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The Rise and Fall of Record Labels

Ilan Bielas
Claremont McKenna College

CLAREMONT McKENNA COLLEGE

THE RISE AND FALL OF RECORD LABELS

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PROFESSOR GEORGE BATTA

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DEAN GREGORY HESS

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ILAN BIELAS

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Abstract

This thesis studies the music industry as a whole, and delves more specifically into how new technologies have disrupted the old business model. Advances in technology such as the Internet, MP3s, and file-sharing software have made it possible to bypass the traditional role of record labels, thus creating a closer link between artists and consumers. As the music industry transformed over time, the role of record labels became less defined. This has left once behemoth labels struggling to find a competitive advantage in a rapidly devolving industry. Record labels are no longer the most relevant segment of the music industry, and this work provides an in-depth analysis of the processes that destroyed their relevance.

This thesis begins by examining the music industry at a macro level, before tracking record labels from their prominence to their current marginalized role. Advancements in MP3, P2P networks, and other consumer-enabling technologies have transformed the music industry. The lack of a significant response to this shifting landscape within the industry has left record labels on a slippery slope towards extinction. As record labels failed to adapt to shifting demand and changing methods of consumption, private entrepreneurs have intervened to solve inefficiencies in the market. This thesis will leave the reader with an expansive knowledge of how the music industry has transformed, as well as its future trajectory without record labels.

Chapter 1

Introduction to the Music Industry

In June of 2006, famous rock band Radiohead, announced that they had completed all of their contractual obligations to its record label *EMI*. In its announcement, the band announced that it was receiving most of its profit from merchandise and concert tickets, and due to this they would be seeking to release their next album independent of any record label[1]. This would be the first time that any band bypasses record labels in the creative process, and the beginning of the end for record labels.

Artists had for a long time complained about the pricing and payout schemes that record labels offered to them. Radiohead was about to test their theory that with the adoption of new technologies, the need to work with a record label had been minimized. In October of 2007, Radiohead released their new album, *In Rainbows*, directly to consumers online[2]. While releasing albums online was not a new distribution channel, it was the pricing scheme that caught the attention of the entire music world.

On Radiohead's website, when purchasing the new album, after proceeding to checkout, the price of the album had a blank space with a question mark next to it.

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[1] Welsh, Jared S. "Pay What You Like- No Really: Why Copyright Law Should Make Digital Music Free for Noncommercial Uses." *Emory Law Journal* 58 (2009) 1495

[2]Keesan, Joshua. "Let It Be? The Challenge of Using Old Definitions for Online Music Practices." *Berkeley Technology Law Journal* 23.353 (2008).

Anyone who clicked on the question mark would receive a pop up message stating, "It's Up to You![3]" Most people found themselves questioning whether or not this was possible. Can I really choose the price for this album? Can I really pay whatever I want? Can I get it for free? The answer to all these questions was Yes. Radiohead was not creating a controversy but rather responding to the cultural change over the last few years which was making record labels irrelevant in the music industry.

For the last few years, record labels were struggling to catch up to the technology available to consumers in order to prevent "copyright infringement" from downloading free music. Many consumers were downloading their music for free and record labels were having a difficult time finding a solution to this "problem." Radiohead's decision to let consumers decide their own price to pay for their album was radical, but from the band's perspective it was merely accepting what the market had dictated. Most consumers were no longer willing to pay $10-15 for an album when it was readily available for free online. Radiohead provided a legal option for consumers that would be free (if one chose to) or allow consumers to pay a reasonable amount by their standards to support the band.

The recording industry responded negatively to Radiohead's actions. Most professionals did not think that Radiohead's album would be successful for being independent, and for allowing consumers to pick their price. Initially, it was unclear if Radiohead's decision would pay off. Little information was known in the first few days after the online release of the album on the amount of downloads and revenues. The

[3] Welsh, Jared, p. 1495

release was successful enough for Radiohead to announce that they would also be releasing a physical copy of the album in 2008. The reports finally came out and showed that downloads numbered in the hundreds of thousands, and had made about $3 million in revenues[4]. When the album was finally released in a physical form, it immediately made it to the top of billboards.

Radiohead's *In Rainbows* album was a huge success but even more importantly it was a huge loss for Record Labels and their position within the music industry. Radiohead proved several things with their new album. First, Record Labels were no longer a necessity for artists. The Internet had become a huge resource and distribution channel for artists that allowed them to individually fulfill the role of record labels. Also, the decision to allow people to choose their price was proof that most consumers were willing to pay much less for music than Record Labels were demanding. Regardless, Radiohead's success was the ultimate proof that the music industry had thanks to some of the technology advances that had been made. These advances, such as that of the Internet, were changing the music industry and redefining the roles of many of the players in the industry. Record labels are becoming irrelevant, and pretty soon record labels will no longer exist as a major part of the music industry.

