

State University - Higher School of Economics

Research Project
"Scales of Gray Import and Counterfeit Production
in the Russian Consumer's Market"
(Analytical report)

Executed by request of the Community of branded trademarks manufacturers (Rusbrand)

State University - Higher School of Economics (GU-VShE) by request of Community of branded trademarks manufacturers (Rusbrand) has carried out research on the subject: "Scales of Gray Import and Counterfeit Production in the Russian Consumer's Market".

The given report represents methodology and major results of the research as well as brief summary of opinions by representatives of Rusbrand member companies concerning the general dynamics of the stated phenomena and actions necessary in order to minimize and prevent them.

Problem Statement

The cardinal problem has been caused by the fact that in the Russian markets the products imported into the country without authorization of trademark owners, frequently with infringements of customs formalities are spread wide enough as well as by manufacturing and sale of infringing goods. The existence of such phenomena undermines the market, creates unequal competitive conditions for its participants and damages the image of leading companies and interests of ultimate users of the products. Besides as a result of parallel import and manufacturing of false products the considerable means escape the state budget. And since there are no reliable official statistics in this connection the representatives of state structures are far from realizing scale of such loss in full measure.

There is every reason to believe that overall scales of parallel import and sale of counterfeit products have been reducing gradually during the last two years (as regards some items this reduction is rather drastic). As to gray import this occurs as a result of grave changes in policy of the Russian State Customs Committee connected with toughening of customs value fixing procedure control. As to counterfeit products the positive shifts should be considered to a result of efforts by companies themselves. Nevertheless the scales of infringements are still considerable and for want of active actions the recurrence of these infringements growth is rather possible.

Basic Concepts:

Parallel import means importation of the goods protected by the trademark without authorization of the trademark owner. As a rule, the parallel import is connected to gray or black merchandise import.

Gray import means importation of goods with infringements of customs registration procedure connected with understatement of cost and-or quantity of the imported goods.

Black import means importation of goods with infringements of customs registration procedure connected with goods recoding or without customs registration (smuggling).

Counterfeit products mean products manufactured with unauthorized use (imitation, falsification) of trademarks and manufacturer's marks with a view to mislead consumers.

Trademark means a set of indications (name, logos, symbols) assigned to a company, with the help of which the company or its products differ from other companies and products.

Brand means a set of characteristics and images, with which one can associate the present company or product in the view of consumers.

Major Objectives of the Research

The major objectives of the research have been determined as follows:

1. To measure aggregate loss of companies and state budget caused by parallel import and counterfeit products.
2. To determine of the basic trends in dynamics of parallel import and counterfeit products turnover.
3. To reveal problem points in implementation of parallel import and counterfeit products control policy.

4. To propose material for development of coordinated corporate policy and developments drawing-up of recommendations with respect to alteration of the situation in the areas under consideration.

Target Parameters

The scheduled result of the research consists in measurement of four target parameters as to the chosen product groups:

1. Loss of companies caused by parallel import,
2. Loss of companies from counterfeit products,
3. Loss of the state budget from parallel import,
4. Loss of the state budget from counterfeit products.

Data Collection Methods

The primary data collection method was a series of depth interviews with representatives of companies (directors general, lawyers, sales and logistics managers). The series of interviews was supplemented by elements of standardized interrogation connected with filling of special microquestionnaires.

In all 15 companies-members of Rusbrand Community have taken an active part in the research. Two companies have refused having referred to lack of coordination of the research conditions and objectives with them. The others have refused to participate because the problems of gray import and counterfeit products did not seem urgent for them at that time.

In addition the information was gathered from analysis of marketing firm reports.

Data Sources

The major sources of the data provided by Rusbrand companies included the following:

- fragments of operations reports by Rusbrand companies,
- results of special researches conducted by Rusbrand companies or by third parties,
- expert evaluation of market situation parameters.

Completeness of the data provided by Rusbrand companies differed strongly enough. In many cases the requisite quantitative data were not available to them. Several companies have refused to provide data referring on commercial classified information. Since the task group had no right to insist on granting of such data it made additional calculations using the following sources of information:

- marketing companies reports data as regards a state of this or that market and shares of its major participants,
- cross comparisons of different companies data,
- estimations received as a result of our previous researches of parallel import problems.

