SERCI Submission:
The Recording Industry's Digital Dilemma: Challenges and Opportunities in Spain and Other High-Piracy Markets

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Abstract. Globally, the recording industry has experienced significant revenue decline and piracy growth within the last five years. In some countries like the United States, piracy is comprised mainly of the illegal sharing of digital recorded music files such as MP3s. In other countries like Spain, recorded music piracy is dominated by the physical production and sale of CD-Rs by organized crime networks. Spain is fairly unique among high physical-piracy countries in that the country's citizens have a relatively high GDP per capita. There are a number of specific characteristics that combine to cause Spain's high physical piracy rates. And, while there have been a number of legislative and law-enforcement changes made in Spain in an effort to fight piracy, these defensive efforts have at best served to slow piracy's growth. The next step for the recording industry is to develop a recorded digital music strategy for each country in an effort to restore revenue growth and reduce piracy by offering consumers a compelling digital music value proposition. In this paper, I propose a framework for this process.

Introduction

Piracy has been an issue for the recorded music industry forever—but only within the past five years has it become an issue that affects the industry's revenues in a significant way. Over the past five years, the industry has focused on refining legislation, laws, and attitudes in an attempt to preserve their current CD-based business model. However, though these efforts have shown some slight effect on piracy in some countries, it is clear to this author that the industry must develop compelling digital music products to consumers in order to regain revenue growth momentum and push piracy levels to manageably low levels.

At the outset of my Fulbright Scholarship, I set out to better understand the current state of the global and Spanish recorded music industry. I then sought to quantify the importance of high-piracy countries, in general and individually, to the recording industry's future financial health. Armed with this knowledge, I developed a framework for evaluating a country's "digital-music readiness level" as well as a digital recorded music strategy to follow in developing compelling digital music products.

Methodology

In order to better understand the current state of the global and Spanish recorded music industry, I performed a significant amount of reading of popular American, British, and Spanish magazines and newspapers from the past five years. For this research, I gathered data from a contact at the US Embassy in Madrid who had studied the issue for years, researched Spanish papers and magazines in the National Library, and read American and British magazines and newspapers online. In quantifying the importance of high-piracy countries, I researched and compared GDP and per-capita spending on recorded music through the World Bank, the International Federation of the Phonographic Industry, and the Economist through on-line and text-based research across a number of identified high-piracy, high-revenue-generating countries. Then, I developed a framework on my own to address the complex issue of devising a global strategy to fight piracy and regain revenue growth immediately

The Importance of Spain and Other High-Piracy Markets to the Recording Industry's Future

Legal music revenue has dropped; seizures and shutdowns of pirated CD manufacturing paraphernalia and online piracy network shutdowns have been surpassed only by the growth in illegal activity in both areas; and yet piracy shows no significant signs of slowing. However, with the entertainment saturation of mature music markets such as the United States, the United Kingdom, and Japan, high-piracy countries such as China, Greece, Spain, and Italy actually offer the largest near-term opportunity for regaining revenue growth--but it is a growth that will come only in response to the industry's introduction of digital music products with novel value propositions for unique consumer groups. Amongst all high-piracy markets considered in this section, Spain offers a unique combination of characteristics conducive to significant near-term revenue growth.

The Global Revenue Contradiction

In 1999 the recording industry achieved US$38.5 billion dollars in global revenue, its highest sales total in history **(Exhibit 1)**. By 2002 this number would fall to roughly US$32 billion, representing a 17% drop in only three years as a result of the rampant growth of piracy and the general slowdown in the worldwide economy. However, this global picture obscures a variation of country-specific trends. A major factor of this decline came from the world's largest market, the United States, where revenue dropped from US$14.3 billion in 1999 to US$12.6 billion in 2002. In most major music-consuming countries in the EU, recorded music revenue declined over this three-year period despite moderate population and GDP growth **(Exhibit 9)**. The United Kingdom and France, on the other hand, both experienced revenue growth over this period, US$265 and US$400 million respectively.

Exhibit 1: Value of Global Recorded Music Sales 1973-2003[1]

[1] *The Recording Industry in Numbers 2004*. (London: IFPI) 181.

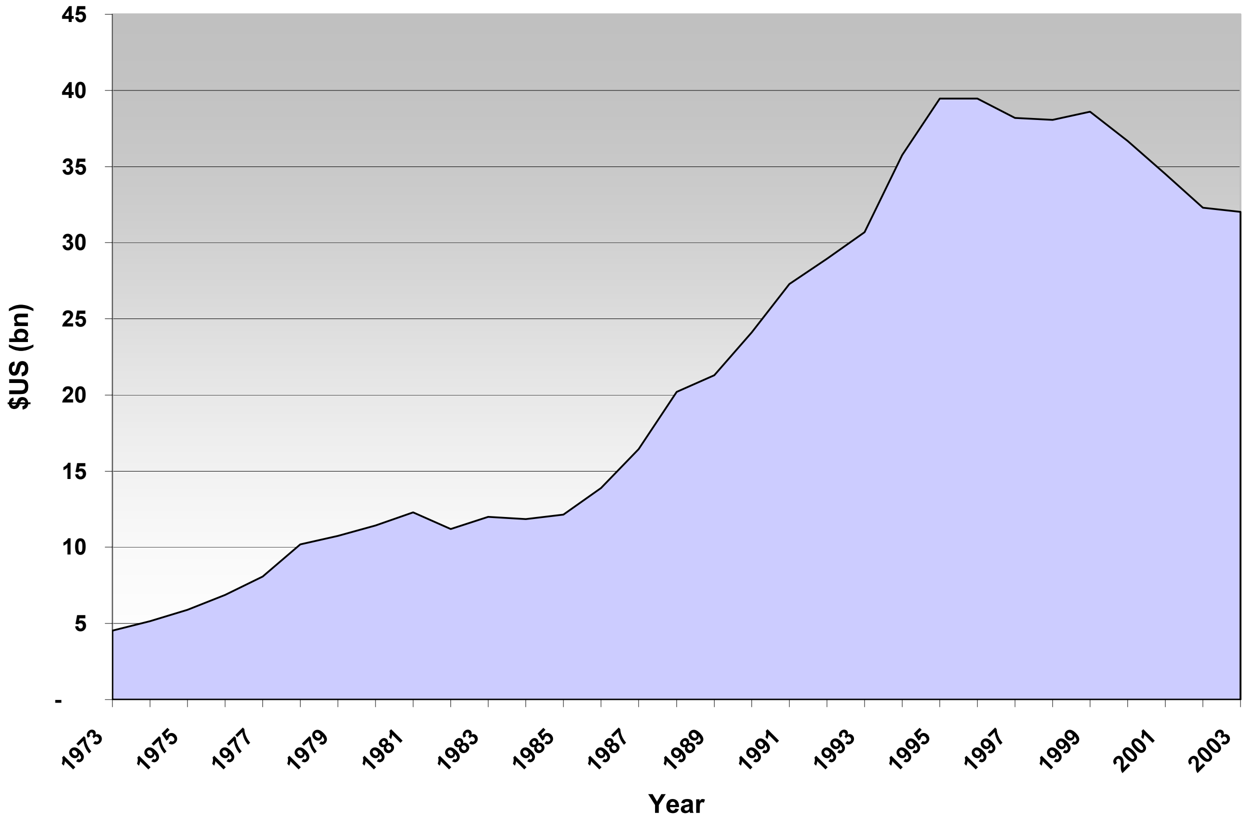
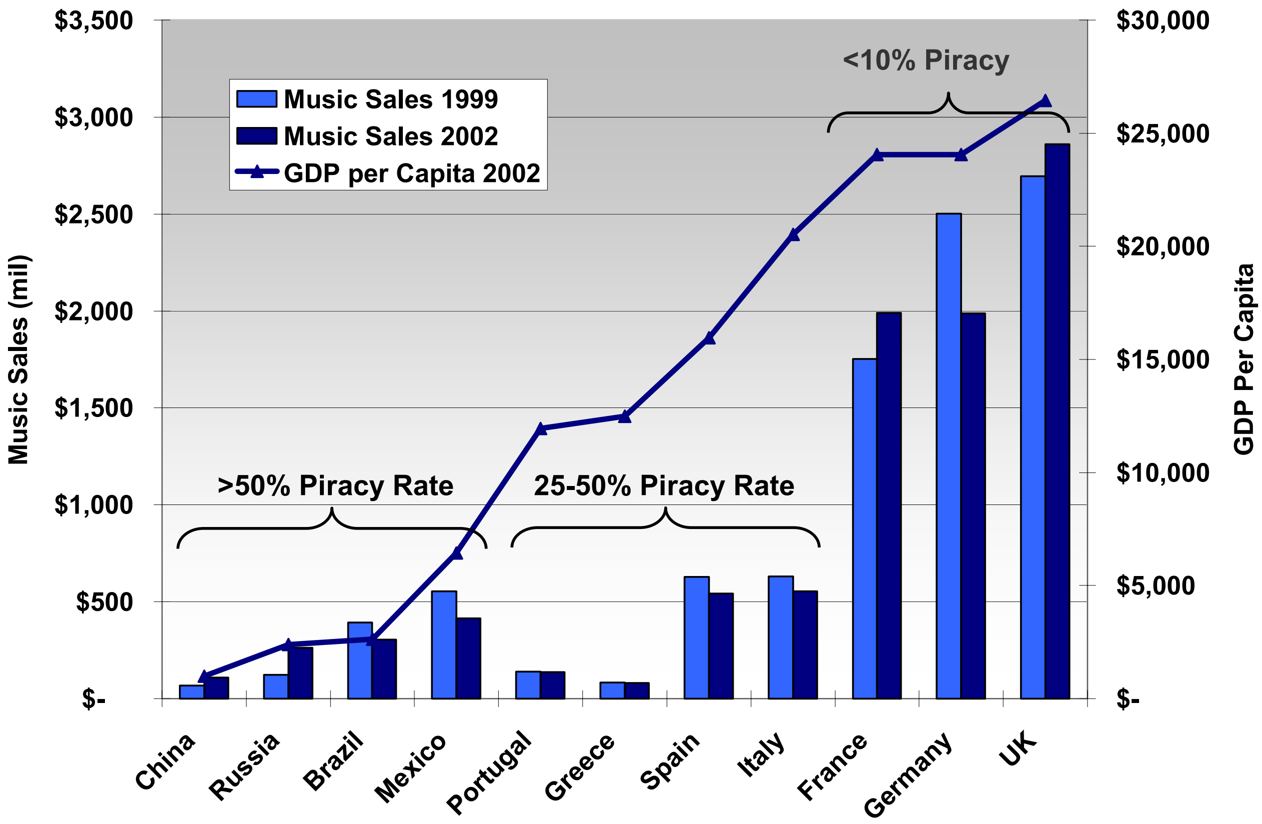


