic production processes can be estimated by the increased use of domestic/ indigenous raw materials as compared to imported raw materials.

It has been observed that as businesses develop their own technology, the need for imported raw materials or inputs reduces. The underlying objective of most R&D projects is to enhance

business efficiency thereby reducing production costs. By substituting imported raw materials with indigenous raw materials, businesses can hope to reduce their costs in the medium to long term.

Methodology

The World Economic Forum in their Global Competitiveness Report 2013,²¹ points out that import as a percentage of Indian GDP is 33.7%, which is fairly high as compared to other countries. India ranks at 107th position among 148 countries on imports as a percentage of GDP. Of the same 148 countries, India stands at 52nd position in the production process sophistication ranking with a score of only 4.1 out of 7. Considering these results, this study looked at the following proxies for the FMCG - personal goods sector:

- Ascertaining the percentage of indigenous raw materials and imported raw materials used in production by Indian manufacturing units.
- Comparing the above ratio over a period of five financial years to examine whether there has been any import substitution with indigenous raw materials.
- Analysing import of finished products as a percentage of total production over a period of five financial years.

The proxy used for examining the above hypothesis is the following:-

$$\frac{\text{Imported raw materials consumed}}{\text{Total raw materials consumed}^*} \times 100$$

*Total raw materials consumed is the sum of imported and indigenous raw materials

This section uses the production data from ASI (2007-08, 2009-10 and 2011-12) and data on imports from DGCI&S to assess the level of dependence on imports against the total production. To quantify the level of reliance on imports and for a relative comparison, a proxy which serves this purpose and seems to capture the trend over years is imports as a percentage of total production.

Use of Indigenous and Imported Inputs and Imports of Goods into the Country

- Analysis of indigenous and imported inputs used by sample manufacturing units
- Distribution of indigenous and imported inputs as a percentage of total inputs used over a period of five financial years, 2007-2012, and percentage change in use over the sample period
- ASI data for 2007-08, 2009-10 and 2011-12 was extracted for the relevant blocks, for the sample factories covered in the survey, on imports and indigenous materials used in production
- Analysis of import of finished goods is done using data extracted from DGCI&S over a period of five financial years.
- To estimate the dependence of the sectors on import of finished goods, the percentage of imports over total production is analysed over a five-year period between 2007-2012.



Use of Indigenous and Imported Inputs

Total raw materials consumed comprises indigenous and imported raw materials. A general trend has been observed, that over a span of five financial years, the use of imported raw materials has increased in comparison with indigenous raw materials.

As the table below shows, in the FMCG-personal goods sector indigenous raw materials comprise 84% of the total raw materials in 2008, which reduced to 79% in 2010 and increased to 85% in 2012. The use of imported raw materials increased by 91% between 2008 and 2012, while the use of indigenous raw materials increased by 109% during the same period.

Table: Inputs consumed by Sample factories (DSL) - FMCG – Personal Goods

Source	Type	2007-08		2009-10		2011-12		%age increase in the sample period
		Amount in ₹ Mn	%age	Amount in ₹ Mn	%age	Amount in ₹ Mn	%age	
Block H	Indigenous	94,723	84.1	1,17,154	79.3	1,98,321	85.3	109.4
Block I	Imported	17,910	15.9	30,536	20.7	34,155	14.7	90.7
	Total	1,12,633	100	1,47,690	100	2,32,476	100	31.1

Imports of Finished Goods over Total Production

We now examine the extent of imports of finished goods over total production to estimate the level of production capacity within the country. An increasing trend would show that value (and jobs) is being created outside the country while a lower trend would show greater value being retained/generated within the country.

In the FMCG-personal goods sector the trend in the percentage of imports of finished goods over total production is increasing thus: 2.6% in 2008, 2.69% in 2010 and 3.29% in 2012.

Industry Sector	2008	2010	2012	Trend
FMCG - Personal Goods	2.6	2.69	3.29	Increasing

The percentage is low but increasing. For a country's transition from a developing to a developed one, it is imperative that reliance on imports, especially by the FMCG sector is minimal, and that domestic markets are able to meet these demands. This can only be done by undertaking more innovation initiatives, which is critical for the long term survival and growth of these sectors.

Capital Employed over Sales

This section will analyse the relationship between capital employed and sales. Businesses invest in capital with a view to generate increased sales revenue. The ratio between sales and

capital employed indicates that sales or revenues are 'x' times the money used in the business. This ratio helps to understand what level of sales are being generated by each rupee worth of assets invested in the business.