In some cases we addressed to the company representatives once again in order to ascertain the necessary data and, as a rule, received them.

Organization of the Research

In every company we picked up one or two aggregative commodity groups, which occupy a weighty share of total sales volume (usually 30-70%) and are relevant for this research.

These commodity groups included the following:

- Spirits
- Shaving blades
- Sanitary towels
- Hair and body care cosmetics
- Mineral water
- Instant coffee
- Sportswear and footwear
- Insecticide
- Tea
- Cleansers and detergents
- Batteries

Some commodity groups were presented by one company, other commodity groups – by 2-3 companies. Total sales volume made above \$1 billion (\$1,153 million).

General methodology of estimating companies loss caused by parallel import and counterfeit products

The companies loss was measured as a difference of conditional sales volume in the absence of parallel import or counterfeit products and actual sales volume for 2002. Then they were also supplemented by a sum of direct costs of the companies for these phenomena control (if any).

Thus, loss of the companies was formed by several parameters:

1. Decline in sales of Rusbrand companies as a result of substitution of authorized production by gray import and original production by counterfeit products.
2. Decline in sales of Rusbrand companies as a result of forced decrease in price for Rusbrand companies output by use of trading discounts.
3. Direct costs of Rusbrand companies for gray import and counterfeit products distribution control.

Calculation of loss caused by parallel imports and counterfeit products were carried out separately.

Additional explanations

Decline in sales volume is considered as a probable sales volume subject to exclusion of parallel import or counterfeit products. Thus, as gray and counterfeit products are frequently sold at lower prices (on average by 10-20 %) the recalculation for the Rusbrand companies prices was made.

Along with manufacturing of counterfeit products there is also a problem of *trademarks imitation* (look like). It seems impossible to estimate loss from the said phenomenon now and this factor was not taken into account in the calculations.

Only forced *direct discounts* applied by Rusbrand companies were considered. It is problematic enough to estimate a stress on price level as a result of competitiveness by gray and counterfeit products, therefore, the this effect was not taken into account.

The companies costs for *parallel import and counterfeit products control* include transaction costs connected with the following kinds of actions:

- situation research and revealing event of infringements,
- assistance in legal registration of infringements and pursuit of offenders,
- training of controlling bodies representatives,
- explanatory work in mass media.

As a rule, the complete evaluation of such costs is rather difficult. In some cases the company did not provide such data. However this fact could not have a grave influence on general result since as a rule it was a question of amounts within the limits of 100 thousand dollars annually.

General methodology of estimating the state budget loss from parallel import and counterfeit products

Loss of the state budget were measured as a sum of payments, which would be paid into the budget by the leading companies subject to exclusion of parallel import or counterfeit products. At that the assumed volume of payments made by gray dealers and dealers of counterfeit products was deducted. As a result the state budget loss was evaluated as a sum of taxes and dues, which are underpaid by offenders as compared with companies-legal owners.

When estimating the state budget loss we proceeded from the assumption that the leading companies paid 100% of all taxes and gray and black dealers - only a part of the taxes. Naturally, the level of

effective rates as regards different types of taxes and dues varies. The estimates of such levels have been received as a result of the previous researches. They were also compared to the individual data provided by Rusbrand companies.

Calculation of loss caused by parallel imports and counterfeit products were carried out separately.

Basic Research Results

Loss of the companies from parallel imports
with respect to examined product groups

\$145.4 million.

Loss of the companies from counterfeit products
with respect to examined product groups

\$119.1 million.

Loss of the state budget from parallel imports
with respect to examined product groups

\$30.3 million.

Loss of the state budget from counterfeit products
with respect to examined product groups

\$30.7 million

Estimated Research Result

The abovementioned amounts of loss are obtained according to the results of survey of 15 Rusbrand companies and each of them had one-two aggregative commodity groups assigned to. *The total sales volume* with respect to the given groups values at \$1,153 million that makes about one percent of all volume of Russian retail turnover for 2002.