For nearly 60 years the recorded music industry has thrived. Since the invention of record players that allowed individuals to consume music on their own instead of going to live performances, the popularity of owning music has risen. Since the 1940's there have been many advances made to increase the quality and portability of the music

[4] Welsh, Jared, p. 1496

that is consumed at home. The music industry is a thriving industry that peaked in the 1990s when it was making $40 billion a year.[5] People are consuming more and more music every day and new genres and artists are appearing every day to meet the consumer's everlasting demand for new and better music.

The music industry is highly dependent on the United States for its success. The United States of America consumes about 30% of globally recorded music and the music industry tends to move cyclically with that of the US economy[6]. The music industry has grown exponentially over the last 20 years. According to a recent report done by the US Census, the average American spends $50.17 on music annually and listens to three hours of music daily[7]. Consumption of music has increased over time, yet the amount that individuals are paying for music has been declining. Technological advances have permitted people to increase their consumption of music at a cheaper price. This has also caused the price to acquire music to decrease. While most people take for granted their ability to open up their iTunes, pick any song and listen to it, there were many advances that were made that lead to the ability of consumers to listen to music on their computer without a physical source for the music.

The music industry began to take off in the 1940s. With the invention of the commercial phonograph, consumers were able to consume music differently than previously possible. Before the 1940s people would either go see live performances or

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[5] Vogel, Harold L. "Music." *Entertainment Industry Economics: A Guide for Financial Analysis*, p. 192
[6] Vogel, Harold, p. 196
[7] Bender, Mark T., and Yongsheng Wang. "The Impact of Digital Piracy on Music Sales" International Social Science Review. pp. 157-158

would purchase sheet paper in order to recreate music themselves. People would buy the sheet music for a famous Mozart piece and would then be able to play it themselves on the piano as long as they knew how to read sheet music and could also play an instrument with some expertise. With phonographs gaining popularity in the 1940s, the history of recorded music really begins at this time. In 1948, Columbia Records released twelve different vinyl records that were made available to the public[8]. The technology to mass produce records was still very new and therefore few records were being made.

The 1950s brought on the next era of innovations. Several different advancements were made in this decade that helped drive down the costs associated with producing vinyl records. The decrease in price allowed for a competitive market to be created. The major players in the recording industry today all entered the market in the 1950s when it became cost effective to do so. The 1950s saw Decca Records, RCA, and Columbia all become major players in the recorded music industry[9]. Many more record labels entered the scene in the 1950s but eventually the record labels began to merge and consolidate to form a few corporate giants.

The 1960s were a decade of consolidation in the recorded music industry. Due to economies of scale and the large-scale distribution needed to truly commercialize the music industry many of the smaller players from the 1950s joined together to create some of the media moguls that we still see today. The 1960s witnessed the emergence of companies like RCA, CBS, Warner Communications (soon to be Warner Brothers), and

[8] Vogel, Harold, p. 193
[9] Vogel, Harold, p. 194

Polygram[10]. In order to unite the distribution methods and create the most cost efficient method to mass produce music, these labels bought out and merged with many of the smaller record labels that specialized in one area of the distribution process for music. By becoming giant recording corporations, these few labels were able to vertically integrate the entire recording and distribution process in order to take advantage of the economies of scale.

The 1970s were a decade where little technological advancements were made for the music industry. The consolidation of the major record labels in the previous decade were a major advantage and music demand was on the rise during this time. The economic downturn of the 1980s initially hurt the music industry. As the music industry is highly dependent on the US market and therefore the US economy, the financial struggles of the 1980s hurt the music industry as consumption of music initially wavered. However, several big technological advancements in this decade helped the music industry recover and thrive. The recording and disking process was digitalized in the 1980s, which allowed for cheaper production of recorded music. This in turn lowered the price of music which allowed consumers to demand and purchase more music. The other major innovation of the 1980s was the creation of the Music Television Network in 1981. MTV, as it would go on to be known, became a source for most Americans to consume, listen, and experience new music. By 1984, MTV had gained massive popularity and was able to reach and influence a large audience[11]. MTV's mass appeal made the network a popular distribution channel for record labels. Record labels would release

[10] Vogel, Harold, p. 194
[11] Vogel, Harold, p. 199

new music through MTV in order to test the popular response to new up and coming artists.

