FICCI CASCADE

ILLICIT MARKETS - A THREAT TO OUR NATIONAL INTERESTS

THE TOBACCO INDUSTRY

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ILLICIT MARKETS - A THREAT TO OUR NATIONAL INTERESTS

THE TOBACCO INDUSTRY

Foreword

Counterfeit, fake and smuggled goods are no longer just about luxury items. Today, almost all sorts of products are being copied and smuggled having serious implications. The existence of grey or illicit markets is a matter of serious concern for any economy, more so in India where rapid technological advancement and economic liberalization seem to have made it easier for a parallel economy to flourish out of tax evaded and counterfeit products.

FICCI has been at the forefront of advocating policy framework on various aspects affecting the industry. In 2012, a FICCI CASCADE study 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 sector specific reports on 'Illicit Markets - A Threat to Our National interests'. This report is specific to the tobacco industry and aims at updating the estimates of grey markets in this sector, projecting the resultant losses to the industry, Governments and further assessing its impact on tax arbitrage, terrorism, 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 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
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Executive Summary

The existence of grey or illicit 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 for a parallel economy to flourish out of tax evaded and counterfeit products.

In a 2012 FICCI CASCADE study titled "Socio-Economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Industry Sectors", the sales loss to industry and tax loss to the government due to the operation of the grey market in the tobacco industry was estimated for the years 2008 and 2010.

The present study, commissioned by FICCI CASCADE is aimed at not only updating these estimates but also expanding the scope to explore the relationship that grey markets have with tax arbitrage, terror funding, investment and innovation.

Illicit markets or goods include counterfeit, smuggled, tax evaded, knock offs etc., for which the government, society and legitimate industry pays the costs, both real and qualitative, to illegitimate players to the detriment of all stakeholders.

An accurate assessment of the real costs of counterfeiting, smuggled and tax evaded goods is vital to convincing decision-makers that strong action is necessary to curb the growth of the illicit markets. This study takes off from the earlier one, and sets out to ascertain the percentage of illicit markets in these sectors, using latest available government published data.

This report deals exclusively with the tobacco industry. The bidi segment, though a key component of the industry, has been kept out of the study as bidis are perceived to be less prone to factors that influence illicit markets and would therefore have not much impact on our conclusions.

Size of Illicit Market and Loss to Tobacco Industry and Government

The grey market in the tobacco industry has grown significantly since 2010. Our study estimates that it has grown from 15.7% in 2010 to 20.2% in 2012 - an increase of 28.7%. The consequent loss to the industry estimated for 2014 (based on discussions and consultations with industry experts) has increased in comparison with estimates made in the 2012 FICCI CASCADE study, from ₹ 8,965 crores to ₹ 13,130 crores.

The total loss to the government estimated for 2014, on account of the illicit markets in the tobacco industry is ₹ 9,139 crores, up from ₹ 6,239 crores in 2012. This loss is only on account of tax revenues - both direct and indirect taxes. We have not estimated the incremental costs incurred by government on account of welfare measures, enforcement and legislation and interest costs.

Impact of Inter-state Tax Arbitrage within India

Successive studies have postulated that high tax rates tend to exacerbate illicit markets by creating greater demand for cheap and counterfeit substitutes. A significant reason being, 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.

Tobacco and tobacco products are not only highly taxed, the tax structure is highly intense and dual in nature with both the central and state governments levying separate taxes - excise duty, value added tax and many others. These taxes add up to more than 50% of the selling price of the product. Besides, there are considerable differences in tax rates between states which open up opportunities for illegal cross-border trade.

Tax arbitrage can be defined as transactions that are designed to take advantage of differences between national tax systems to achieve double non-taxation.[1] Accordingly, cross-border tax arbitrage involves using differences between the tax rules of two jurisdictions to structure a transaction with the goal of securing tax benefits that would not exist had the structure occurred entirely domestically.[2]

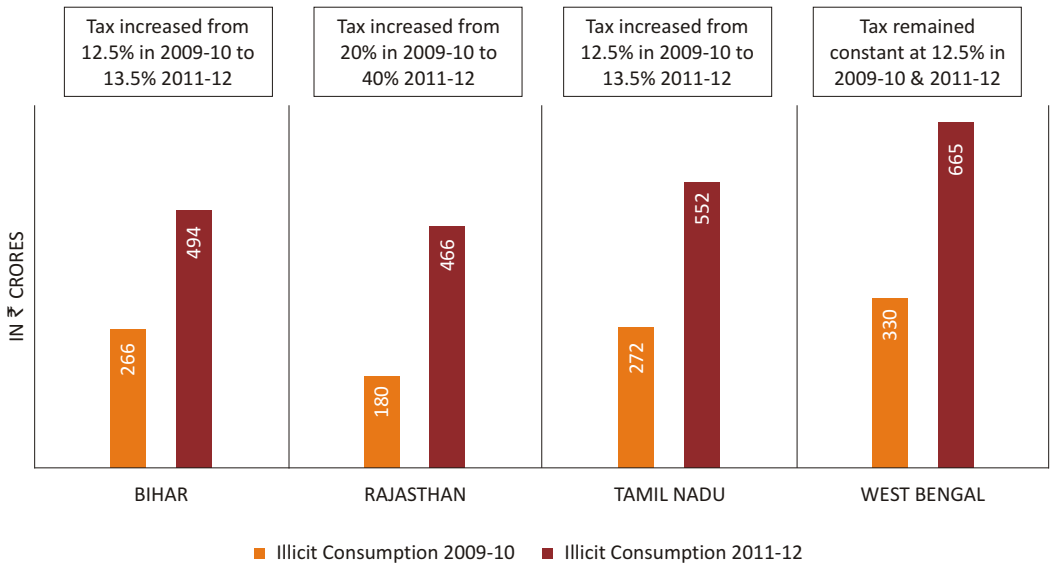
This section makes an attempt to establish these relations.

- **Effect of rising taxes on tobacco consumption**

A comparative study of changing tax rates (in some of the states with high tax rates) and illicit consumption between 2010 and 2012 provides an interesting result which is captured in the graph below.

CHANGING ILLICIT CONSUMPTION & TAX RATES

(EXCLUDING BIDIS)



The graph shows that illicit consumption increases with increase in tax rates in most states. The rise in taxes show a positive co-relation to the rise of illicit markets in the states that have higher taxes and lower tax collections after factoring the normative growth in consumption in these states. In such cases the legitimate industry gets significantly disadvantaged.

Increase in consumption can be attributed to increasing disposable incomes, changing demographics and urbanisation. In a recent report, Dun and Bradstreet[3] has estimated that expenses of the Indian consumer on food, beverages and tobacco, both rural and urban, will continue to increase for a foreseeable future and hence consumption will keep on rising.

This increase in prices has fuelled illegal markets at the cost of legal business and lower government collections. The ability of legitimate businesses to meet this growing demand is hampered due to stricter regulations and higher taxes, thereby resulting in growth of the illicit markets and given the demographics and growing income levels this will continue to be a heightened risk.

- **Effect of higher tax on revenue and illicit markets**

Our study shows that high and varying tax rates are leading to inter-state tax arbitrage in which the states with higher tax rates are losing revenue to those with lower tax rates.