The objective of this section is to address the following questions -

- Is the pace at which sales are generated higher than the amount of capital employed in business?
- If so, are such increased sales attributable to investments or to imports?
- Are Indian companies shying away from making an investment?

To answer the above questions, a sector wise comparison between the year on year percentage change in sales and capital employed is analysed over a period of six financial years. Also, the ratio of sales to average capital employed has been calculated for the same time frame of six years. The ratio of sales by the average capital employed reflects a company's ability to generate sales revenue from efficient utilisation of assets.

Methodology

To analyse the relationship between sales and capital employed, the following approach has been adopted -

Sales and Capital Employed
<ul style="list-style-type: none"> ● Analysis of percentage change in capital employed and sales over a six year period, between 2008-2013. ● Analysis of ratio of sales over average capital employed ● To determine the relationship between percentage change in capital employed and sales data extracted from CMIE's Prowess database has been used.

Using the CMIE Prowess database, data pertaining to financial details of companies like assets, liabilities, etc. has been extracted for a period of six years, 2008-2013. Our sample size comprises public and private limited companies operating in India and belonging to the sectors covered in this section. There are a total of 27,650 companies whose information is available in the public domain; this was examined in detail to ascertain the nature of products/ services produced/ rendered by them. The companies were classified into the relevant industry sectors on the basis of the major kinds of products being produced and the industry group they belong to.

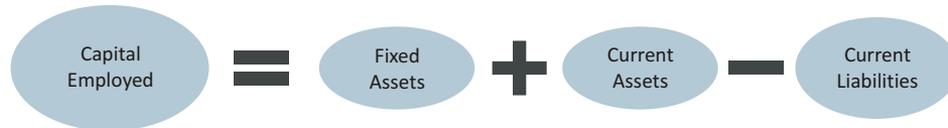
A total of 2,706 companies were selected pertaining to the industry sectors under review and information relating to following parameters was extracted for a period of six years from financial year 2007-08 to 2012-13:



- Fixed Assets
- Current Assets
- Current Liabilities
- Sales

More than seven lac data points were analysed to understand the trend in sales and capital employed over the last six years across the selected sectors. Data was collected for a period of six years to ensure that a complete economic cycle of low, medium and high level of business activity is captured.

The formula for calculating the capital employed is as follows -



$$\text{Average Capital Employed} = \frac{(\text{Opening Capital Employed} + \text{Closing Capital Employed})}{2}$$

The percentage change in the average capital is then calculated and compared with the percentage change in sales for each sector over a period of six financial years.

The other metric used is the ratio of sales over average capital employed. This captures the ability of a company to efficiently use its assets to generate sales revenue. This ratio is also calculated for a period of six financial years.

Comparison of Percentage Change in Sales and Capital Employed

A higher year on year percentage change in sales than capital employed implies utilisation of the assets to generate sales. A huge difference will imply either over-utilisation of assets or generating the sales revenue by sourcing through import of products instead of domestic production and is characterised by a low level of investment. However, if the year on year percentage change in capital employed is much greater than that of sales, this means that the quality of investment is low and use of assets is inefficient. In such a scenario, the investments made by the companies are not generating the desired level of sales.

The FMCG-personal goods sector shows a lot of variation in both the percentage of sales and capital employed between 2008 and 2010. The year on year percentage change in both have stabilised 2011-12 onwards. The percentage change in capital employed and sales in 2012 vs 2011 is equal but the percentage change in capital employed is seen to increase slightly in 2012-13 and is greater than that of sales. The year on year percentage change in sales of the FMCG-packaged foods sector has been decreasing over the period 2008 to 2013. The year on year percentage change in the capital employed shows a similar trend except for a sudden spurt in