Exhibit 2: Music Sales (US$) from 1999-2002[2]

[2] *The Recording Industry in Numbers 2004*. (London: IFPI).



Of all the countries shown in **Exhibit 2,** the most financially intriguing cases are Portugal, Greece, Spain, and Italy due to their high piracy rates yet relatively high GDP per capita. Other high-piracy markets tend to demonstrate low per capita GDP while low-piracy markets demonstrate high-per capita GDP, theoretically because a lower GDP per capita represents lower disposable income levels for recorded music purchases. The deviating behavior in these countries suggests that there is significant opportunity for revenue growth in these four markets as pirated music becomes replaced by legitimate music.

Quantity of Recorded Music Experienced & Implications

It is important to note that the decline in spending on legal music worldwide does not equate to a lesser quantity of music consumption. In fact, the *quantity* of all recorded music being experienced has certainly risen over the past five years. However, this overall growth, which is not reflected in **Exhibit 2**, is the direct result of an increase in usage of illegal music while legal music use as represented by sales revenue of recorded music has clearly declined. Therefore, the gap between consumption levels from 1999 to 2002 represents the consumption threshold in 1999 for legal recorded music products. At present, the consumption of music *is* much higher, but it is illogical to assume that all current consumption of pirated media translates to consumption of legal music products.

However, the gap between consumption levels in 1999 and now represents the minimum consumption that could yet does not yield revenue for the recording industry. This gap should be viewed as a challenge and opportunity for revenue growth, as the industry could regain this revenue by substituting pirated recorded music consumption with legal recorded music consumption.

Furthermore, the growth in consumption by many consumers as a result of pirated products offers an opportunity for the industry to grow sales past what has been experienced in prior years, as theoretically once consumers are accustomed to a certain level of usage of a product they should have a propensity to stay relatively close to that level of usage given a relatively similar value propositions. The key issue is adjusting consumers to the different value proposition offered by legal digital music—both in the shift from CDs to digital music and from pirated digital music to legal digital music.

Consumers will undoubtedly expect the industry to meet them somewhere in between "free" and the current CD-model prices in addition to seeing other forms of added-value. Some sources of this increased value will come from the product's legality, time-saving, high quality relative to pirated alternatives, product variety, easier meta-data organization, and other "extras" such as special artist clubs and other services. Mass-sales of digital singles over the internet should be attainable as the industry finds ways to leverage the cost-saving attributes and flexible distribution advantages offered by digital media.

With this potential in mind, let's try to quantify the feasibly recognizable revenue gains that the industry could gain on a country-by-country basis by taking a look at recorded music spending per capita as a percentage of per capita GDP.

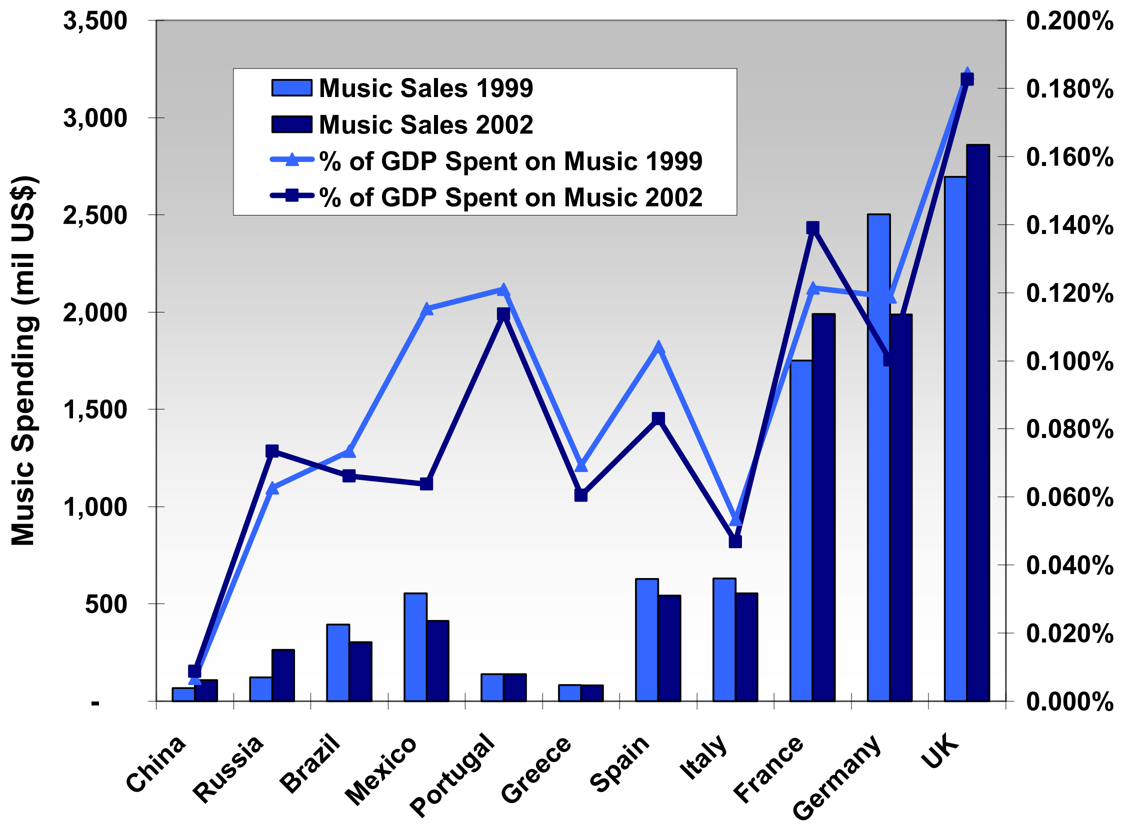
Recorded Music Spending per Capita as a Percentage of per Capita GDP

Worldwide, music is an important piece of every culture, though the economic demand for recorded music clearly differs on an individual and intercultural level as with any product or service. Yet while some countries may differ slightly in the percentage of income dedicated to recorded music due to a number of complex factors, a significantly lower percentage might come as the result of one of the following three substitution reasons: first, that consumers purchase other entertainment products such as television, video games, cell phones, and movies. Second, that the consumers in that country, due to low income levels (as represented by GDP per capita), have less disposable income to spend on recorded music products and entertainment products in general, instead focusing their purchases on products needed for everyday living. Third, that the recorded music offerings in that country do not adequately satisfy the needs of the consumer, and so they instead purchase illegal recorded music products at a lower price.