This is best illustrated by Rajasthan where VAT on cigarettes increased from 40% in 2011-12 to 50% in 2012-13 and 65% in 2013-14. The impact on revenue collection is shown in the following table:

State ↓ / Year →	Tax Rates	Tax Collections (₹ crores)		%age change
	2013-14	2012-13	2013-14	
Rajasthan	65%	282	120	-58%
States in Rajasthan's Neighbourhood				
Madhya Pradesh	13%	187	243	30%
Uttar Pradesh	25%	345	459	33%
Delhi	20%	281	365	30%
Haryana	21%	158	230	45%

As the table shows, as tax rates on tobacco and tobacco products went up the revenue collection from the industry fell by 58% in 2013-14. At the same time, tax collections increased in neighbouring states with lower taxes – Madhya Pradesh, Uttar Pradesh, Delhi and Haryana. It appears that either consumers are sourcing their supply from the illicit markets and/or from neighbouring states with lower taxes.

Therefore, certain measures may be taken to counter the consequences of illicit markets, which include applying uniform rates for all types of tobacco products, streamlining of tax levies by implementing GST and improving overall enforcement.

The conclusions can be summed up as follows:

Assessment of inter-state tax arbitrage in the tobacco industry highlights that total consumption, either increases or remains constant even when there is an increase in taxes. Enhanced taxes lead to price increase, thereby lowering affordability levels of tobacco products. The illicit markets take advantage of this to bridge the demand-supply gap.

While both production and consumption of tobacco products is increasing, the gap between legitimate production and share of illicit markets is also increasing. Further, states with significantly higher taxes are losing revenues to neighbouring states with lower taxes, which are being fuelled by illegal players and often by organised criminals.

Studies have also held that raising taxes decreases consumption, though consumers, especially the poor tend to trade down to cheaper products. However, in case of growing disposable income and demographics having a younger population like in India, this increase in prices due to taxation and reduction in consumption is small and has very little effect on overall consumption and has not increased commensurate tax collections. However, when taxes are raised beyond a certain optimum level, consumers gravitate towards cheaper alternatives or towards cheaper illicit supplies, which are normally smuggled or tax evaded goods.

Illicit Markets, Terror Organisations and Criminal Networks

Illicit markets have grown across the world, not only costing the industry and governments dear but also promoting criminal enterprises and generating funds for terror activities. In Australia[4] for example, an assessment by the Australia Crime Commission states that organised crime groups perceive their involvement in Australia's illegal tobacco market as a low-risk-high-profit activity in which large profits can be made with minimal risk of detection or significant penalties. Organised crime has sustained access to cheap tobacco product overseas which can be illegally imported, avoiding tax obligations, to supply to the tobacco market in Australia. Minimal quantities of illegal tobacco are produced domestically.

The assessment further states that in 2011-12, the ACBPS (Australian Customs and Border Protection Service) detected and seized 46 sea cargo importations of illegal tobacco, comprising a combined 175 tonnes of tobacco and 122 million cigarettes with duty evaded on these estimated at 128 million Australian dollars.

A number of international studies have been conducted in the past which highlight the involvement of counterfeiting and piracy of tobacco products in financing terrorist activities. For example, a woman found to be a retailer of counterfeit cigarettes was arrested in an airport en route to Lebanon with $230,000 cash strapped to her body. While the reported reason for her trip was “vacation,” authorities believed her to be funnelling money to Hezbollah.[5] Several similar examples have been reported related to other illicit products as well.

The UK government in their Report of October 2014 estimated that they lose about 1.3 % of their total tax collection due to criminal networks, mainly from smuggling.

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 illicit trade and its corollary, terror and ensure that genuine business interests do not suffer.

Way forward

To counter the consequences of a high tax structure and curb smuggling and illicit production in the tobacco industry, the following measures may be evaluated by the government and other stakeholders:

- Bringing uniform taxes on all tobacco products, thereby increasing the tax base
- Streamlining state levies on tobacco through implementation of GST;

- Improving enforcement and governance. An appropriate structure with strong tax administration will facilitate better compliance and improve revenue collection and curb illicit markets; and
- Taking stringent measures to combat smuggling and evasion just as would be required for all other products and industries, which include effective recording, improved border security, implementing banking controls to counter money laundering, improved coordination amongst multiple agencies (finance, customs, excise, etc.).

In addition, an important means of curbing illicit trade of tobacco would be continued coordination and cooperation between various stakeholders. This includes:

- Strategic partnerships that may be developed between the manufacturers, local government, police, customs/excise/ commercial taxes departments, border patrols and healthcare organisations;
- Training enforcement agencies on how to detect counterfeit tobacco products;
- Continued intelligence sharing about manufacturing and transport of illicit tobacco products and manufacturing equipment;
- Identifying and keeping a close watch on areas where illicit trade takes place; and
- Increasing awareness on the consequences of illicit trade and consumption of illicit tobacco.

SUMMARY OF CONCLUSIONS

- The illicit market percentage in the tobacco industry (excluding bidis) has increased from 15.7% in 2010 to 20.20% in 2012.
- Loss to the industry has increased in 2014 in comparison with 2012 by approximately 35% - from ₹ 8,965 crores in 2012 to ₹ 13,130 crores in 2014.
- Loss to the government has increased from ₹ 6,239 in 2012 to ₹ 9,139 in 2014
- While consumption of tobacco and tobacco products is increasing, the legitimate production has been marginally growing and in the case of cigarettes have shown a decrease. The gap in demand is being met significantly by illicit products.
- The states with higher tax rates are losing revenue to those with lower tax rates.
- The industry and government need to make a concerted effort to curb growth of the illicit markets and reduce the related attendant costs. Government needs to keep in mind other considerations for fixing tax rates, such as uniformity of tax rates across states, uniform tax rates for both cigarette and non-cigarette products and improve governance.

To conclude, the quantum of loss due to the operation of the grey markets in this industry is high. The year on year increase is quite large affecting innovation and investments in the industry. Further, high and varying tax rates are resulting in inter-state tax arbitrage where one state with high taxes seems to be losing revenue to other states with lower taxes. Consumption in states with high taxes has also increased. It appears that the illicit market is a significant source of supply for consumers.

Both industry and government therefore need to make a concerted effort to curb the growth of the illicit markets and reduce the related costs.

Objective of the Study

In a 2012 FICCI-CASCADE study titled **"Socio-Economic Impact of Counterfeiting, Smuggling and Tax Evasion in Seven Key Indian Industry Sectors"** the sales loss to industry and tax loss to the government due to the operation of the grey market was estimated for the years 2008 and 2010. Two years have elapsed since then. As an accurate assessment of the real costs of counterfeiting, smuggled and tax evaded goods, is vital to convince decision-makers that strong action is necessary to curb the growth of grey markets this study takes off from there, and sets out to ascertain the percentage of grey markets as on date and its impact on or relations with other economic activities in the industry.

Grey market percentages are currently ascertainable for 2012, as reliable data from the Ministry of Statistics and Programme Implementation (MoSPI) of the Government of India is available for the year. This data includes the Annual Survey of Industries for 2012, which provides data on factory production across the country and National Sample Survey Organisation's National Sample Survey 68th round, which provides household consumption data across the country for the year 2012.

Loss to the industry in 2014 has then been ascertained by extrapolating the industry size determined for 2012 based on assumptions about the growth of the industry over 2013 and 2014. These assumptions have been obtained from industry sources 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 to arrive at the loss to the industry for 2014.