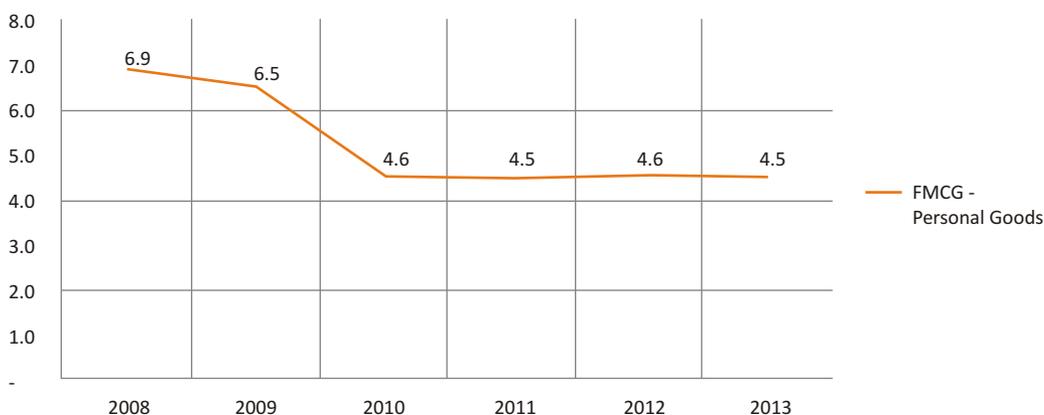
2011 vs 2010. The percentage change in sales has been higher than that of capital employed except the year on year change for 2011 vs 2010 and 2013 vs 2012.

Ratio of Sales by Average Capital Employed

The ratio of sales over average capital employed measures the management's efficiency in generating revenue from the net assets at its disposal. It depicts the amount of sales revenue generated for every rupee of capital invested in the business. The higher the ratio, the more efficient the business is in utilising the net assets and generating sales revenues.

The FMCG-personal goods industry has the highest ratio among all the sectors under FICCI CASCADE review. However, the ratio was close to 7 in 2008 and 2009 but fell to 4.6 in 2010 and has more or less remained at that level till 2013.

Ratio of sales by average capital employed



In the sectors under FICCI CASCADE review, the ratio of sales to average capital employed remains fairly steady, indicating that there has been no dramatic increase in investments in the years under review against which higher sales can be expected in the coming years.

Summary

The GVA in this sector has increased, and in fact doubled over the period from 2008 to 2012. Furthermore, the sector shows a marked preference for indigenous inputs/raw materials which is good for it saves cost and adds value in the manufacturing process. These are positive signs for the industry.

The proportion of imported inputs however has not fallen significantly remaining fairly stagnant over the years, implying that the industry still relies to some extent on imported inputs. The ratio of imports of finished goods over total production also, though low, has increased from 2.6% in 2008 to 3.29% in 2012. The significantly large and increasing illicit markets are a contributing factor.

The ratio of sales to average capital employed remains fairly steady over the last few years, indicating that there has been no dramatic increase in investments against which higher sales can be expected in the coming years.

As stated earlier, ***the illicit markets, particularly counterfeiting and smuggling, at significantly lower prices than the legitimate products rips legitimate businesses of profits. It acts as a disincentive for companies to invest resources for research and development, a critical element for innovation and growth. The continued dependence of the FMCG-personal goods sector on imported inputs and finished products shows that businesses are yet to fully develop their own technology which would enhance business efficiency and reduce production costs.***



Impact of Inter-state Tax Arbitrage within India



It is often claimed, that higher tax rates, stringent entry barriers and excessive regulatory compliances tend to exacerbate the illicit markets of a country. A significant reason for higher tax rates giving a fillip to the illicit markets is the fact that high tariffs and taxes create opportunities for those involved in illicit markets to step in and supply 'reduced' versions of the original product at lower prices.

The purpose of this section of the report is to attempt to establish a relationship between high taxes and availability of illicit products. Discussions with FICCI-CASCADE set the framework for coverage of tax arbitrage to sectors with higher incidence of tax, set at 20%-25%.

However, we observed that in case of FMCG-personal goods, tax rates for excise and custom were lower than 20-25%. VAT rates for these products did not vary significantly from state to state ranging from 4% to 5% in most of the states. It was therefore concluded that there is no scope for inter-state tax arbitrage in this sector. Accordingly analysis of tax arbitrage for this industry is not relevant for this part of study.



Anti-counterfeiting measures



There are a large number of laws to protect intellectual property rights (IPR) and check counterfeiting, piracy and smuggling. The IPR regime includes Copyright Act, Trademarks Act, Geographical Indications of Goods (Registration & Protection) Act and Patents Act. India is a signatory to the International Registration of Trademarks, known as Madrid Protocol. It has taken several measures to improve and enforce IPR by formulating a National IP Strategy Plan, increasing the level of computerisation, creation of a computerised IP records data base, interconnecting various enforcement agencies and providing an online facility for filing and processing of patents and trademark applications etc.²² There is a proposal to set up a task force to implement IPR under the national policy.