Per capita spending on music as a percentage of a country's per capita GDP provides a quantitative measure of the relative importance of legal recorded music products to each country's consumers. Simple per capita spending on music is a less accurate measure of this relative importance due to the vast difference in countries' per capita GDP, which is a good relative indicator of each consumer group's available income to be spent on recorded music products.

For example, a comparison between China's per capita spend of legal recorded music and the United States' per capita spend on legal recorded music fails to take into account the fact that the United States' per capita GDP averages US$32,000 while China averages US$800.[3] Clearly, Chinese consumers are unable to spend the same absolute dollar amount on recorded music as U.S. consumers. See **Exhibit 3** for a graphical representation of specific countries' percentage of GDP spent on recorded music in 1999 and 2002.[4]

Exhibit 3: Analysis of % of GDP Spent on Recorded Music 1999-2002



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[3]This, and all subsequent GDP data used in this section, has been derived from the World Bank Group Online Database. 10 Oct. 2004.

[4]This, and all subsequent recorded music revenue used in this section, has been derived from *The Recording Industry in Numbers 2003*. (London: IFPI) and *Recording Industry in Numbers 2004*. (London: IFPI). Japan and the US have been omitted from this and all subsequent exhibits due to the fact that their recorded music revenue, in absolute terms, is significantly higher than other countries considered in this analysis and therefore would dilute the value of the Exhibits.

While the true importance of recorded music to a consumer's life is more complicated than one measure, this method allows for comparison of consumer groups from different countries. One would expect a lower percentage of GDP per capita to be spent on music in poverty-stricken countries since poorer consumers spend a greater percentage of their annual income on basic necessities than very wealthy consumers. With the countries listed in order of lowest GDP per capita to highest and assuming that all consumers value music importance of recorded music to all consumers across the globe, one would assume that consumers with more money would spend a greater percentage of their annual income on music until they have satisfied their desire for music regardless of additional available cash to spend—however, there are clear variations from this trend exhibited in **Exhibit 3**.

Mexico's percentage of GDP spent on recorded music in 1999 is much higher than countries with significantly higher per capita GDP such as Spain and Italy. Since 1999, however, this measure has dropped drastically, due in large part to the greater appeal of cheaper pirated music alternatives.[5] Portugal also has maintained a surprisingly high percentage and but has seen only a slight decline since 1999. Spain, Italy, and Germany are also anomalies, with a lower percentage of their income spent on recorded music products than other countries with lower GDP per capita. Since 1999, Spain has experienced a significant drop in this measure, Italy has always ranked extremely low in comparison to other countries and experienced only a minimal decline, and Germany's significant decline is likely as much a result of the country's recent economic struggles as piracy.

As **Exhibit 3** shows, consumers in Greece, Italy, and Spain spend less on recorded music as a percentage of their per capita GDP than nearly any other country's consumer group in Europe.[6] China's consumers spend even less on music in relation to their per capita GDP than these three high-piracy markets, though this percentage has grown in the last three years to 0.09%. Also telling is the magnitude of the decline in this measure between 1999 and 2002 in Spain, Mexico, and Germany—from 0.104% to 0.083% for Spain, 0.114% to 0.064% for Mexico, and 0.119% to 0.100% for Germany. While alarming, these low percentages—in particular, in the high-GDP, high-piracy, high-GDP markets of Italy and Spain—represent a significant opportunity for the recording industry. Of further interest, for means of comparison, are China, the world's fastest growing economy and highest-piracy market in the world, and Greece, another high-piracy market in Europe with far less economic strength than Italy or Spain.[7] Let's focus in on the recorded music industry trends in each of these four high-piracy markets, and then do some more analysis of the GDP and per capita recorded music spending of each of these countries in order to identify which offers the most enticing financial reward for the introduction of successful digital music products.

[5] *Commercial Piracy Report 2004* (London: IFPI) 126.
[6] Certainly less than any of the other significant, from a revenue standpoint, recorded music markets.
[7] *Commercial Piracy Report 2004* (London: IFPI) 8.

High-Piracy Market Focus: China, Portugal, Italy & Spain

China

In 2002, China actually grew its legal sales of music by around 10% year-over-year and 67% from 1999. However, this growth belies the abysmally low revenue derived from the world's single largest consumer population: a shift from US$67 million in 1999 to US$101 in 2001 to US$110 million in 2003—for 1.3 billion people.[8] Illegal sales in China were estimated by the IFPI to value roughly US$600 million in 2003, representing nine pirated CD sales per every legal sale. This piracy rate—the highest in the world—is as much a reflection of a disparity between the typical Chinese citizen's income and the price of a legal CD as the out-of-date IP laws and policies. China's average units purchased per consumer equaled 0.05 in 2002; in other words, one in twenty Chinese consumers purchased a music product in 2002.

Like many other economic and legislative policies in China, intellectual property legislation and policing policies are experiencing significant modernization as policymakers are pressured by international organizations to meet the higher standards of the G8.[9] Indeed, before 1983, China had no specific IP property laws at all, but as part of the country's entry into the WTO in 2001 the government has been required to further develop IP protection to be more consistent with the rest of the modern economic world.[10]

Digital media is likely the only legal music product that can offer Chinese consumers the product they want at a price they can afford. The physical costs of producing and distributing legitimate CDs will continue to keep it out of the price range of the average Chinese consumer. With lower product creation costs, the recording industry should be able to offer a range of lower-priced products that appeal to the average Chinese consumer. These products should allow the industry's revenue from China to grow roughly in-line with the country's GDP over the next decade, although its enormous consumer group cannot yet afford the types of digital music products currently on the market. The present-day lack of broadband penetration in Chinese households means that the industry will need to find innovative channels of distribution, and the low median income will require new and specialized digital music products.

Greece

While Greece's economy is not as large as the rest of this group, it represents a combination of opportunities and problems similar to those presented in the case of China—robust economic growth and high physical music piracy rates. While music sales grew from US$76 million in 2001 to US$80 million in 2002 on a fixed-currency basis, it

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[8]*The Recording Industry in Numbers 2003*. (London: IFPI) 90. These numbers do not include the value of DVD and VHS sales since prior to 2001 the IFPI did not include this revenue in its calculation of total gross music revenue. In 2002, DVD sales equaled 18.3% of total revenue in China, or roughly US$25 million.

[9]The G8 is comprised of the US, Japan, Germany, France, the UK, Italy, Canada, and Russia.

[10]*General Council Decision* (WTO) 23 Nov 2001.

is estimated that half of all music sales on a unit basis were illegal.[11] This recent growth has regained some of the revenue base eroded since 1999, when music revenue totaled US$83. Like China, Greece's 0% broadband penetration means that the industry will need to seek other means of distribution of digital music.

As Greece's economic growth continues, its population of 10.6 million people will have an increasing amount of disposable income to spend on entertainment and other luxury goods and services, offering the industry an opportunity to grow its average of 0.7 music units purchased per consumer per year.

Italy

Like China and Greece, Italy's music sales increased from 2001 to 2002 but only from US$552 to US$555 million from, representing an annual growth rate of slightly less than 1%.[12] Despite this moderate growth rate, it is alarming to note that amongst the ultra-important 14-24 year-old age group, sales have declined by 6% over the past three years.[13] Overall, music sales have dropped from a fixed-currency total of US$630 million in 1999, representing an overall 12% decline.

Italy's economy, despite its status as one of the more powerful economies in the world, has stagnated significantly in the last two years with annual GDP growth averaging 0.4%.[14] As broadband penetration of households grows from its low rate of 3.7% and as the economy emerges from its current decline, digital music purchased online should become more palatable to Italian consumers. The recording industry should be able to improve significantly upon the average 0.9 music units purchased per consumer, less than half that of the European average of 2.5.

Spain

Of all the high-piracy markets analyzed in this section of the paper, Spain seems to offer the best environment for developing a worldwide strategy to combat the effects of piracy through digital media. First and foremost, Spain's economy is experiencing historic

[11] *The Recording Industry in Numbers 2003*. (London: IFPI) 49. The effect of DVD and VHS music sales was negligible in Greece in both 2001 and 2002 and therefore not included in the numbers presented in the IFPI report.