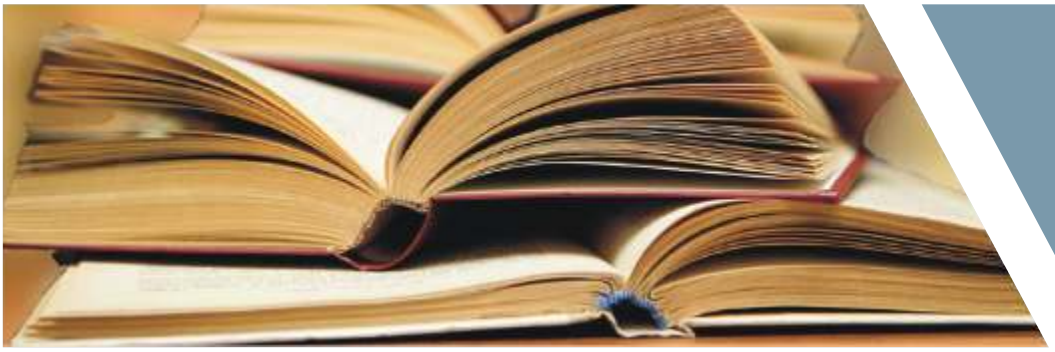
As indicated in several studies, including the 2012 FICCI CASCADE study, since counterfeiters operate outside the law, estimating the extent of counterfeiting and piracy and the harm these activities cause is extremely challenging. Illegal businesses do not report information on their activities to any government agency and, therefore, the measurement has to base on indirect methods.[6]

Industry Coverage

The present study estimates the grey market percentage in tobacco industry and quantifies related losses. It also assesses the relations that grey markets have with investment, innovation and tax arbitrage, as well as their impact on consumers. Bidis have been kept out of the study since they are perceived to be less prone to illicit markets and would therefore have insignificant impact on our conclusions.

The study relies on latest Government of India data on consumption and production, like NSS and ASI, 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, 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.

Tobacco Industry in India

Indian tobacco is appreciated world-wide for its rich, full-bodied flavour and smoothness and is found in cigarettes manufactured in many countries across the world.[7]

The tobacco industry contributes greatly to India's foreign exchange earnings and tax revenue. India Brand Equity Foundation (IBEF) says that tobacco makes a significant contribution to the national economy by earning about $ 900 million of foreign exchange and accruing $ 3.4 billion to the central exchequer by way of excise levies on manufactured tobacco.[8]

According to Central Tobacco Research Institute (CTRI), India is the second largest tobacco producer and exporter in the world after China.[9] As per an industry body report of 2014,the industry employs nearly 38 million people who are engaged in various processes of tobacco cultivation, curing, grading, manufacturing and marketing.[10] As per CTRI, 10 distinct types of tobacco are grown in 15 states of the country, which include cigarette (FCV, burley, Oriental) and non-cigarette types (bidi, chewing, hookah, natu, cheroot, cigar and HDBRG).

The Tobacco Board was set up under the Tobacco Board Act of 1975 to take care of planned development of the industry. It is set up under the Department of Commerce, of the Ministry of Commerce and Industry of India. The primary function of the Board is export promotion of all varieties of tobacco and its allied products. Its functions extend to production, distribution (for domestic consumption and exports) and export promotion of Flue Cured Virginia (FCV) tobacco. It monitors domestic and international markets, runs auction platforms for sale of Virginia tobacco by registered growers, recommends minimum prices for exportable Virginia tobacco, regulates its marketing, besides sponsoring and assisting scientific, technological and economic research in tobacco and tobacco products for promotion of the industry.

Structure of the Industry

The main types of tobacco grown in India are:

- Flue Cured Virginia (FCV), grown primarily in Andhra Pradesh and Karnataka;
- Burley & Oriental;
- Suncured Country, Fire Cured Kentucky and Bidi of different varieties grown in Andhra Pradesh, Telangana, Gujarat, Maharashtra and Karnataka;
- Cigar varieties; and
- Chewing Tobacco grown in Anand area of Gujarat.

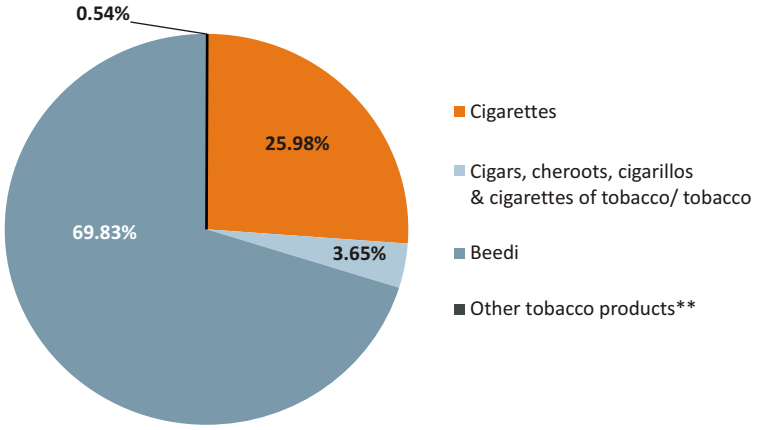
India is the second largest exporter of FCV tobacco in the world, exporting to more than 100 countries. According to the Tobacco Board, India exported 264,384 ton of tobacco and tobacco products in 2013-14. The top export destinations for tobacco products in this period were:

Commodity	Top Export Destinations (by quantity)
Cigarettes	Belize, Singapore, Saudi Arabia, Panama, Jordan, the UAE, the US, Libya and Kuwait
Cut tobacco	The UAE, Yemen, Cyprus, Cambodia, Azerbaijan, Ukraine, S. Korea and Colombia
Chewing tobacco	The UAE, Afghanistan, Saudi Arabia, Malaysia, Nepal, the US, Bahrain and Yemen
Hookah tobacco paste	Saudi Arabia, Tunisia, South Africa, Brazil, Egypt, the UAE, Yemen, Iran and the UK
Bidis	The UAE, Afghanistan, Singapore, Iran Bahamas, Trinidad & Tobago and the US
Snuff	China, the UAE, Afghanistan and The UK

Source: Tobacco Board

As per latest data from the Annual Survey of Industries (ASI-2012), bidis are the largest product manufactured in the industry (in terms of quantity). Refer chart below:

Production * of Tobacco Products 2012 (Quantity)
(including beedis)

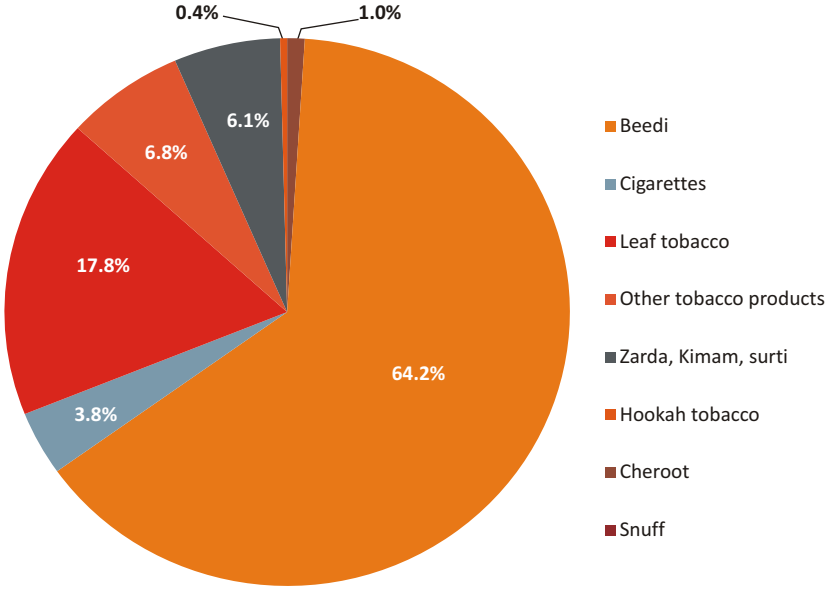


**Other tobacco products comprise chewing tobacco(processed and unprocessed, hookah tobacco, betel nuts)
*based on ASI 2012

About 94% of the production in 2012 came from 9 states - Uttar Pradesh, Karnataka, Maharashtra, Andhra Pradesh, Bihar, Delhi, West Bengal, Gujarat and Assam.