The office of the Controller General of Patents, Designs and Trademarks (CGPDT), under the Department of Industrial Development and Promotion (DIPP), is the nodal authority to enforce these laws. The Customs Act and IPR (Imported Goods) Enforcement Rules of 2007 enable authorities to seize counterfeit goods and check its entry to India by suspending clearance of suspected goods. The Drugs and Cosmetics Act is specifically meant to ensure health and safety requirements are maintained and spurious goods not allowed in the market.

India may not lack in terms of laws but enforcement is poor, which is reflected in the growing market of counterfeit products particularly in the FMCG-personal goods sector. The industry has taken several measures to fill the gap by launching helplines, setting up their own monitoring mechanisms to identify and report counterfeit products and organising raids with the help of enforcement agencies. It has also been using high-tech packaging to counter counterfeiting. These efforts may not have produced adequate results considering our estimates show that counterfeiting in this industry has gone up.

Some of these innovations include:

- Use of transparent film wrappers with distinctive designs around a product
- Use of inherently tamper proof packaging like tin cans, tetra packs sealed hermetically

- Breakable caps that those in drinking water and soft drink business use
- Sealed tubes in which the mouth of the tube is sealed and needs to be punctured before use
- Holograms
- Packaging features that require image scanning devices
- Bar codes, watermarks, taggants (multi-optical layers) unique pack serialisation, nano printing or microscopic application of UV inks which allow invisible printing etc.



Impact on Consumers



Counterfeit goods can be dangerous and potentially harm or even kill unsuspecting consumers. These products may contain hazardous and untested ingredients and provide no assurance of safety or efficacy. Given the lax regulatory mechanism in India, there is always a threat, even from inadequately tested and untested products getting regulatory clearances for sale in market.

A recent study by the Delhi Institute of Pharmaceutical Sciences and Research (DIPSAR) found that many of the toothpaste manufacturers are adulterating toothpastes and toothpowders with high quantity of nicotine. Out of 24 well-known brands of toothpastes examined, which were produced and marketed by leading FMCG companies, seven were found to contain nicotine, which is expressly banned as the Cigarettes and Other Tobacco Products Act, 2003, prohibits use of tobacco in any non-tobacco product. Similarly, out of 10 well-known toothpowders, six contained nicotine.²³

The most remarkable aspect of these findings was that the companies involved were leading national and international brands of the FMCG world. Similar cases have been reported from Mumbai and Ahmedabad in which nearly half of all cosmetic and beauty care products sold over the counter (OTC) were found to be fake or spurious and more than half contained harmful ingredients. Even ayurvedic products manufactured by FMCG giants were found to have misleading information about the ingredients.

All such cases come to public notice only through private initiatives. The government regulatory bodies have a notional presence and there is little by way of official data or literature to show any harmful effects of spurious products on the consumers, though the presence of harmful and substandard ingredients are acknowledged both in genuine and counterfeit products.

Apart from the health and safety issues, counterfeit products in the market mean low satisfaction or benefits to the consumers and poor value for their money.

Illicit Markets, Terror Organisations and Criminal Networks



Terrorism in India

Terrorism, in all its forms, constitutes a grave threat to peace and security of a nation. Those indulging in it use disruption and violence as the weapons of intimidation against the civilian population, the government to influence public policies or even effect a regime change. By its very nature, terrorism is against the established order of the day. There is, however, no universally accepted definition of the word. Different countries fighting the menace define it differently. In India, the Unlawful Activities (Prevention) Act of 1967, amended in 2004 to fight terrorism, uses the word "unlawful activity" instead of terrorism and defines it as "any action...intended, or supports any claim, to bring about, on any ground whatsoever, the cession of a part of the territory of India or the secession of a part of the territory of India from the Union, or which incites any individual or group of individuals to bring about such cession or secession; and which disclaims, questions, disrupts or is intended to disrupt the sovereignty and territorial integrity of India."²⁴

Terrorist Attacks and its Financing: Need for Funding & Costs Incurred

Running a terrorist organisation requires substantial financial resources which are transferred to the groups through clandestine and often illegal channels. Terror expert Jean-Charles Brisard argues that 90 per cent of terror financing goes toward general maintenance of cells and equipment. Less than 10 per cent actually finances the execution of operations.²⁵ Costs incurred by terrorist organisations include materials such as bombs, vehicles, weapons and communication equipment and those related to planning and execution of attacks and expenses for running terrorist outfits.

While it is relatively easy to provide historical data citing an observational link between counterfeiting and terrorism, it is much less so to analyse the aggregate effects of the illicit

markets industry on terror crimes in general. **Moreover, lack of reliable data on terrorist financing leads to an enormous mismatch between the costs of a single attack and the supposed costs of running and maintaining a terror organisation.** At the same time, estimates of actual financial flows among the parties involved in terrorist activities appear rather preliminary. However this information is essential in order to develop a sound cost-benefit analysis of anti-terrorist measures associated with terror funding.