[12] *The Recording Industry in Numbers 2003*. (London: IFPI) 56. These numbers do not include the value of DVD and VHS sales since prior to 2001 the IFPI did not include this revenue in its calculation of total gross music revenue. In 2002 DVD and VHS sales represented 1.8% of total music revenue, or US$10 million.

[13] *The Recording Industry in Numbers 2003*. (London: IFPI) 56. Throughout the world, the "25-and-under" age group spends more on average on music products than any other age group, though they also download more free music and have less disposable income than older music consumers. See Bernoff, Josh. *The Digital Music Consumer: 2003*. (Forrester Research).

[14] In 2003, Italy's GDP totaled US$1.5 billion, ranking fourth in the EU. In 1998, 1999, and 2001 Italy's GDP grew by roughly 1.8%; in 2000 it grew by 3.1%; Overall, from 1999-2003, Italy averaged annual GDP growth of 1.4%; Western Europe's average annual GDP growth from 1999-2003 was 2.1%, and of the six largest economies, only the UK had a lower annual GDP growth over the same period, with 1.2%. Data cited from The World Bank Group Online Database, 10 Oct 2004.

levels of economic growth after decades of self-contained stagnation. This revitalized Spain, set against its high-piracy backdrop, provides a promising opportunity for music revenue growth via the introduction of legitimate digital music products through novel distribution channels.

In 2002, Spain's music sales totaled US$542 million, down from US$645 in 2001 and US$628 in 1999.[15] Overall, this represents a 14% decline in music revenue in the past three years and a 12% decline alone from 2001. It is estimated that over 18 million illegal CDs were sold in 2002 alone in Spain, or roughly 1 out of every 4 CDs sold. Spanish consumers also buy fewer legal music products per year than most other countries—with around 1.5 per year in comparison to the EU average of 2.5.[16]

Revenue Growth Analysis using Recorded Music Spending per Capita as a Percentage of per Capita GDP

Recorded music consumption as a percent of GDP can be used to calculate the three types of potential revenue gains available in China, Greece, Italy and Spain. The first type is the short-term revenue growth as derived from annual GDP growth. The second type is the revenue potential that substitution of pirated products with legal products can yield. Third, we'll assess the long-term revenue growth potential in each country.

GDP Growth

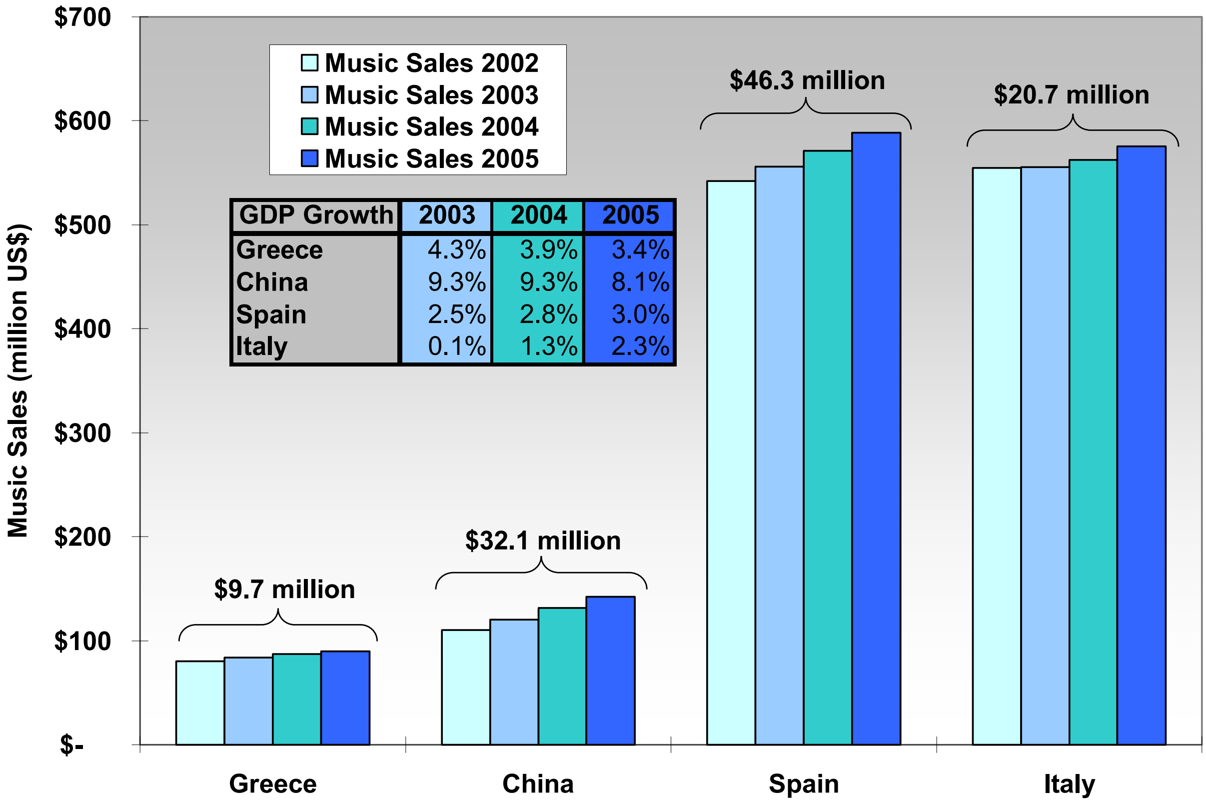
One can see the effect of country-specific economic growth using the current percentage of income spending rates as shown in **Exhibit 4**, most important in the cases of China and Spain, whose economies are growing at high rates. The assumption made in this case is that the percent of a consumer's income that they spend on recorded music stays constant as that income grows. While reality likely mirrors a correlation where increases in GDP cause an increasingly less increase in spending on recorded music, the assumption is a good indicator for the future. Further statistical studies could be done on a global and country-specific basis to determine the true correlation between GDP growth and recorded music revenue growth.

Exhibit 4: Growth in Recorded Music Sales per GDP Growth 2002-2005[17]

[15] *The Recording Industry in Numbers 2003*. (London: IFPI) 76. These numbers do not include the value of DVD and VHS sales since prior to 2001 the IFPI did not include this revenue in its calculation of total gross music revenue. In 2002 DVD and VHS sales represented 1.6% of total music revenue, or US$9 million.

[16] See Section II for further background on the problem of music piracy in Spain.

[17] The Economist Intelligence Unit (Forecast and Profile Sections), October 24, 2004 and World Development Indicators Database (World Bank), October 10, 2004.



Revenue Impact of Recorded Music Spending per Capita as a Percentage of per Capita GDP

Previously, three causes for a decline in percentage of GDP spent on recorded music were identified: a slow economy and the resulting decrease in spending on entertainment goods, substitution by other entertainment products, and substitution of legal products by pirated products. In truth, the effect of the substitution of other entertainment products can be assumed to be zero because this type of dramatic consumer preference trend typically takes effect over a much longer timeframe.[18] Therefore, the two primary causes of any country's decline in this measure are the growth of pirated substitutes and poor overall economic climate. With this assumption in place, one can further assume that in countries that have experienced strong economic growth since 1999 this difference can be entirely attributed to piracy.