Consumption of tobacco products by quantity is provided in the chart below.

Consumption * of Tobacco Products 2012 Quantity
(including beedis)



*based on National Sample Survey data 2012

12 states contributed approximately 84% of the total consumption, as per the National Sample Survey (68th round, 2012). The high consumption states are: Andhra Pradesh, Maharashtra, Uttar Pradesh, West Bengal, Tamil Nadu, Kerala, Bihar, Rajasthan, Karnataka, Gujarat and Madhya Pradesh.

Since production provided by ASI pertains only to output of registered factories, and consumption of bidis, available from NSS, is largely sourced from unregistered and/or illegitimate units, production and consumption presented in the two charts above are not comparable.

Strengths & Weaknesses of the Industry

Considering the significance of tobacco as an agricultural product in India, it is important to analyse the drivers of growth of the industry as well as the related threats and weaknesses it faces. Some of these are listed below.

Growth Drivers and Strengths:

- Increasing disposable income of the population;
- Huge growth potential in the cigar market;
- Continuing export potential of tobacco and tobacco products;
- Advantages for Flue Cured Tobacco(FCV) listed in the Tobacco Board brochure include:
  - Low pesticide residues and heavy metals;
  - Low or negligible TSNA (tobacco specific nitrosamines) levels;
  - Availability of a range of tobaccos at competitive prices; and
  - Consistent volumes and supplies.

Challenges faced by the Industry:

- High taxes and VAT rates which vary from state to state (refer section "Impact of Inter-state Tax Arbitrage);
- Ban on advertising affects sales;
- Warnings on packs;
- Short-films prior to movie shows, warnings displayed in television and movie shows that smoking kills and is injurious to health;
- Growing public concern regarding health implications of consuming tobacco products;
- Ban on smoking in public places since 2008; and
- Competition from international brands like Marlboro, Dunhill, Davidoff, Camel etc.
- Growing and continuing threat from illicit markets including smuggled and tax evaded products.

Illicit Markets in the Tobacco Industry

According to a 2008 OECD survey,[11] trademark infringement was found to be the most common form of counterfeiting in the tobacco industry. The illicit markets have two elements:

- Counterfeit or fake products produced at low cost, designed and affixed with a legitimate brand/logo closely resembling the original brands; and
- Legitimately produced cigarettes that are smuggled across state or international borders without paying the tax.

Each of these has an impact on stakeholders, the former in the form of health hazards to the consumers and the latter resulting in tax losses to governments, and revenue and profit losses to the manufacturer.

Factors Driving Illicit Tobacco and Tobacco products

The illicit markets, like legitimate trade, are driven by the demand and supply of products. Tax evaded products tend to be less heavy on the consumer pocket building up demand, which is met by producers and traders who take advantage of high profits and lax monitoring.

The 2008 OECD survey mentioned earlier, lists some of the specific factors that drive production and consumption of illicit tobacco products:

Producers or suppliers of illicit products:

For the producer/manufacturer the main drivers of production are:

- High profit margins by evading high taxes (excise and VAT) imposed on tobacco products.
- Potential market size: The Global Adult Tobacco Survey (GATS) of India, 2009-10, found 34.6% using tobacco products in some form (47.9% males and 20.3% females). The term adult is defined as the population in the age group of 15 years and above. The survey was conducted by the Institute of Population Sciences, Mumbai, on behalf of the Ministry of Health and Family Welfare, Government of India.

For the Consumers of illicit products:

- Low prices are always a key driver for purchase of counterfeit or smuggled tobacco products.
- Lack of awareness and ability to distinguish between a legitimate product and a fake despite differences in tastes, due to the near perfect resemblance between the two.

Size of the Illicit Market in the Tobacco Industry

Methodology

In order to calculate the grey market percentage for 2011-12, the gap between the supply and demand need to be derived. For ascertaining the supply and demand we have to determine the different kinds of products that have to be considered under the industry category. These products have been identified through literature reviews, consultation with FICCI-CASCADE members and industry representatives. They remain the same as in the 2012 FICCI CASCADE study.

Data Sources

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). This has been supplemented with data from the Directorate General of Commercial Intelligence and Statistics (DGCIS) under the Ministry of Commerce and Industries and 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 Annual Survey of Industries (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 in the following table.

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 digits) to determine the product classification.

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 sectors concerned. Additional NPCMS codes identified post mapping with ASICC codes have been further deciphered to allocate to the industry sectors 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 10 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 crores and medium enterprises are those which have investment values between ₹ 5 crores to ₹ 10 crores.

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.

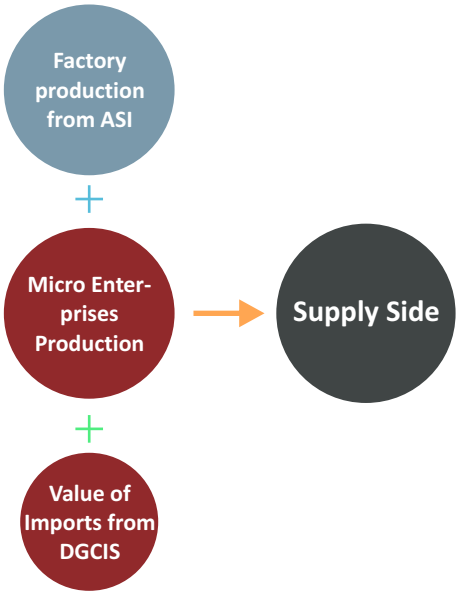
Out of the total 24.01 lakh units surveyed in 2006-2007 as a part of the MSME Census, only 22.48 lakhs were found relevant to MSME of which 15.64 lakh units were found working, 4.96 lakh units were closed and 1.88 lakh units were not traceable. The survey results give details of

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 sectors 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 the 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 8-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. It is not possible to map NPCMS and 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 National Sample Survey (NSS) 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, 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, subsample code, consumption value, multiplier, weight to be applied, NSS/NSC code.

Estimating the Illicit Markets-Methodology

Using the data obtained from the sources listed in the previous section, we have ascertained the grey market percentage in 2012 in the tobacco industry using the following formula:

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

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

- Goods produced or imported and sold in the country by evading taxes.
- Sale of domestically produced illicit goods.

Tobacco: Data Analytics

Indian tobacco is today appreciated worldwide for its rich, full-bodied flavour and smoothness. It is now an increasingly well-known and well-respected commodity in world tobacco markets and has found its way into cigarettes manufactured in many different countries. In India it contributes significantly to the national economy in terms of foreign exchange and excise duties levied on manufactured tobacco.[12]

The cigarette industry in India is highly tax intensive with excise duty levied by the Central Government and VAT levies of States. Increasing taxes are one of the significant reasons for the lucrative illicit tobacco market which includes genuine and counterfeit products.