It is important to note that while statistical data is available for the number of attacks that have taken place in India, it is difficult to directly correlate it to the grey market data in absence of sufficient information and research, which are lacking at present, especially in the Indian context.

Furthermore, despite the existence of requisite laws in India and arrests of suspected criminals by the police, the scale of illicit markets is huge and the criminal networks and illicit markets organisations continue to thrive. Clearly, this means that the existing laws and police operations are not resulting in the desired outcome and are unable to act as a deterrent. This could be due to the low conviction rates in India.

The scenario in other jurisdictions is not very different, although, credible data on seizures may be more easily available. The UK government in their Report of October 2014, has estimated that they lose about 1.3 % of their total tax collection due to criminal networks, mainly from smuggling.

A number of international studies have been conducted in the past which highlight the involvement of counterfeiting and piracy in financing of terrorist activities, for example, Al Qaeda²⁶ has been linked to the counterfeit industry through the sales of fake perfumes and shampoos. Also, Al Qaeda training modules recovered in 2002 reveal recommendation of sale of fake goods as a means to raise funds for cells.

The illicit markets have grown exponentially across the world, not only costing the industry and governments dear but also promoting criminal enterprises and generating funds for terror activities. Inadequate laws, poor governance and information gaps have aggravated the problem. It is, therefore, crucial to tackle the menace on a global footing in which all countries share information and join forces in creating a legal and regulatory framework, backed by effective enforcement.

So far as India is concerned, lack of adequate data based on search and seizure makes it difficult to link or correlate the increase in illicit markets to terror funding. Establishment and determination of the extent of such a link calls for strategic intelligence gathering and preparation of robust databases, which are clearly missing at present. Given the security implications, if not outright financial considerations, there is little to argue against carrying out such exercises. This would be the first step to contain counterfeiting and its corollary, terror and ensure that genuine business interests do not suffer. It is therefore imperative to

build a framework for prevention of terrorist financing which not only tracks down their financing hubs but also acts as a deterrent for them to ultimately bring down the threat of terrorism. The framework must deal with financing of terrorism from the following perspectives:



Conclusion & Way Forward

Our study shows that there is not only a significant presence of illicit market in the FMCG-personal goods sector, it is also growing. As against 25.9% in 2010, the size of the illicit markets in this sector has grown to 31.6% in 2012. The resultant loss to the industry estimated for 2014 works out to ₹ 19,243 crores. Total loss to the government has increased to is ₹ 5,954 crores in 2014, up from ₹ 4,646 crores in 2012. The study further shows that the illicit market impacts innovation and investment adversely. None of these is good for any of the stakeholders concerned - businesses, governments or consumers.

There are other ways too in which counterfeiting harms. It also undermines employment as products are copied and produced illegally, thereby displacing sales of original merchandise and reducing the turnover of legitimate companies. The prices of products also go up because companies increase security systems to counter organised criminal activities and have to invest more in research and development.²⁷ Besides, fake and spurious goods can have serious health and safety implications for the consumers.

Data Collection and Analytics

As a significant and first step stakeholders must work in tandem to improve information sharing which will enable collation of credible statistics. Credible statistics will help to draw up and implement action plans that could undermine the activities of the perpetrators of this crime. Improving information sharing would entail:

- Systematic data collection;
- Comparability across sectors and across borders; and
- Comprehensive-drawing from multiple sources.

Quality information would provide a solid basis for establishing the scope of illicit markets and form a key input in assessing the magnitude and effect of illicit markets.

There are several initiatives that industries may also undertake which may include:

- Supporting research and analysis of issues related to illicit markets;
- Conducting awareness programmes for retailers and consumers; and
- Innovations in products or packaging to combat illicit markets.

Encouraging Innovation & Investments and Enhancing Regulations

Innovation and investment are keys to economic growth and sustainability of business. India can ill-afford to ignore either as it attempts to better the living conditions of its huge and growing population and move up in the value chain in the world economy. It has to check and

substantially reduce the illicit market to create a conducive environment for innovation and investment.

Our study found the FMCG-personal goods sector to be marked by low incidents of patents and low level of R&D expenditure as a percentage of operational expenditure - an average of 0.59% during the study period of 2008 and 2013. This could be due to uncertainty of returns due to the increasingly high risk of counterfeiting, smuggling and piracy in the industry.