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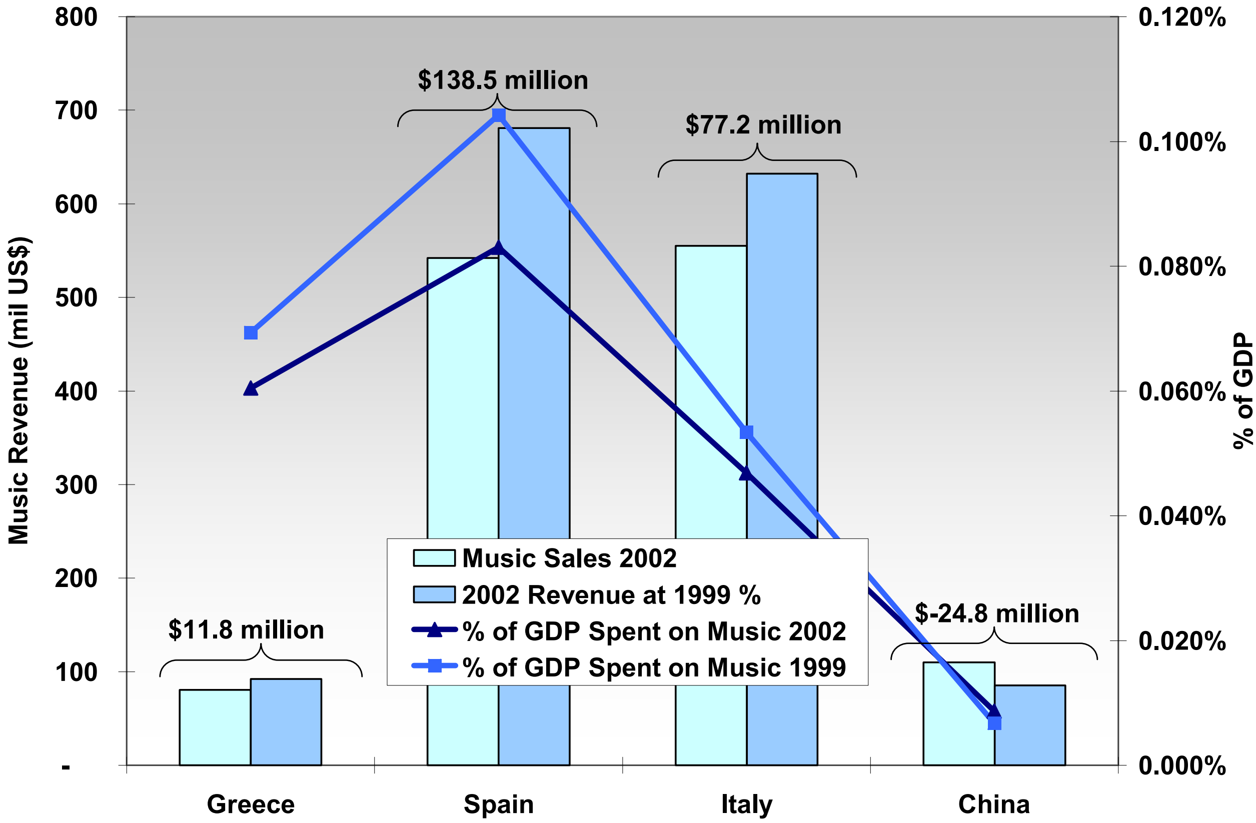
[18]Furthermore, by offering novel legal recorded music products in an attempt to provide a better value proposition than pirated alternatives, recorded music will automatically be increasing its relative value proposition against other entertainment media.

In the case of Greece, China and Spain, one can thus directly calculate the potential revenue that the recording industry stands to gain by multiplying prior percentages of GDP spent on recorded music products as representatives of pre-pirated by 2002. In a very real sense, this quantifiable dollar difference represents feasible growth for the industry if it can replace pirated products with legal ones **(Exhibit 5)**.

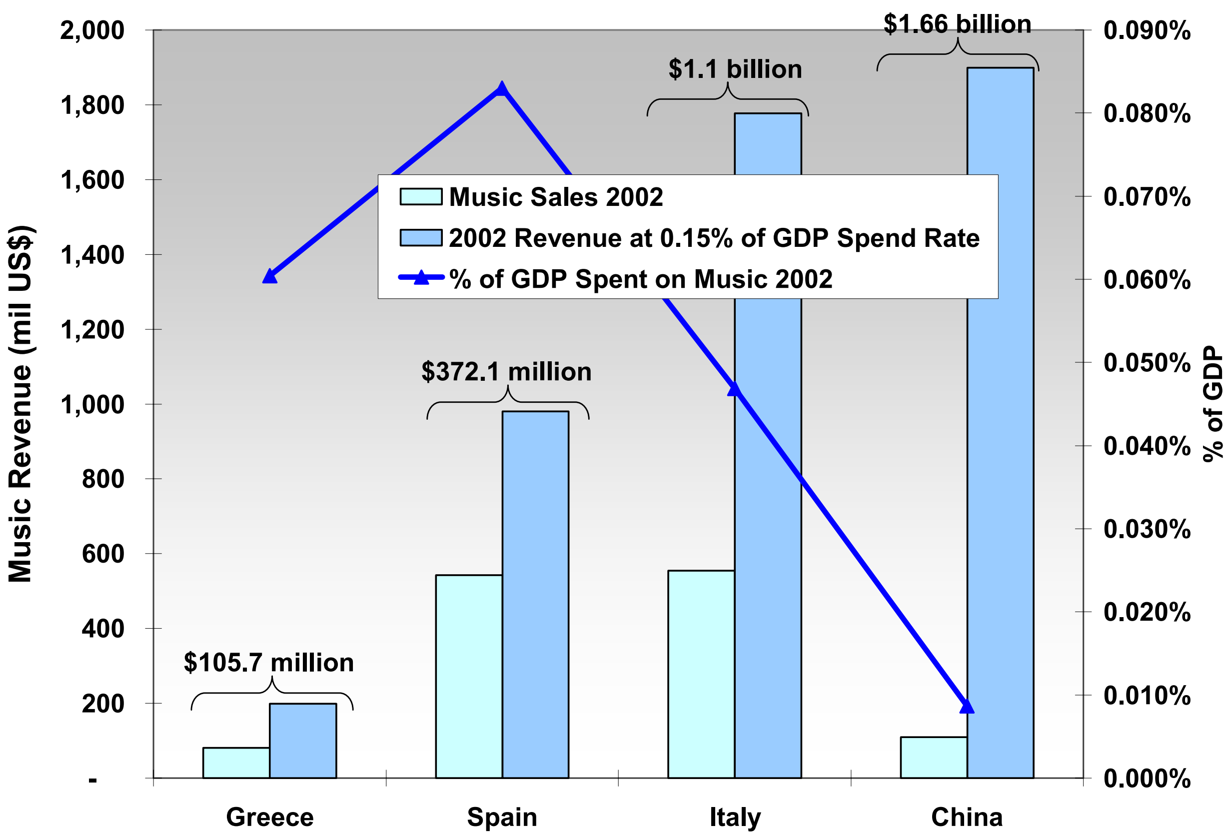
Exhibit 5: Analysis of Revenue Growth through Substitution of Pirated Music Consumption with Legal Music Consumption



In the case of Spain, analysis suggests that the industry could realize around US$140 million dollars in incremental revenue if it were able to substitute legal music purchases for consumers' current illegal music purchases and downloads. In Italy the incremental revenue could total US$77 million, though some portion of this total would likely remain unattainable until Italy's economy emerges from its current slump. Like Spain, Greece's recent economic boom suggests that the full amount of US$12 million could be available for the recording industry under the right circumstances. China's growth in this measure makes this calculation impossible—as the legitimate recorded music market has never been established. The world, as an entity, could stand to realize $US3.17 billion revenue according to this analysis, and these four markets would fill nearly US$250 million of that gap, or around 9%.

Further revenue growth could be attained by increasing this measure to even higher rates than those demonstrated in each particular country in 1999—such as the rates demonstrated in the United States in 1999 (.16%) or the United Kingdom (.18%). Let's take a look at the examples of Spain, Greece, Italy, and China to gauge the potential revenue gain in each country given a 0.15% percentage of GDP spent on recorded music products. **(Exhibit 6)**.

Exhibit 6: Analysis of Potential Revenue Growth through Growth in % GDP Spent on Music



Increasing the percentage of GDP spent on recorded music in Spain by 1% yields US$65 million in incremental revenue whereas in Italy it yields US$118 million. In Greece and China, this 1% gain yields US$13 million and US$127 million in incremental revenue. Were the recording industry capable of growing the percentage of GDP spent on recorded music to levels similar to the United States, or 0.15%, it would realize hundreds of millions of dollars of revenue growth: US$1.6 billion in China, US$1.1 billion in Italy, US$372 million in Spain, and US$106 million in Greece. While none of these gains are immediately realizable and have a certain dependency on overall economic prosperity, they are a stake by which the industry should seek to measure itself. Further statistic research might yield insight into the true correlation between GDP and GDP growth and recorded music spending, which would allow one to calculate a more concrete revenue growth figure in this manner.

Still, with the aggressive but not impossible goal of achieving a 1% growth in percentage of GDP spent on recorded music products over the next five years, nearly US$350 million of revenue growth could be achieved in just four countries: Greece, Spain, Italy, and China.