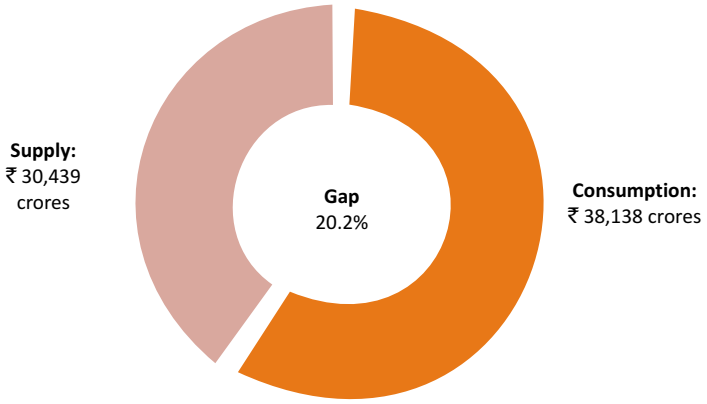
The Indian tobacco industry is divided into three distinct sectors: bidis (smoking products hand-rolled in tendu leaves), smokeless tobacco (mainly chewing tobacco) and cigarettes.[13]

According to a Euro monitor report illicit trade consists of domestic duty non paid, contraband and counterfeit products. The increase in VAT rates in most states reduced legitimate cigarette sales. The domestic duty non-paid and smuggled, lower priced cigarettes from countries such as China, Myanmar, Nepal, Bangladesh, Indonesia and Pakistan are posing a great threat to cigarettes in the country. Illicit trade is an inevitable threat to legal tobacco sales unless concrete steps are introduced by the government to curtail the phenomenon.[14]

For determining the size of grey markets in this study, tobacco consumption has been extracted from NSS 68th round data which comprises 7 codes related to the product, viz 311 (cigarettes), 312 (leaf tobacco), 313 (snuff), 314 (hookah tobacco), 315 (cheroot), 316 (zarda, kimam, surti etc.) and 317 (other tobacco products).

The total domestic consumption in 2012 under all the NSS codes is ₹ 38,138 crores.

Tobacco Supply vs Consumption Gap 2012



Total supply of tobacco comprises:

Domestic Factory Production: ASI 2012 production data has 12 NPCMS codes representing various kinds of tobacco including graded tobacco, smoking tobacco, hookah tobacco, cigarettes, cheroots, cigars, cigarellos, etc. The total value of these products is ₹ 30,160 crores.

Imports: Total value of imports of tobacco for 2012 is ₹ 97 crores, according to DGCIS data.

Production of micro enterprises: To the above numbers have been added the production of tobacco by registered micro enterprises, which is not covered in ASI data. In the previous report

it has been determined, through analysis of MSME data and discussions with industry experts, that most such units are engaged in the production of bidis. Bidi production accounts for 80-85% of the total production of micro enterprises. Thus on a conservative basis, for this study we have excluded bidi production, and attributed 20% of micro-enterprise production to other tobacco products.

The sum of these categories gives a total supply of ₹ 30,439 crores.

The gap between consumption (₹38,138 crores) and supply (₹ 30,439 crores) works out to be ₹ 7,699 crores. The size of grey market in the tobacco industry thus works out to be 20.2%.

Summary

Based on the analysis of reliable data published by the government sources for the year 2011-12, it has been established that illicit trade exists in all industry segments, which may be in the form of sale of counterfeited products, smuggled goods, or tax evaded goods. The results of the analysis are summarised below:

(in ₹ crores except where stated otherwise)

Industry	2012		Grey Market		
	Total Supply*	Total Consumption*	2012		2010
			Total Loss	%age	%age
Tobacco	30,439	38,138	7,699	20.2%	15.7%

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

The tobacco industry has shown a significant increase in the grey market percentage in 2012 vis-à-vis 2010, an increase of 28.7%.

Impact of Illicit Market: Estimating Loss to the Tobacco Industry

Grey market percentages have been established for the year 2011-12. For the purpose of arriving at the loss to the industry in 2013-14, we have assumed that the grey market percentage will remain constant over 2012-13 and 2013-14. Industry size for 2013-14 has been arrived at as per estimates provided by Tobacco Institute of India and application of expected and actual growth rates obtained from industry reports or analysts. These growth rates have been used to extrapolate the industry size established for 2011-12 to 2013-14.

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

***Estimated Loss of Sales to Industry** = Size of Industry in 2013-14 X Grey Market Percentage (2011-12)*

Estimating the Loss for 2013-14

As per industry sources the Indian tobacco industry market is estimated to have grown to approximately ₹ 65,000 crores in 2014.

According to Data Monitor, the market in India was estimated to be worth around $13.5bn in 2009, growing at a compound annual growth rate (CAGR) of 8.5% during 2004-09.[15] Cigarettes form the largest component of the tobacco industry. Major domestic players have shown a growth ranging from 12% to 15% during 2012-13 to 2013-14.

Based on industry projections therefore, we have ascertained the loss to industry in 2014. Applying the grey market percentage calculated for the industry (i.e. 20.2 % determined in the previous section) to the market size of ₹ 65,000 crores, **the loss to the industry for 2013-14 is estimated to be approximately ₹ 13,130 crores.**

Fig: Estimated Loss to Tobacco Industry in 2013-14

Estimated Size of Industry in 2013-14 X Grey Market Percentage (2011-12) = Estimated Loss of Sales to Industry

₹ 65,000 crores X 20.2% = ₹ 13,130 crores

The estimated loss to the tobacco industry for 2014 and 2012 (ascertained in the 2012 FICCI-CASCADE study) is tabulated below:

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

Industry Sector	2014	2012
Tobacco	13,130	8,965

The loss has increased significantly, by approximately 46% in comparison with previous estimates. Obviously the illicit markets pose serious challenges to various stakeholders. The governments lose tax revenues, industries lose sales revenues, and customers knowingly or unknowingly lose out due to low quality products which could often lead to hazardous health and safety consequences.

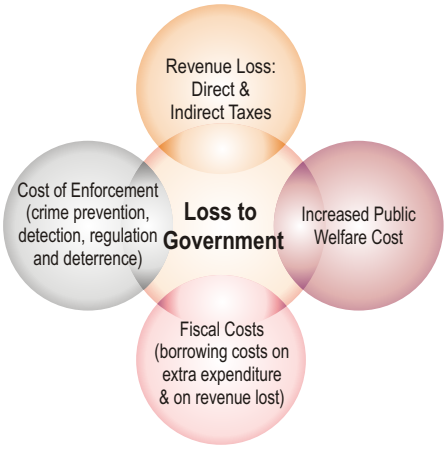
While completely eliminating the existence of illicit markets may not be a feasible proposition more rigorous efforts need to be made to limit further growth. This would include, among other things, cooperation amongst various stakeholders, streamlining of high tax structures, introduction and/or enforcement of standard quality parameters for various products, stringent governance practices and enforcement of existing laws.

Estimating Illicit Markets - Loss to Government

Apart for 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.