Rusbrand companies loss from parallel imports in whole amounts to 12-13 % of turnover with respect to the chosen items and from counterfeit products - about 10 % of turnover. Thus, certainly, one should allow for considerable differences between commodity groups. As a result certain companies may regard problems of gray import as more actual and have no problems with fabrications at all while the situation of other companies may be just on the contrary.

The state budget loss from the activity of gray dealers and dealers of counterfeit products amounted to \$61 million. If we compare this amount to, for example, the total amount of tax proceeds of the state budget or customs payments according to 2002 totals it will only make a fraction of one percent. Nevertheless, the loss extent is rather sizeable. It should also be remembered that it is a question of a share of sales making only about one percent of retail turnover.

The findings may not be extrapolated automatically to the whole volume of Rusbrand companies activity and, especially, to the whole turnover since the situation with the presence and volumes of parallel imports and counterfeit products strongly differs as regards product groups and inside groups – as regards separate brands. However, the findings, in our opinion, give an estimate of aggregate scales of the given phenomena and importance of the loss caused by them.

The obtained amounts of loss are some times less than the similar amounts presented according to the results of compatible research of Rusbrand companies (previously – Brand Protection Group) held in 1999 by *Deloit&Touch Company*. While putting aside probable divergences in calculation techniques we shall note that such reduction, in our opinion, reflects a general trend towards drastic decline in volumes of gray and black import and production of counterfeit output, which took shape in Russia in 2001-2002.

The stated amounts should be regarded as *minimum estimations*. It is due to a number of reasons.

1. We have much higher estimations of scales the phenomena under consideration in our disposal. For example, as regards fake production the estimates published by state trade inspections and Chamber of Commerce and Industry of Russia with respect to the same kinds of the goods and several trademarks exceed estimates of Rusbrand companies by an order (for example, it was reported that the share of counterfeit products constituted 30-60% while the estimates of the companies representatives did not go beyond 1-5%). The discrepancies may result from, on the one hand, the fact that trade inspections and outside experts use systematic biased sample. And on the other hand, the gap in the estimates may be caused by the fact that the trademarks owners prefer to underestimate scales of the given phenomenon in order not to cause probable damage to their own sales. We used estimates of the companies holding them as more adequate. However, in the present state of affairs they should be regarded as a minimal boundary.
2. The calculations did not account for some appertained losses. For example, when measuring the state budget loss the results of partial sales tax evasion were not taken into account since the wholesale companies did not immediately deal with discharge of such tax. Nevertheless, one should bear in mind that since Rusbrand companies output mostly is sold through store trading and output of gray dealers – through open markets the comparative shortage of tax payments occurs here, too. We value it at about additional \$2-3 million (minimum level).
3. Certain costs fell out of the calculations. For example, in case the company had not provided data on

direct costs on property rights infringements control we were not able to receive them from other sources.

General dynamics the phenomena under consideration

Volumes of *parallel importation* tend to decrease recently. Reduction Decline in gray and black import occurs as a result of toughening of the State Customs Committee's control over customs value fixing procedure that results in, in addition to other factors, increase of expenses of gray and black business schemes. In some cases gray import turns to more expensive product groups. We have also revealed a trend towards its reorientation from open markets to store trading.

Volumes of *counterfeit production* sales have been also reducing recently. In many respects it is due to persevering efforts of a number of leading companies-legal owners. At the same time the quality of imitations has been upgraded (especially, with respect to packing). Simultaneously the price gap between original and counterfeit products has decreased or completely disappeared that results in additional difficulties during identification of imitations.

General conclusion with respect to dynamics consists in the following:

1. In spite of positive dynamics the scales of loss as regards many commodity groups remain sizeable.
2. The downward trend of shady activity scales has non-linear character. The fluctuations connected with standstill and spree of such activity become apparent.
3. The situation varies in different commodity groups and in separate brands within one commodity group. Consequently, control toughening in one sphere may result in migration of gray dealers and counterfeit products traders from one market segment to another.
4. It is necessary to monitor permanently situation with the view to prevent and localize shady activity.