The Industry's First Battleground—Spain

Looking at the most economically significant high-piracy markets in the world—China (in the future), Italy, and Spain—it is apparent that the industry's first high-piracy target in its attempt to turn the tide of piracy should be Spain. The reasons for this conclusion are that Spain offers the greatest near-term potential revenue growth through GDP growth ($US46.3 million) and substitution of pirated music products with legal music products ($US140 million) as well as significant potential for long-term revenue growth ($US65 million per 1% increase). Italy is a close second, with roughly half the near-term potential revenue from GDP growth (US$20.7 million) and substitution of pirated music products with legal music products (US$77 million), and with a significantly larger long-term revenue growth potential (US$118 million). However, Spain's higher near-term potential and generally strong economy make it a more attractive target at present. China and Greece both offer significantly less near-term potential; although China's long-term potential should make it a priority country for the industry's long-term global strategy.

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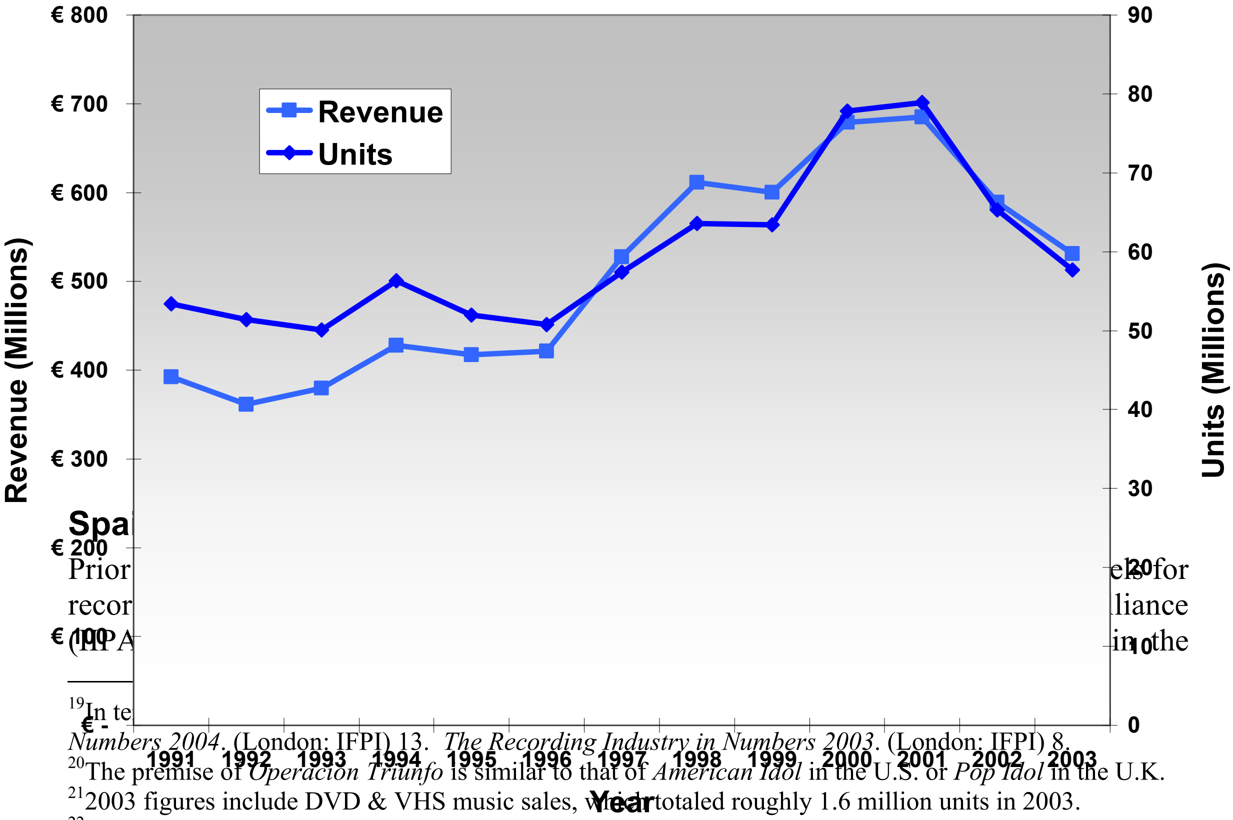
A Brief History and Analysis of the Spanish Recording Industry

The Global Importance of the Spanish Recording Industry

In 2003 Spain's music revenue output ranked ninth in the world, falling two spots from 2001.[19] 2001 was a landmark year for the Spanish recording industry as a result of the success of recorded music sales from the reality TV series *Operación Triunfo*. However, since 1999 Spain has seen music piracy grow rapidly despite concerted efforts by the industry to actively pursue legislative and legal fronts against piracy.[20] Spain presents a difficult proposition for the industry with the juxtaposition of its modern global economy and high piracy rates. In truth, Spain is the recording industry's worst nightmare—an industrialized and modern economy and society with appallingly high piracy rates and year-after-year revenue declines. Unlike many other countries in Asia and South America with similar high piracy rates, Spain's consumers possess the economic means to purchase legal music in significant quantities but instead elect low- or no-cost pirated alternatives. As a result, music sales in Spain suffered a significant decline from €693 million in 2001 to €531 in 2003.[21] **Exhibit 7** shows Spain's total recorded music revenue since 1991.

Exhibit 7: Spain's Recorded Music Sales 1991-2003[22]



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[19]In te… *Numbers 2004*. (London: IFPI) 13. *The Recording Industry in Numbers 2003*. (London: IFPI) 8.
[20]The premise of *Operación Triunfo* is similar to that of *American Idol* in the U.S. or *Pop Idol* in the U.K.
[21]2003 figures include DVD & VHS music sales, which totaled roughly 1.6 million units in 2003.
[22]Sánchez García, R., ed. Anuario SGAE 1999. (Madrid: Fundación Autor) 1999.

[23]http://www.iipa.com/rbc/1999/rbc_spain_301_99.html, accessed Feb. 28, 2005.

United States, where cheap access to CD-burners, broadband, and hard drive storage had become a reality, few consumers in Spain owned computers and even fewer had broadband access. Even today, although more consumers now own personal computers, broadband penetration rates are still low, leading to a low level of digital piracy relative to physical piracy. Still, an estimated 190 million songs were illegally downloaded in Spain in 2004.[24]

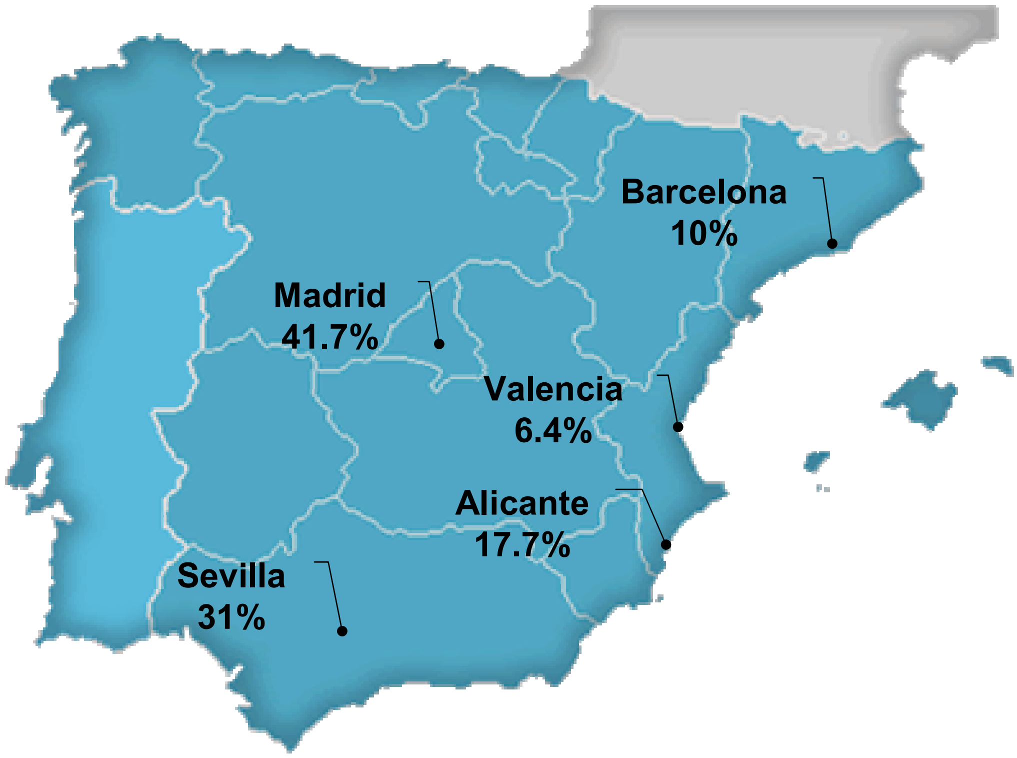
Physical piracy existed on an amateur level but there were very few, if any, organized piracy networks yet in operation. In 1999 illegal immigrants began to appear in large quantities on the streets of major metropolitan areas offering illegally copied CDs for sale. These street vendors displayed their wares on blankets and as a result were soon referred to as *manteros* (blanket-men). These physical-piracy networks grew rapidly throughout Spain's major cities as organized crime bosses realized that there were higher profits and lower risks to selling illegal music than cigarettes, alcohol, and drugs and consumers demonstrated their preference for low-cost, pirated CDs. As a result, physical piracy has been the dominant piracy type in Spain and the leading cause of concern for the recording industry to date, with pirated goods accounting for 24% of physical recorded music units sold in Spain in 2003. Let's take a closer look at the physical piracy phenomenon.