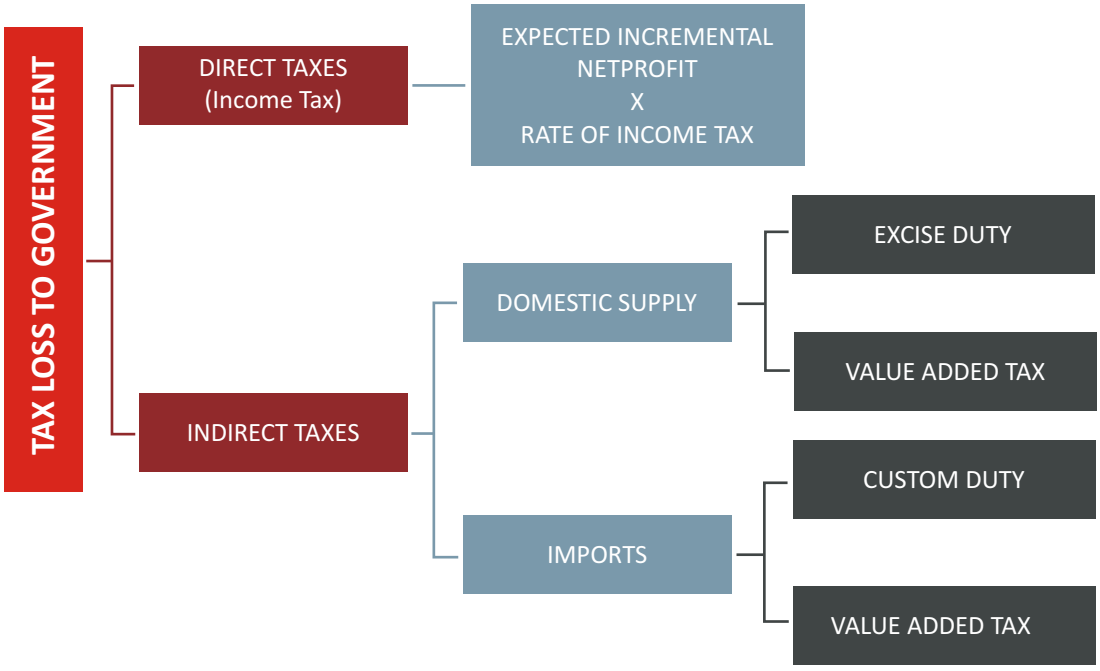
Governments that lose taxes will find it difficult to function and will be unable to provide quality and timely public services. They will be unable to deliver their legislative programmes, provide public goods or redistribute wealth.

This section aims to estimate the loss to the government of India on account of the illicit markets in the tobacco 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 illicit trade and the losses to public revenues and employment. 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/ 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 Tobacco 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 tobacco industry is tabulated below:

Loss of Direct Tax Revenue to Government (₹ Crores)

Industry Sector	Net Profitability Percentage	2014	2012	Change	
				₹ crores	%age
Tobacco	29.1	1,261	860	401	47%

Indirect Taxes (On Domestic Manufacture and Imports):

Loss of indirect taxes to the government on account of illicit markets will now 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 account of 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 tobacco 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
Tobacco	13,130	13,088	42	60	60

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.

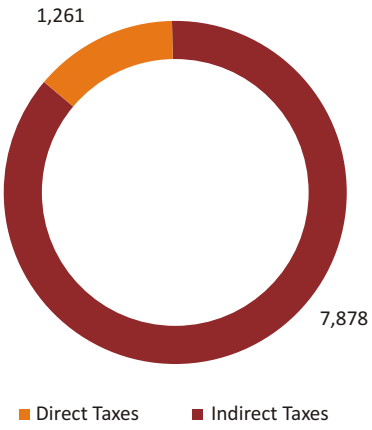
Loss of Indirect Tax Revenue to Government (₹ Crores)

Industry Sector	Excise Duty + VAT	Import Duty + VAT	Total Indirect Taxes Loss - 2014	Total Indirect Taxes Loss - 2012	Change	
					₹ crores	%age
Tobacco	7,853	25	7,878	5,379	2,499	46%

Conclusion:

Thus, the total loss to the government estimated for 2014, on account of the illicit markets in the tobacco industry is ₹ 9,139 crores, up from ₹ 6,239 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
Tabacco
(in ₹ crores)



Impact of Inter-state Tax Arbitrage within India

(Analysis excludes bidis as in rest of the report, except where specified otherwise)

It is often claimed that higher tax rates tend to exacerbate the illicit markets. The reason being, 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. Inter-state tax arbitrage is a challenge for all the states, as one state loses tax revenue to another due to the variation in tax rates and systems as well as operation of illicit markets. This enables consumers to limit their tax obligations and counterfeiters to avoid payment of taxes through sales of 'tax-evaded' goods.

At the global level, various studies have defined the concept of tax arbitrage.

According to a law and economics working paper of the University of Michigan (2007), tax arbitrage can be defined as transactions that are designed to take advantage of differences between national tax systems to achieve double non-taxation.[17] Accordingly, cross-border tax arbitrage involves using differences between the tax rules of two jurisdictions to structure a transaction with the goal of securing tax benefits that would not exist had the structure occurred entirely domestically.[18] Increasing globalisation and the operation of businesses in multiple jurisdictions opens up these opportunities for tax evaders and illicit marketers.

In taking advantage of differing tax regimes, tax payers would obviously seek jurisdictions where the lower tax structures and systems are beneficial to them. The Australasian Tax Teachers' Association study[19] states that 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.

According to a 2007 OECD report, "The Economic Impact of Counterfeiting and Piracy", the revenue losses (to governments) are particularly high in sectors such as tobacco and alcoholic

beverages, where excise taxes are high and smuggling of counterfeit products to avoid those taxes is widespread.[20]

An earlier OECD study (1998) stated that a further direct loss for the government of countries that become havens for counterfeiters, are tax losses, since the counterfeits are normally sold through clandestine channels and counterfeiters are not generally keen to pay tax on their ill-gotten gains. Fiscal losses are increasingly shown to justify action by enforcement officials.[21]

All these definitions and studies support the fact that tax payers and/or counterfeiters are prone to avoiding taxes in high tax regimes thereby turning to jurisdictions with lower taxes - the loss of one jurisdiction being the gain for another.

Tax arbitrage, therefore, increases costs for governments due to reduced revenues. Accordingly, greater cooperation within the international community is also an imperative to limit these.

Studies have also held that raising taxes decreases consumption, though consumers also tend to trade down especially the poor. However, when taxes are raised beyond a certain optimum level, consumers gravitate towards cheaper alternatives or towards cheaper illicit supplies, which are normally smuggled or tax evaded.

Taxes on Tobacco and Tobacco products

Taxes on tobacco products in India are high and attract multiple incidences, varying from product to product and state to state.

The Central Government imposes central excise duty on manufacture of different tobacco products. In addition, there is a special excise duty, a surcharge towards the National Calamity Contingency Fund and additional excise duty by way of a surcharge on pan masala and specified tobacco products to finance the National Rural Health Mission.

Tobacco products contribute significantly to central excise collections (approximately 13% in 2011-12),which is the reference period of this report and as indicated below, cigarettes alone contribute approximately 71% of the total excise duty collection from tobacco products. In 2013-14 it increased to 85%.