The FMCG-personal goods sector throws up some interesting results in the analysis of impact on investment. Three proxies were used - gross value addition (GVA) over total output, ratio of indigenous with imported goods (raw materials and finished goods) and ratio of capital employed to sales. The sector shows a marked preference for indigenous inputs/raw materials which is good, as it saves cost and adds value in the manufacturing process. However the proportion of imported raw materials has remained relatively stagnant during the period under review. The ratio of imports of finished goods over total production is low, although there has been a steady increase. The ratio of sales to average capital employed remains fairly steady over the period of review, indicating that there has been no dramatic increase in investments against which higher sales can be expected in the coming years. These results suggest that the sector needs more innovation which requires further investment.

Continued dependence on imports shows that businesses are yet to fully develop their own technology which would enhance business efficiency and reduce production costs. The growing illicit market is only further killing the incentive to invest and innovate.

The study also finds that the illicit market is a product of several factors, including lax regulatory mechanism, lack of consumer awareness, low deterrence. Moving forward, India will have to address these issues to incentivize the sector for higher innovation and investment.

The regulatory mechanism needs to be strengthened by providing manpower and funds. The Government needs to be more proactive in implementing and tracking down culprits to bring them to book. Greater coordination between customs, police and right holders is also necessary to bring in stricter enforcement of anti-counterfeiting laws and protection of business interests from illegitimate manufacturers.

To encourage innovation and investment the overall business environment needs to be improved. The patenting procedure should be simplified and the industry given incentives to file more patents. Consumer awareness, better collaboration between the industry and academia and simplification of the tax regime are some other measures that are equally important. So is the proposed unified tax regime, Goods and Service Tax (GST), which would address some of the tax anomalies, simplify tax structure, reduce tax cascading and remove incentives for imports in the FMCG-personal goods sector.

According to a recent Dun & Bradstreet report titled "India 2020 Economic Outlook",²⁸ rising income levels coupled with increase in the young working-age population will lead private final consumption expenditure to grow steadily over the years. As per D&B's projections, growth in



private final consumption expenditure is expected to average at around 7.0% during FY15-FY20.

Given this growth which would also impact the FMCG personal goods industry, collaborative efforts are required between all stakeholders to curb the rising illicit markets which vitiate the environment and restrain such growth, reducing business efficiency, profitability and overall development.

Countering Financing of Terrorism

With regard to funding terror organisations, owing to the extensive research carried out globally on terrorism and its links to proceeds from illicit markets, it is possible to state with certainty that illicit markets are instrumental in providing the much required funding to such organisations. In addition to the FBI, the former US Customs Service also brought attention to the link between the sale of fake goods and terrorism and has noted that the events of September 11, 2001 "changed the way American law enforcement looks at intellectual property crimes."²⁹

Terrorist groups need financial resources to train and support members, maintain and sustain logistics, and meet operational costs. Therefore, if the threat of terrorism is to be nipped, the access to funding has to be choked. The truth is that many countries do not possess the legal and operational wherewithal and technical expertise needed to zero in on terrorist financing sources and initiate prosecution.

It is imperative therefore to build a framework for prevention of terrorist financing which not only tracks down their financing hubs but also acts as a deterrent for them to ultimately bring down the threat of terrorism. Such a framework will include training and capacity building among enforcement agencies, use of technology to detect and track sources of finance and increasing consumer awareness to empower consumers to take more informed decisions.