Breakdown of Physical Piracy by Region

Although Madrid and Barcelona began as and remained the two centers of operations and sales for these piracy networks, other big cities such as Valencia, Sevilla, Alicante, and Granada soon saw significant growth in piracy activity. In 2003, police officials estimated that there were over 9,000 *manteros* across Spain, with nearly 3,500 in Madrid and 900 in Barcelona. **Exhibit 8** highlights the relative share of pirated music sales for Spain's high-piracy cities.

Exhibit 8: Percent of Overall Piracy by City[25]

[24]Pedro Farre López. "La Música en Internet Tampoco es Gratis." *Expansión* 12 Jan. 2005: 61.
[25]Sánchez García, R., ed. Anuario SGAE 2004. (Madrid, Fundación Autor) 2004.



Physical Piracy Network Operations[26]

While initially the production of pirated CDs for sale within the country occurred elsewhere, piracy networks are increasingly turning to the legal importation of blank discs and machinery used to produce piracy for actual production within the country's borders. This process is much more difficult to counteract from a legal perspective. Typically, network bosses rent one or more apartments on a short-term basis, install the necessary computer and CD-burning equipment, and dedicate one or more resources to the full-time production of copied CDs. Street vendors come to the apartment as necessary to obtain additional products, usually paying a set fee for the CDs that they do buy. Then, the street vendors either set up their wares on a blanket in a major metropolitan area, or, as is increasingly the case, wander into restaurants and bars offering products from their backpacks. While there are still many *manteros* selling their wares on blankets in the street, increased law-enforcement scrutiny has led to the growth of *mochileros* (backpackers), who enter bars and restaurants and offer customers pirated

[26]International Intellectual Property Alliance. 2005 Special Mention Report: Spain. http://www.iipa.com/rbc/2005/2005SPEC301Spain.pdf, accessed March 18, 2005.

CDs from their backpacks. These vendors are much harder to arrest from because their pirated goods are hidden as they move around.

Piracy Effects

In 2004, the IFPI measured Spain's piracy losses at €52 million and named Spain the only western nation in the top-10 piracy markets.[27] With an estimated 50,000 employees in the recorded recording industry in 2003, piracy has had a direct effect on a significant number of working-class Spaniards. Artists in Spain have seen a 37% decline in royalties received since 2000—dropping from over €25 million in that year to just under €16 million in 2003. Specialty music stores have been forced to close, such as the flagship downtown store of Madrid Rock which closed within the last few months as a result of a 30% decline in sales over the past three years.[28]

Principal Causes of Physical Piracy in Spain

Perhaps the most pervasive question regarding Spain's physical piracy problem is why Spain in particular is such a hotbed of physical music piracy? The answer to this question involves six principal factors that combine to create a fertile environment for physical music piracy:

1) **Spanish consumer norms**—Spanish culture tends to look down upon the act of making money with excessive profits serving as a sign of greed not success. The recording industry is resented by the general public due to the general perception that their products are significantly overpriced for profits' sake. Furthermore, they have a far more relaxed stance towards intellectual property than consumers in countries such as the US, U.K. and Japan.
2) **Gap between median income and legal CD prices—**While Spain has a lower median income than such countries as the U.S., U.K., Japan, Germany, Italy, and France, the prices of legal recorded music products are the same. This cost-to-income ratio makes the value proposition for legal products less appealing in Spain than in many other countries.
3) **Weak intellectual property (IP) laws and legislation**—cumbersome laws make it very difficult for policemen and judges to arrest and prosecute both the illegal street vendors and the higher-level bosses that organize them. Furthermore, sympathy towards street vendors results in few arrests and even fewer convictions of the distribution level of these organized crime networks. Instead, officials focus their efforts on arresting the mafia men who run the networks, which is a vastly more difficult proposition. This factor has changed over the past few years as Spain's legislature adapts its laws to the "new model" of music piracy, but has yet to demonstrate its effectiveness in discouraging piracy.
4) **Low broadband penetration**—Spanish consumers have less access to high-speed than many other countries' consumer groups, so they buy more pirated music on the street than they download online. This characteristic is beginning to

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[27] *Commercial Piracy Report 2004*. (London: IFPI) 11.
[28] Navas, Jose A. "La piratería acaba con Madrid Rock" *El Mundo:* 17 Feb. 2005. http://www.elmundo.es/elmundo/2005/02/17/madrid/1108637374.html, accessed Feb. 28, 2005.

change as consumers gain access to broadband at home—from 2003 to 2004, the penetration rate grew from 4% to 11%.[29]

5) **The public nature of Spanish society**—Spain is a very pedestrian country, and as a result, there is greater exposure of physical pirated goods sold on the street to Spanish consumers in cities than there is in other countries such as the US where cars are a more normal means of transportation.

The Industry's Response

Anti-Piracy Education and Legislation

One of the reasons for the initial rapid growth of piracy in Spain was the inability of law enforcement officials to attack the problem due to awkward laws and policies. As the result of intense lobbying on the part of the Productores de Musica de España (ProMusicae) and SGAE during the latter part of 2004, economic sanctions, criminal penalties, and pre-trial custody of offenders have been increased in quantity and duration.[30] These changes will give police and judges the ability to more effectively deter IP piracy, although further modifications to the process are still being petitioned by industry groups. For example, the trial process of an IP offender can last up to a year, which is a significant amount of time for an illegal alien who can move their life and livelihood in one day.

On top of these legislative changes the industry has attempted to gain government support in fighting piracy. In June of 2004, Spain's most famous musicians met President José Luis Zapatero to promote a campaign entitled "Se muere la música—ayúdanos" (Music is Dying—Help Us). The purpose of the meeting was to show the government's support in the anti-piracy battle and to ensure that future anti-piracy initiatives will be supported by the current Socialist government.

In a further show of support the Spanish government announced a five-point "Integrated Government Plan" to fight music and movie piracy on January 3, 2005. The most important output of the plan is the creation of an official anti-piracy commission that unites politicians, trade representatives, and consumer representatives along a common front. Further plans include the creation of an annual report on piracy, investment in anti-piracy training for public servants, the continued deployment of anti-piracy educational campaigns, and analysis of the current effects of anti-piracy legislation.

Finally, Spanish industries affected by piracy have teamed up to mount several publicity campaigns against street piracy with government support. In 2001 the "Mesa Antipiratería" (Anti-Piracy Table) was formed under the support of the recording and movie industries. The goal of this organization has been to leverage industry forces and form a united front in pushing forth anti-piracy initiatives and proposing anti-piracy

[29]Compared to 16% to 23% for the U.S. from 2003 to 2004. *Commercial Piracy Report 2003*. (London: IFPI) 76. *Commercial Piracy Report 2004*. (London: IFPI) 80.

[30]ProMusicae was known as the Asociación Fonográfica y Videográfica Española (AFYVE) prior to 2005, and represents the record labels and businesses in much the same way as the RIAA does in the U.S.

legislation changes. The most recent joint campaign, organized by SGAE and ProMusicae is called “Tira de la Manta” (Stop the Piracy) and commonly uses the catchphrase “Sé Legal” (Be Legal) to push consumers to consider the effects of their physical piracy purchases on everyone—not just music superstars.

Law-Enforcement Results

In its anti-piracy bulletin released in March of 2004, the SGAE revealed that more than 6 million pirated CDs and 2,600 CD-recorders were confiscated in Spain during 2003.[31] In addition, roughly 2,800 perpetrators were detained in the same year. These figures represent a significant increase in police activity from 2002, when 4.3 million pirated CDs and 1000 burners were seized, and 2,300 people arrested or charged with IP violations. In 2000, only 520 people were charged. This trend reflects the reality of continuing piracy growth as well as increased anti-piracy efforts by law-enforcement officials but more importantly points out the fact that physical piracy is growing despite this increased activity.