Objects of parallel import and fabrication

Most often the *objects of parallel imports* include the following sorts of goods:

- goods not imported by authorized dealers and not manufactured outside Russia,
- goods sold at discount in other countries,
- goods in great demand,
- relatively expensive but at the same time bulk commodities,
- goods not belonging to excise goods,
- nonperishable goods,

Объектами подделок чаще всего становятся следующие виды товаров:

Most often the *objects of fabrications* include the following sorts of goods:

- goods sold at the territory of Russia,
- goods in great demand,
- goods not connected with sophisticated fabrication and packing methods,
- goods not requiring unique or critical obligatory components.

Major problem areas

1. Maintenance of gray and black schemes in the sphere of customs registration (including, due to a great number of bonding points for the same goods).

2. Lack of activities coordination between custom authorities and trademarks owners (*inter alia* in handling intellectual property objects register).
3. Relatively low interest from of state controlling bodies, as a whole, in problems of intellectual property rights infringement (for example, as compared with fiscal interests).
4. Difficulties in revealing large dealers and manufacturers of counterfeit products and, sometimes, difficulties in termination of their activity, seizure and destruction of fabrications.
5. Inadequately effective regulation of trading activity in open markets, where the considerable or predominant part of non-certificated and counterfeit products are sold.
6. Overall tolerance of public opinion and consumers to intellectual property rights infringement.

Lines of activity towards reduction in scales of parallel imports and counterfeit products (corporate policy)

- Severance of companies connected with parallel imports from manufacturers of branded trademarks.
- More organic policy of discounts for goods sold in different countries.
- Diversification (including, advertised for sale in open markets).
- Establishment of official representations in Russia dealing with, among other things, the state issues.
- Organization of manufacturing of the given sorts of goods in Russia.
- Regular monitoring of the situation through own distributors and special researches, revealing of delivery channels of gray import and counterfeit products.
- Coordination of efforts for shady activity control between leading companies.
- Explanatory work in mass media aimed at disclosure of negative consequences for consumers, in whole, not referring any individual brands.

Lines of activity towards reduction in scales of parallel imports and counterfeit products (interaction with public authorities)

- Toughening of the legislation dealing with trademarks, including in connection with the future entry of Russia into WTO.
- Coordination of legislative instruments allowing to create precise uniform procedures for market participants and controlling bodies.
- Introduction and implementation of legislative regulation concerning destruction of counterfeit products.
- Closer coordination with state customs authorities, including, disclosure of information on contract prices and imported range; receiving of on-line information on all deliveries of the goods in question.
- Implementation of proposals concerning bonding of the given sort of goods in a limited number of customs terminals.
- Setting up of interdepartmental state body carrying out a coordinated policy in the field of intellectual property rights observance.
- Assistance to state regulatory and law-enforcement agencies in revealing and exclusion of gray dealers and counterfeit goods traders.

Gratitude

We would like to express our thank to all companies managers and representatives for effective cooperation. We express special gratitude to the companies, which have provided us with additional materials collected during their own researches or use of marketing firms data.

Confidentiality

The task group observes the accepted rules of confidentiality. All collected data concerning activity of specific firms are classified. Initial materials (interview recordings and completed questionnaires) are not subject to transfer and distribution. The data with respect to individual companies, surnames of respondents and firm names are not mentioned in working and final materials.

Responsibility for Basic Data

The conclusions contained herein are based on information received from the companies. We tried to verify these data by means of analysis of additional information concerning the markets under study. However GU-VShE team has not checked accuracy and authenticity of the initial data used herein and, consequently, bears no responsibility for the accuracy and completeness of this information.

Project Team

This project has been carried out by a research team of State University - Higher School of Economics employees consisted of:

1. Radaev V.V., Doctor of Economics (Project Director),
2. Barsukova S.Yu., Ph.D. in Economics.
3. Karacharovsky V.V.
4. Kotelnikova Z.V.
5. Nadezhdina E.V. (organizational and technical support)

State University - Higher School of Economics is a new dynamically developing university established by the Russian Federation Ministry of Economic Development and Trade and the Russian Federation Ministry of Education in 1992. Now it belongs to five leading Russian universities in sphere economic and social sciences. Besides, GU-VShE is widely known as a research center in the field of institutional economy and market analysis.