S. No.	Products	Excise duty collected (in ₹ crores)	
		2011-12*	2013-14**
1	Cigarettes	10,454	15,225
2	Chewing tobacco	1,074	1,301
3	Bidis	377	486
4	Others including Gutkha	2,899	820
	Total	**14,804**	**17,832**

**Provisional collection data for financial year 2011-12 up to January 2012. Total excise duty collection during this period being ₹ 114,046 crores.[22]*

*** Source: Ministry of Finance*

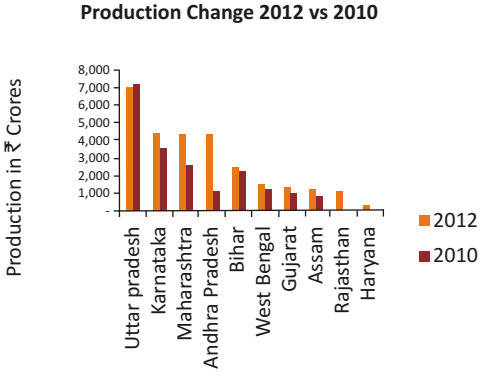
The 2014-15 budget also increased basic excise duty from 12% to 16% on pan masala, from 50% to 55% on unmanufactured tobacco and from 60% to 70% on zarda scented tobacco, gutkha and chewing tobacco. Duty has been increased by 11-21% for regular length cigarettes, while for smaller sized cigarettes of 64mm length the duty has been increased by 72%.[23]

In addition, the state governments levy value added tax (VAT) on tobacco and tobacco products. Bidis and bidi leaves enjoy the lowest rates of VAT - either exempt or often at 4% or 5%. State taxes on other tobacco products zarda, chewing tobacco etc., are comparatively much higher with cigarettes attracting the highest rates. In the case of other industries VAT stood mostly at 4% or 5% for concessional rate goods and 12.5% to 16.5% for other goods. The table below shows the range of VAT rates levied by states (other than bidi and bidi leaves).

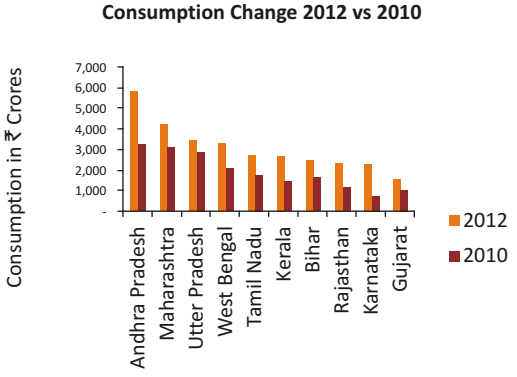
VAT Rates for Tobacco (last available on respective state websites and industry sources)	
Slab Rate	Number of States
>50%	1
>30% ≤50%	5
>15% ≤30%	23
≤15%	6
	35

Increasing Production and its Comparison with Consumption

ASI data presented in the chart below, shows that production of tobacco has increased in 2012 vis-à-vis 2010. Except for Uttar Pradesh (the largest tobacco producer in 2012), all other states reflect increase in production. Similarly, NSSO data shows that consumption of tobacco has gone up across the states.



Top 10 2012 producers



Top 10 2012 Consumers

India, is a large exporter of tobacco and ranks amongst the largest in the world. Despite this, total consumption exceeds total production of all states and union territories put together. The unmet demand is satisfied by the illicit market, smuggled goods or goods illegally transferred from one state to another or across borders or tax evaded goods. This creates a present and clear danger for India as organised crime and terrorist organisations take control of the supply chain of such trade and create unmitigated risks for the society and country.

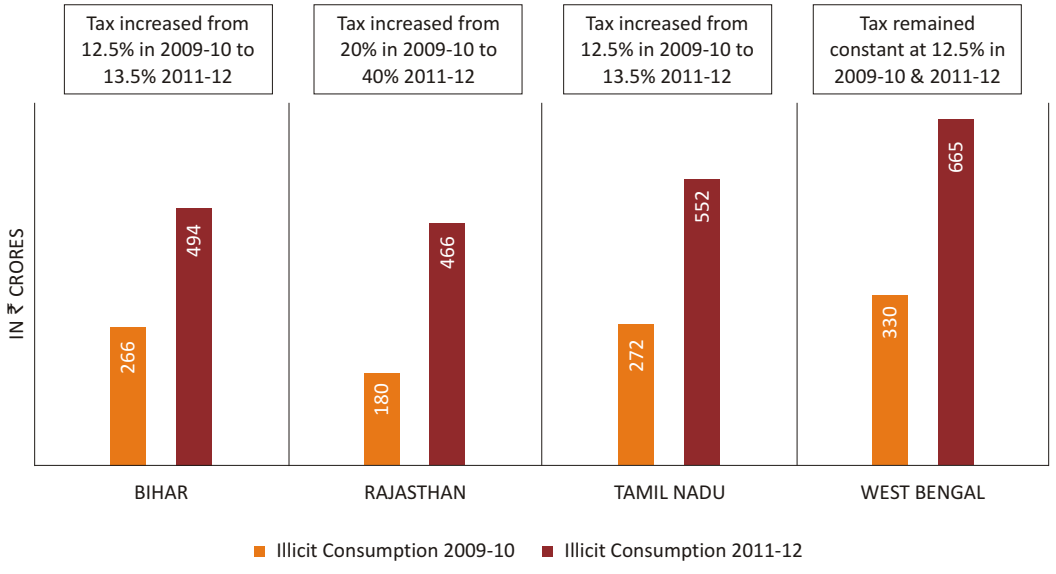
Taxes on tobacco and its effect on consumption

States have been increasing VAT levies over the past few years. However data suggests that in spite of increases ***in tax, consumption has increased in some states or has remained more or less constant in others.***

The study analysed the impact of increasing rates of VAT on consumption in states with the highest VAT rates. VAT rates of Bihar, Rajasthan, Tamil Nadu and West Bengal were determined for the past 5 years (2007-08 to 2011-12). In 2007-08, these states had the same VAT rate, that is, 12.5%. In 2009-10 Maharashtra and Rajasthan increased it to 20%. The rate increased marginally in Bihar in 2011-12 to 13.5%. In the same year it increased to 20% in Tamil Nadu, and in Rajasthan it jumped from 20% to 40%.

Changing tax rates were compared with illicit consumption for 2010 and 2012 provided by NSS's 66th (2010) and 68th (2012) rounds. The result is shown in the graph below:

CHANGING ILLICIT CONSUMPTION & TAX RATES
(EXCLUDING BIDIS)



This increase in consumption has fuelled illegal markets and needs attention as the ability of legitimate businesses for this growing demand is hampered due to stricter regulations and hence, the illegal markets given this situation will continue to rise in future.

The increase in consumption can be attributed to increasing disposable incomes, changing demographics and urbanisation. In a recent report, Dun and Bradstreet[24] has estimated that expenses of the Indian consumer on food, beverages and tobacco, both rural and urban, will continue to increase for a foreseeable future and hence consumption will keep on rising.

The data shows that while in most states tax rates increased only marginally or remained static, consumption and tax collections have increased, significantly in some cases. The increase, however, is not at the same rate and with no clear pattern.

Rajasthan is also one of the states where consumption exceeds production. If consumption had been sourced through the legitimate market, tax collection and cigarette consumption would follow a similar pattern. This is obviously not the case with Rajasthan, where it appears that the illicit market (counterfeit or tax evaded cigarettes imported from other states) is a significant source of supply for consumers.

We also notice that high and varying tax rates are resulting in inter-state tax arbitrage where one state with high taxes seems to be losing revenue to other states with lower taxes. This can be reasonably illustrated in the case of Rajasthan, where VAT on cigarettes increased from 40% in 2011-12 to 50% in 2012-13 and 65% in 2013-14.

Consumption has significantly increased in Rajasthan (during 2007-08 to 2011-12) while state tax collections have actually fallen in 2013-14 by 58%. Collections have increased in neighbouring states with much lower taxes. It appears, therefore, that either the consumers are sourcing their supply from the illicit markets and/or from neighbouring states with low taxes.