On February 18, 2005 Spanish police made the largest CD piracy bust in Spain’s history—seizing CDs valued at over €900,000, over 160 CD-burning machines, and 8 men, including the network’s boss. The operation took over a year to come to culmination and demonstrated the increased sophistication of the Spanish police’s anti-piracy operations as well as the growing difficulty of these types of sting operations. Relying on intimate knowledge of how these networks function, officers traced the gang through their excessive use of electricity, the constant flow of bag-carrying people in and out of the apartment, and the unusually high build-up of trash.

Industry Innovations

Very few new digital recorded music products have been released over the past few years as the industry focused on fighting piracy. There are currently three online digital music stores available in Spain—iTunes, los40.com, and Terra. However, this new distribution method is as yet undeveloped in Spain, where the only legitimate digital music products center on the mobile phone. In 2003, ring tones grossed over €78 million, up from €56 million in 2002.[32] With ring tones and callbacks already fairly popular offerings in Spain, the three major mobile carriers, Telefónica, Amena, and Vodafone, announced in November that they will begin to implement portable music stores for use with 3G networks.[33] These companies plan to offer non-transferable MP3s for €1.50 each that can be directly downloaded from a mobile phone.

Important Trends

While the future of the Spanish recording industry is still very much undecided, it is possible to identify some trends among Spanish consumers that have major implications

[31] “Las operaciones policiales han acorralado la piratería.” infoCampaña ed. 3 (*SGAE*) 7.
[32] *Libro Blanco de la Musica Española*. (Madrid: ProMusicae) 22.
[33] Martín, J., Pantaleoni, A. “Las operadoras de telefonía móvil se suman a las descargas musicales” *El Pais:* 25 Nov. 2004. Ciberpaís 1.

for the recorded music marketplace—high-growth music genres, Spain's increased dialogue with the rest of the world, and economic growth and its implications on spending and technology uptake.

Growth Genres for Spanish Recording Industry

The hip-hop music movement has seen significant growth in Spain in recent years, although it still occupies a small niche in terms of overall popularity and revenue generation. Spanish rap is the musical style that holds the greatest hope for musical creativity and innovation in the near future for Spain, according to a panel of experts surveyed by SGAE.[34] And, from the same survey, 43% of experts believe that rap will become a dominant force in the Spanish music scene. The raw energy and enthusiasm of this nascent genre resonates with the youth of Spain and current trends suggest that rap will very quickly become as dominant within Spain's borders as it is in so many other countries of the world.

Flamenco is another musical genre that offers much hope for the Spanish recording industry—both within Spain and on the global stage. Though the genre is over 200 years old, it has only emerged onto the national stage within the last 50 years. It now occupies a mystical and mysterious reputation within the world music scene, gaining critical acclaim and popular favor places as diverse as New York City and Tokyo. Flamenco music ranks third in the same survey on musical creativity and innovation, only slightly behind Rap/Hip-Hop and Electronica.[35] However, its overall presence has significantly less momentum than Rap/Hip-Hop with only 22.5% of experts selecting it as a major driving force in the Spanish music scene. Its unique style, however, will certainly continue to drive its marketability on a global level.

Spain's Growth in the Global Economy

Largely as a result of the isolationist policy maintained by the Franco regime from 1939-1975, Spain has been kept separate from the rest of the world in the last century. However, beginning with its transition to a democratic monarchy at Franco's death in 1975 and gathering force with Spain's entrance into the Economic Community (EC) in 1986, Spain has made remarkable strides in developing an economic and cultural dialogue with the rest of the world. This transition can be seen in the juxtaposition of the growth of English as the secondary language of choice for young Spaniards as well against the low percentage of elderly Spanish who speak the global economy's unofficial language.[36]

As Spain continues to develop its economic presence on a global level there will be opportunities and challenges for the recording industry both in selling international recorded music products to Spain and vice versa. With Spain's acknowledged position as the motherland of the Spanish language, its music products have significant global

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[34] *Delfos* ed. 10, Nov. 2004. 8.
[35] *Delfos* ed. 10, Nov. 2004. 8.
[36] Sánchez García, R., ed. Informe SGAE sobre hábitos de consume cultural. Madrid: Fundación Autor, 2000.

revenue potential—even in the U.S., where Hispanic Americans are the fastest growing demographic segment.[37]

Economic Growth & Leisure Spending

Spanish consumers are enjoying an economic boom, driven in part by development funds provided by the EU and a relentless westernization of Spanish business. The subsequent increase disposable income for luxury and leisure goods means that Spanish consumers will have more money to spend on entertainment and leisure goods and services. In 1990, 4.8% of Spanish household spending centered on entertainment; By 2002, this percentage reached 6.05%, representing 26% growth.[38] This growing share-of-wallet will be divided between movies, television, video games, music, and other emerging areas, meaning that competition for consumer entertainment time will be fierce. The following passage, which was released by *Euromonitor* in 2004, details the impact of this trend on leisure good spending[39]:

> *Spaniards spend more and more money on leisure goods, especially those products related to new technologies. Thus, the video games sector and especially Playstation 2 have revolutionised leisure patterns, hooking not only young people but also adults.*
>
> *El Corte Inglés, the only department store in Spain, is the leading operator regarding the sale of leisure goods. Spanish consumers value to a great extent the wide offer of leisure products (books, music, toys and games), the constant promotions and the guarantee offered on all products. Moreover, the company widens its offer of toys and games at Christmas, which represents more than 80% of its annual sales.*
>
> *From a low base, online sales of leisure products, such as music, books and DVDs, grew sharply. According to the Commission for Telecommunication Market (CMT), sales through the Internet rose by 90% in 2003, with leisure goods the second most requested sector.*

These trends have several significant implications for the recording industry, in particular for the development and deployment of digital music products in Spain. First, the growth in leisure good spending bodes well for the recording industry, as a booming Spanish economy gives consumers more disposable income to spend on entertainment. However, it also means that the recording industry will need to develop innovative products, services, and distribution channels to maintain and ideally grow its share of entertainment revenue against mobile phones, television, movies, video games, and other spare-time consumptive products and habits.

Second, the dominance of El Corte Inglés within the retail industry suggests that Spaniards highly value the shopping experience, perhaps even more so than prices. This

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[37] Suro, Roberto. *Hispanic Trends 2005*. (PEW Hispanic Center) 72.
[38] *Libro Blanco de la Musica Española*. (Madrid: ProMusicae) 112.
[39] *Consumer Lifestyles in Spain*. (*Euromonitor*) Nov 2004 Sec. 14.4.

lesson should be noted in the development of digital recorded music distribution. Furthermore, this analysis indicates that in terms of public distribution points of digital music, there is likely no better option than El Corte Inglés.

Third, online shopping has grown substantially and will likely continue to grow along with Spain's growth in broadband penetration, technology, and economy. Leisure goods are high on the online-shopping list, but it is still unknown how Spaniards will react to the prospect of faceless, completely digital recorded music products sold via the internet.

Finally, increased technological savviness is good and bad for the recording industry—good in that growth in broadband penetration, game console, MP3 player, and computer ownership will give the industry more devices for content distribution and use. However, with increased knowledge of technology comes greater ability to pirate content, meaning DRM systems will need to become ever-more sophisticated.

Conclusion

While piracy growth seems to have slowed slightly on the streets, physical piracy continues to gouge the recording industry year after year in Spain. Further impact on the industry will come from rapid growth in illegal downloading of recorded music files as broadband access continues to become more affordable and accessible to Spanish consumers. There have been a significant number of changes within every aspect of the industry within the past five years, and yet there have been very few innovative product offerings as the industry has focused largely on developing a defensive strategy to protect their current CD-based business model. Even with increased efforts on the part of industry associations, governments, and legislative bodies, the industry's next step towards winning the fight against piracy, and towards building a business model that can succeed in the future, is to offer Spanish consumers compelling digital recorded music alternatives.

It is this author's opinion therefore that the industry's efforts should shift focus to developing a strategy to develop and sell digital recorded music products as quickly as possible. While in Spain, I developed a framework for analyzing a country's digital music readiness level and developing a set of recorded digital music products to fit that country's consumers. I used the framework on Spain by surveying a set of six industry experts but feel that further extension of the framework could be done by surveying a statistically significant consumer set and by experimenting with the digital recorded music products that I have developed in focus groups.

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