

The Cost of Counterfeit Consumer Goods in Russia

This report has been put together based on the findings of a study conducted this spring by Deloitte & Touche CIS for the Brand Protection Group, an informal association of manufacturers of well-known Russian and international goods.

Introduction

It is quite evident that as Russia aspires to join the World Trade Organization or gain PNTR status with the United States, the issue of protection of rights for the producers of branded goods is of paramount importance. We all recognize the problems with piracy in the software and entertainment industry. In this report we acknowledge the magnitude and broadening of this phenomenon to the areas of branded goods. Most of the manufacturers we interviewed in our survey indicate a significant percentage of the products in the market are fakes. From five participants the percentage was even reported to be as high as 60% at times. The counterfeiters of many of these products have sophisticated production, which also copies packaging to a high level of detail. This detail demands investment, which requires significant effort, organization and finances. Russia's weak rule of law and jurisdiction presents an opportunity for these organizations to prosper. The fact that these counterfeiters do not pay taxes is by itself a strong motivation for the Russian government to strengthen investigation and enforcement.

Findings of the Report

Presented below is the summary of our findings with respect to the estimated losses in terms of tax and other revenues resulting from production and sale of counterfeit consumer goods in Russia. The taxes we have considered are limited only to value-added tax, road tax, profits tax and customs duties. We have focused our research on a very limited number of goods - only twenty-two (22), belonging to the following categories:

| | | |
|-------------------|---------------|--------------------|
| Instant Coffee | Tea | Laundry Detergents |
| Cigarettes | Mineral water | Shampoo |
| Photographic film | Batteries | Razor blades |
| Adhesives | Toothbrushes | Luxury Items |

Based on our research, the estimated sales revenues lost by the twelve BPG companies in the study and the twenty-two branded items identified were **\$473 million**. The estimated losses to the Russian Federation in terms of tax and other revenues resulting from production and sale of these twenty-two counterfeit consumer goods was approximately **\$174 million** in 1999. This amount is also approximately just less than 1% of all tax collections in Russia in 1999.

What does this \$174 million of lost revenues to the Russian Federation represent? Let me provide a few comparisons. For example, this sum could support annually 1.5 million pensioners, or it could also provide 2.1 million students with their annual stipend or it could cover the cost of living and benefits for over 1 million orphans per year.

It is important to note the limited numbers of goods we studied and the limited number of companies represented in the study and the limited taxes included. The total retail market in Russia for these twelve categories noted is \$6 billion, or approximately 13% of total retail sales according to Goskomstat. Through our research we became aware of other significant products which are frequently counterfeited. Those products include vodka and other liquors, pharmaceutical products, and staples such as butter and milk. Furthermore, for some of the goods studied, not all-major producers of the product chose to participate in the study. Finally, we were only able within the scope of this study to estimate losses arising from VAT, road tax, profit tax and customs duties. Other taxes and social funds such as sales tax, property tax, advertising tax, personal income tax, unemployment fund, pension fund, social insurance fund and health insurance fund were not able to be calculated from the information presented to us. Therefore, \$174 million represents a lower limit and conservative estimate on the total losses to the Russian government. If these figures are extrapolated, lost sales of branded goods possibly run in the billions of dollars annually, and tax losses potentially in excess of one billion dollars.

Methodology

We have employed both surveys and focused interviews to arrive at our estimates. Using standardized surveys, we compared the market shares of Brand Protection Group participant companies as measured by market research firms to their actual sales. Through interviews, we were able to estimate the percentage of counterfeit goods, and ascertain how each company structured its distribution for each brand group investigated. This information allowed us to create an estimate of lost revenues to genuine producers and an estimate for the lost value throughout the distribution chain to the ultimate consumer.