Annexures

Annexure I: Academic Literature Review

- ❖ **OECD** estimates international trade in counterfeit and pirated products could have been up to USD 200 billion in 2005 excluding domestically produced and consumed counterfeit and pirated products and the pirated digital products being distributed via the internet. The magnitude and effect of counterfeiting are of extreme significance and warrants strong, sustained and coordinated action from government, industry and consumers. Counterfeit and pirated products are infiltrating legitimate supply chains other than informal markets. The Internet has provided counterfeiters/pirates with a new and powerful means to sell their products via auction sites, stand-alone e-commerce sites and email solicitations.³⁰
- ❖ **OECD** further states that the effects of counterfeiting and piracy on government come in the form of (i) lower tax revenues, (ii) the cost of anti-counterfeiting activities, including responding to public health and safety consequences and (iii) corruption. ...Tax revenues. Tax collection is presumed to be far more effective from rights holders and their licensees than from counterfeiters and pirates. Potential losses include corporate income taxes, sales or value added taxes, excise taxes, import tariffs and social insurance charges. The revenue losses are particularly high in sectors such as tobacco and alcohol, where excise taxes are high and smuggling of counterfeit products to avoid those taxes is widespread.³¹
- ❖ **BASCAP** estimates that the total value of pirated and counterfeited products impacting G20 economies for 2008 is \$455 to \$650 billion and has been projected between \$1,220 to \$1,770 billion for 2015 including international trade, domestically produced goods and pirated digital products distributed via internet. The impact of counterfeiting and piracy on government tax revenues, legitimate employment, increased costs of crime, economic costs on consumer health and safety and downward pressures on FDI flows has been estimated at \$125 billion per annum for G20 countries. Employment loss has been estimated at 2.5 million jobs for G20 countries excluding secondary impact on employment in the supply chain.³²
- ❖ **International Anti-Counterfeiting Coalition, Inc. (IACC)** professes that low risk of prosecution and enormous profit potential has made criminal counterfeiting an attractive enterprise for organized crime groups. There are connections between intellectual property theft and terrorist groups and terrorists can use intellectual property crimes not only as a source of funding but also as a means of attack.³³
- ❖ **GAO** states that it is difficult to quantify the economy wide impacts of counterfeiting because of varying assumptions on substitution of legitimate products with the pirated goods across

industries. Hence each method of costs estimation has limitations on account of data availability and underlying assumptions and no single method can be used across industry sectors.³⁴

- ❖ **UNODC** says, "The ramifications of counterfeiting affect everyone, with Governments, businesses and society being robbed of tax revenue, business income and jobs. The flood of counterfeit and pirated products creates an enormous drain on the global economy by creating an underground trade that deprives Governments of revenue for vital public services and imposes greater burdens on taxpayers. It also leads to more public resources being spent on fraud-detection methods by public sector authorities and larger intelligence and policing budgets being needed to counter sophisticated schemes and networks. Counterfeit goods also undermine employment, as products are copied and produced illegally, thereby displacing sales of original merchandise and reducing the turnover of legitimate companies. Fraudulent medicines also have a direct impact on increased medical costs due to prolonged treatment periods and medical complications in the spread of treatment-intensive diseases. The prices of products also go up because companies increase security systems to counter organised criminal activities and have to invest more in research and development."³⁵
- ❖ **A WIPO** study talks about the how intellectual property rights or their protection plays a role in the innovation process, emphasising that technological innovation is a principal determinant of successful firm performance. The study also indicates that small and medium sized enterprises (SMEs) prefer to use trade secrets rather than patents as a form of protecting their inventions to stay competitive. The main reasons given by SMEs for shying away from patenting their inventions include high costs and complexity of the patent system.³⁶
- ❖ **Nam D. Pham** lays emphasis on the impact of innovation and the role of IP rights in his study. The study brings to the fore, the critical importance of allocating resources to innovation in sustaining long-run economic growth in both developed and developing countries. The author argues that countries with the highest technological capacity are better able to enhance the efficiency of their production methods and exploit new market opportunities. The study states that the protection and enforcement of IP rights are imperative for creating strong incentives for innovation and safeguarding it from counterfeiting, piracy, and other forms of IP theft. It concludes that with the growing importance of knowledge as a driving force for innovation and economic expansion worldwide, the protection of property rights has attracted greater attention and concern. The counterfeiting and piracy of products are rising exponentially and are costing the global economy hundreds of billions of dollars a year in lost revenues and thousands of jobs. The challenge for policymakers is therefore to continue encouraging investment in R&D and human capital in order to promote innovation while at the same time developing the policy instruments and frameworks to better protect intellectual property rights.³⁷

- ❖ **A Harvard University** study delves into the relationship between counterfeit sales and financing of activities of terrorist organisations using a number of economic controls to analyse the effect of two proxies of annual counterfeit sales on two measures of international terrorism namely RAND database and DOS database. It states that while the societal and economic costs of counterfeit products are largely incontrovertible, one final effect of this crime industry is less definite: its support of international terrorism. Anti-counterfeiting organizations and luxury goods manufacturers are quick to suggest that counterfeit product revenues are directly funding terrorism. There is, however, only a small amount of hard data in support of this claim. The study conducts an inquiry into the purported causal link between measure of counterfeiting and terrorist incidents in a given year through a regression model but suggests that the empirical analysis fails to provide a conclusive relationship between the two.
- ❖ **A University of Wellington study** on cross border tax arbitrage states that in most cases, cross-border tax arbitrage increases the tax payable in one jurisdiction and decreases the tax payable in the other jurisdiction. The decrease must be larger than the increase for the arbitrage to be worthwhile for the taxpayer. Tax arbitrage, therefore, redistributes resources not only from government treasuries to taxpayers, but often from one government treasury to another. The study says the direct consequence of cross-border tax arbitrage is to distort individuals' and corporations' investment decisions, and to reduce the revenue raised by governments. Although cross-border tax arbitrage may augment the coffers of one government's treasury, this augmentation is likely to be more than offset by a reduction in the revenue raised by the other government's treasury (otherwise the arbitrage is unlikely to be advantageous from a tax perspective).³⁸