To conclude, it is reasonably evident from these comparisons that taxes and their increase or decrease, do not have a significant impact on consumption of tobacco because of larger disposable incomes and the gap in demand is met by illicit markets. Based on the data provided above, this appears true for all forms of tobacco. The difference in tax rates is also leading to tax arbitrage in which the state with a higher tax rate is losing revenue to those with lower tax rates.

High tax rates such as that prevalent in India, in fact, tend to have contrary consequences. These include:[25]

Increased consumption: Consumers either resort to smuggled and tax evaded cigarettes or counterfeits. Alternatively, consumption of other cheaper tobacco alternatives may increase.

Enforcement: A multiple tax structure makes enforcement and compliance difficult, resulting in tax evasion and increased corruption. Increased corruption entails smuggling and penetration of the counterfeit market, which has other adverse effects on consumers.

Revenue stream: An intense and multiple tax structure leads to a less predictable revenue stream for the government.

Impact on Stakeholders

Like in any other illicit market, trading in illicit tobacco and tobacco products deprives manufacturers of revenue, retailers of genuine sales, governments of large amounts of taxes and consumers of high quality products which could also be detrimental to health.

Counterfeit tobacco products are usually made in violation of government set standards using sub-standard raw materials that contain higher levels of tar, nicotine, carbon monoxide, lead, cadmium and arsenic. They may also be stored in unhygienic conditions. Studies have indicated that larger than normal quantities of carcinogens are delivered to the lungs when smoking counterfeit cigarettes. Consuming tobacco and tobacco products is already widely considered (with a lot of research on the subject) to be a health hazard, consuming such counterfeit products therefore obviously increases the health risks involved.

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.[26]

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.[27] 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 illicit markets 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.

For instance, in Australia,[28] according to an assessment by the Australia Crime Commission, involvement in Australia's illegal tobacco market is perceived by organised crime groups as a low risk, high profit activity in which large profits can be made with minimal risk detection or significant penalties. Organised crime has sustained access to cheap tobacco product overseas which can be illegally imported, avoiding tax obligations to the supply the tobacco market in Australia. Minimal quantities of illegal tobacco are produced domestically. The assessment further states that in 2011-12 the ACBPS Australian Customs and Border Protection Service) detected and seize 46 sea cargo importations of illegal tobacco, comprising a combined 175 tonnes of tobacco and 122 million cigarettes with duty evaded on these estimated at 128 million Australian dollars.

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, a woman found to be a retailer of counterfeit cigarettes was arrested in an airport en route to Lebanon with USD 230,000 cash strapped to her body. While the reported reason for her trip was "vacation," authorities believed her to be funnelling money to Hezbollah.[29] Several similar examples have been reported related to other illicit products as well.

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.

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 illicit trade and its corollary, terror and ensure that genuine business interests do not suffer.

Conclusion

The grey market percentage in the tobacco industry (excluding bidis) has increased from 15.7% in 2010 to 20.20% in 2012. Its loss has increased from ₹ 8,965 crores in 2012 to ₹ 13,130 crores in 2014, a rise of approximately 46%. The resultant loss to the government in the form of tax revenues is ₹ 9,139 crores.

With regard to taxation, contrary to belief and claims, analysis of consumption patterns of cigarettes and other tobacco products shows that it either remains constant or increases even when there is an increase in taxes. This gap is normally met by illicit markets, whether smuggled, tax evaded or otherwise illegally supplied or by product substitution by cheaper and more harmful products. The government's aim to reduce consumption of tobacco by increasing taxes is, therefore, being defeated. In fact, the high and varying tax rates are resulting in inter-state tax arbitrage where one state with high taxes seems to be losing revenue to other states with lower taxes.

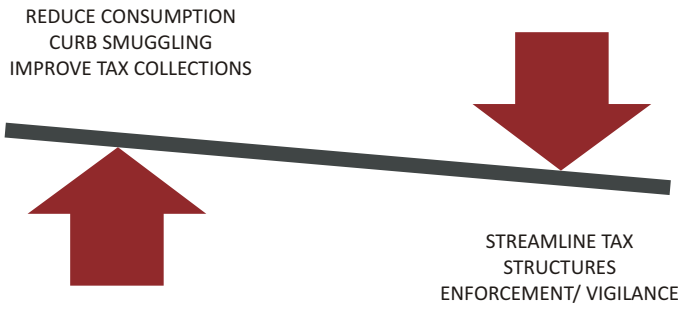
The grey market was earlier projected at 15.7% of the industry (based on NSSO and ASI 2010 data).[30] In 2012, this market is estimated to have grown to 20.2%, representing an enormous increase in an industry in which consumption is intended to be curbed for health reasons.

To counter the consequences of high and multiple incidence of tax resulting in smuggling and illicit production, the following measures may be taken:

- Bring appropriate taxes on all tobacco products thereby increasing the tax base
- Streamlining state levies on tobacco through implementation of GST;
- Improve enforcement and governance. A simplified structure with strong tax administration will facilitate better compliance with overall positive results on collections and curbing of illicit markets; and
- Stringent measures may be adopted to combat smuggling and evasion just as would be required for all other products and industries; these include effective recording, improved border security, implementing banking controls to counter money laundering, improved coordinating amongst multiple agencies (finance, customs, excise, etc.).

Imposing appropriate rate of tax across all products, across all states and improved enforcement and vigilance will help to:

- Curb smuggling and illicit markets;
- Increasing tax revenues for the state.



In addition, an important means of curbing the illicit trade of tobacco would be continued coordination and cooperation between various stakeholders. This includes:

- Strategic partnerships that may be developed between the manufacturers, local government, police, customs/excise/ commercial taxes departments, border patrols and healthcare organisations.
- Training enforcement agencies on how to detect counterfeit tobacco products.
- Continued intelligence sharing about manufacturing and transport of illicit tobacco products and manufacturing equipment.
- Identifying and keeping a close watch on areas where illicit trade takes place.
- Increasing awareness on the consequences of illicit trade and consumption of illicit tobacco.

With regard to terror financing, 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 trade markets are instrumental in providing the much required funding to terrorist organisations.

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. If the threat of terrorism is to be nipped, the access to funding has to be choked. This would be the first step to contain illicit trade and its corollary, terror and ensure that genuine business interests do not suffer.

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. The framework must deal with laws and regulations, training and capacity building, technology as well as consumer awareness.

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.[31]

- **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.[32]

- **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.[33]

- **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.[34]

- 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.[35]

- **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."[36]

- **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.[37]

- **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.[38]

- **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. 13 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).[39]

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

Abbreviations

ACBPS	Australian Customs Border Protection Service
ASI	Annual Survey of Industries
CASCADE	FICCI's Committee Against Smuggling and Counterfeiting Activities Destroying the Economy
CTRI	Central Tobacco Research Institute
CSO	Central Statistical Organisation
DGCIS	Directorate General of Commercial Intelligence and Statistics
FCV	Flue Cured Virginia (Tobacco)
FICCI	Federation of Indian Chambers of Commerce & Industry
GDP	Gross Domestic Product
GST	Goods and Services Tax
GSV	Gross Sales Value
IBEF	India Brand Equity Foundation
MoSPI	Ministry of Statistics and Programme Implementation
MSME	Micro Small and Medium Enterprises
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
TII	Tobacco Institute of India
UNODC	United Nations Office on Drugs and Crime
VAT	Value Added Tax
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.

Federation of Indian Chambers of Commerce 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 18thJanuary, 2011 at FICCI Federation House, New Delhi.

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

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