We have used a number of tax assumptions to arrive at values for the losses to various levels of Russian government. The format of this report does not allow explaining in detail the tax methodologies, but where appropriate, conservative assumptions were

used for VAT, profits tax, and customs duties. For example, value added taxes are 20% on sales, but this amount is netted against input VAT. For those goods that are only imported, such as coffee and tea, effectively VAT paid by importers is non-recoverable. Therefore, for these products, we assumed that no VAT is being collected on counterfeit products.

As cigarettes are the only excisable brand group in the study, we have not included excise tax, as this would have breached the confidentiality of a participant in the study. However, we do note the overwhelming evidence suggesting that excise stamps for cigarettes are being frequently falsified.

Findings

For confidentiality reasons, we are not identifying lost sales or tax revenues by brand group.

| Loss Calculations | | |
|---|---------------------------------------|-------------------------------------|
| <i>For the year ended December 31, 1999</i> | | |
| <i>(in US Dollars and in millions)</i> | | |
| | Total lost Wholesale Sales | Total Lost State Revenue |
| Total | 473.0 | 174.2 |

| Distribution of Lost Taxes | | |
|---|---------------|--|
| <i>For the year ended December 31, 1999</i> | | |
| <i>(in US Dollars and in millions)</i> | | |
| Tax | Amount | Percent of 1999 Collections |
| Value-added tax | 94.6 | 1.1% |
| Road use tax | 11.8 | N/A |
| Profit tax | 19.4 | 0.6% |
| Customs | 48.4 | 2.5% |

Additional Commentary

All of the participants of the survey (with one exception) confirmed that the main distribution channel for the counterfeit goods is open markets. This does not appear to vary between Moscow and the regions. Also kiosks and small shops are of significant concern for the participants. These points of sale are considered to be another important distribution channel for counterfeit goods.

Many of the participants also confirmed that their exclusive distributors do not deal with counterfeit goods.

According to some of the companies, counterfeits may appear in the market in as little as two weeks after the new brand or packaging is introduced. In addition, the external appearance quality of the counterfeits is rapidly improving. For some brands it is virtually impossible for the consumer to distinguish between genuine and counterfeit product based on package appearance. As a result of improved appearance quality, counterfeit goods are generally priced near the price of genuine products at the retail level, though there were notable exceptions.

Many participants commented that counterfeit products are not often cleared through customs properly. For example, one participant stated that according to the State Customs Service, they were responsible for importing 82% of the total product in this group. In reality, they had an approximate 40% market share. Therefore, much of what was being imported was being misreported at customs, presumably to reduce customs duties. It was also noted and well recognized that the Chinese origin for counterfeit goods is assisted by the existence of a relatively permeable border.

Quality and product safety is a key concern when dealing with counterfeits. We were presented with evidence of coffee that contains almost no real coffee, laundry detergents that contain ordinary soap flakes, mineral water containing ordinary tap water, and adhesives containing toxic substances that can have narcotic side effects. It is the Russian consumer who is hurt by such products. The Russian consumer will have no recourse should he or she be harmed by a counterfeit product. The counterfeiter bears no legal responsibility, even if they were ever to be found.

Conclusions

Based on the size and scope of the problem, we believe the government of the Russian Federation should develop a consumer brand protection policy with the following characteristics:

- Utilize existing state product protection laws to apprehend and prosecute those manufacturing, importing, or trading in counterfeit products.
- Create a clear legislative framework to make counterfeiters accountable to the people who buy their “products”, just as genuine producers are.
- Encourage investment into distribution and retail, particularly those investments that would result in greater economies of scale and automation.
- Establish penalties including confiscation of all equipment and raw materials used in production, transportation and distribution of counterfeit products.

Disclaimer

The findings presented in this report are based on unaudited information. Wherever possible, we have sought support for the data provided to us by companies in the Brand Protection Group, market research firms, security companies and others we have interviewed. Deloitte & Touche has not audited or verified any of the information in this document and therefore makes no representation with respect to the accuracy or completeness of this information regarding the current or future position of performance of any of the companies of the Brand Protection Group.