A significant anti-counterfeiting measure undertaken in recent times is the Anti-Counterfeiting Trade Agreement (ACTA). It builds on the Trade-Related Aspects of Intellectual Property Rights (TRIPS), but has been negotiated outside WTO (World Trade Organization) framework. The draft ACTA calls for increased use of criminal and civil penalties against people using copyright circumvention technologies and those accused of copyright infringements, and also for ISPs to have more responsibilities with regards to removing infringing material. **ACTA has been rejected by the European Union in July 2012.**

ACTA binds negotiating states and creates a new international standard which is likely to be imposed on third countries in future trade agreements. The current draft threatens fundamental rights in countries such as the right to freedom of expression and information, right to protection of personal data and fair trial/due process issues related to other fundamental rights. It was negotiated in unwarranted secrecy, without adequate input from civil society or parliamentarians, but in close cooperation with major IP right holders. It has resulted in disproportionate protection to big business.³⁹

Annexure II: Items considered as part of operating expenditure

S. No.	Components of Operating Expenditure
1	Raw material expenses
2	Power & fuel
3	Water charges
4	Salaries & wages
5	Repairs & maintenance of buildings
6	Repairs & maintenance of plant & machinery
7	Repairs & maintenance of vehicles & others
8	Communications expenses
9	Travel expenses
10	Selling & distribution expenses
11	Printing & stationery expenses
12	Donations
13	Social and community expenses
14	Environment and pollution control related expenses
15	Subscriptions and membership fees
16	Research & development expenses
17	Other miscellaneous expenses
18	Miscellaneous expenditure

Abbreviations

ASI	Annual Survey of Industries
CASCADE	FICCI's Committee Against Smuggling and Counterfeiting Activities Destroying the Economy
CSIR	Council of Scientific & Industrial Research
CSO	Central Statistical Organisation
DGCIS	Directorate General of Commercial Intelligence and Statistics
FICCI	Federation of Indian Chambers of Commerce & Industry
FMCG	Fast Moving Consumer Goods
GDP	Gross Domestic Product
GSV	Gross Sales Value
GVA	Gross Value Added
IPR	Intellectual Property Rights
MoFPI	Ministry of Food Processing Industries
MoSPI	Ministry of Statistics and Planning Implementation
MSME	Micro Small and Medium Industries
NIC	National Industry Code
NSS	National Sample Survey
NSSO	National Sample Survey Organisation
R&D Expenditure	Research and Development Expenditure
TARI	Thought Arbitrage Research Institute
UNODC	United Nations Office on Drugs and Crime
WIPO	World Intellectual Property Organisation

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About FICCI

Established in 1927, FICCI is the largest and oldest apex business organisation in India. Its history is closely interwoven with India's struggle for independence, its industrialization, and its emergence as one of the most rapidly growing global economies. FICCI has contributed to this historical process by encouraging debate, articulating the private sector's views and influencing policy.

A non-government, not-for-profit organisation, FICCI is the voice of India's business and industry.

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About FICCI CASCADE

In the recent past India's economic growth story has attracted world's attention bringing new challenges for the domestic economy. One of the challenges currently faced is the growing illicit trade in counterfeits, pass offs and smuggled goods. These activities are also threatening brands not only in every region of the country but across the globe.

Contraband and counterfeit products hurt the integrity of the brand, further diluting the brand owner's reputation. This not only results in erosion of sales of the legitimate product but further [CASCADE]s onto affect the consumers in the form of health and safety hazards.

With the above insight the Federation of Indian Chambers of Commerce and Industry(FICCI) took the initiative to dedicate a forum by establishing the Committee Against Smuggling and Counterfeiting Activities Destroying the Economy - CASCADE on 18th January, 2011 at FICCI Federation House, New Delhi.

FICCI Committee Against Smuggling and Counterfeiting Activities Destroying Economy (CASCADE)

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