By the late 1980s, the music industry was closing in on its peak. Music was being consumed by most Americans, and MTV had become a major source for finding the new and popular music in America. The 1990s were the decade when the most influential advances to the music industry were made. In the early 1990s, vinyl went extinct as Compact Disc technology emerged. CDs became instantly popular due to the quality of the music, portability and size of CDs, and the amount of music that a single CD could hold. CD technology soared as industry sales in the US skyrocketed to $7 billion[12]. By the late 1990s CDs would become obsolete and the music industry would enter an even bigger market. With the Internet growing and becoming more popular, it was only a matter of time before music moved on to a digital space. Due to the incredible success of CDs only a few years earlier, record labels were reluctant to change the technology. It did not take long for consumers to make the shift.

By the late 1990s and early 21st century music had moved to the Internet. File sharing became a very popular method of acquiring music almost instantly. Through file sharing, one person could buy a CD, upload it to the internet and share the files with friends. This permitted friends and eventually anyone to obtain their music for free. The record labels were initially in "denial" over this occurrence claiming that this was a temporary problem and that most people would continue to buy their music in the extremely popular format of CDs. In the four years between 1999 and 2003, US music

[12] Vogel, Harold, p. 194

sales had already plunged by 1/3[13]. Technology was changing fast and neither the music industry nor record labels could keep up to the changing environment in the world of music.

By the beginning of the 21st century everything that record labels knew about people and their music interests had changed. Consumer preferences in the music industry were shifting in a very significant way that would soon inhibit the control and power of record labels. The art of assembling an album or playlist shifted to the hands of the consumer with the adoption of newer technology[14]. Consumers were now able to compile their entire music library on one computer program and choose how to organize their music. The era of having record labels compile a CD and tell consumers how and in what order to listen to their music was over.

Whether or not the rapidly changing landscape of the music industry hurt record labels, it cannot be denied that the music industry as a whole began to decline in the late 90's. There are several reasons for the decline of the music industry. The economy as a whole began to slow down in the 90s. The economic decline hurt the music industry as discretionary income for consumers decreased which hurt music sales. Another reason for the music industry decline was the record label practices. The Big 5 in the music industry were price fixing their albums and CDs and have countless times been accused for overcharging for albums. The price fixing by the Big 5 caused many consumers to

[13] Vogel, Harold, p. 194
[14] Hajdu, David. "The iPod Blues." The New Republic

find alternate solutions for acquiring music[15]. Another cause for the decline was the evolution of the Internet and its effect on music distribution. The emergence of the Internet as a distribution channel for music hurt physical sales of CDs.

Technology was advancing in many different fields besides the music industry. This growth in technology across the board helped create many other forms of entertainment that began to also hurt the music industry. As technological advances continued to be made, American consumers were introduced to products such as the DVD, the BluRay, Xbox 360, and PlayStation 3 which all competed with music for consumers discretionary spending. As DVDs and video games began growing in popularity, the increased competition to the music industry also hurt CD sales. Consumers were now given many more options and therefore consumers began to spend less on music hurting the record labels' ability to increase or even maintain their revenue levels. Record Labels began to suffer large decreases to their revenues, which has lead to the problem the music industry faces today. 2012 was a great year for the music industry. Global Digital Revenues in 2012 increased for the first time since 1998 to $5.6 Billion which is a 9% increase from the previous year[16]. While this increase is great, it does not mean that record labels have recovered from the changing landscape that is the music industry.

The major problem the music industry has supposedly faced is a decrease in revenues due to many different factors. While file sharing has eroded digital music sales,

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[15] Janssens, Jelle, Vandaele, Stijn, and Tom Vander Beken. "The Music Industry on (the) Line? Surviving Music Piracy in a Digital Era"
[16] IFPI Digital Music Report 2013

artists have seen their revenues increase drastically in recent years from live performances and merchandise[17]. If artists, who are the ones making the music we listen to, are making more money now than they did in the 90's, or any decade before that, can one really argue that the music industry is suffering? It seems as if the only party hurting from the changing landscape in the music industry are the record labels. Artists are making more money and consumers are spending less on money. If it weren't for the cries and complaints from the record labels that the music industry is suffering, one would seem to think that the music industry is as vibrant as ever. It therefore seems as if the issue is not the music industry, or even the ability for artists to make money, but rather the problem is that record labels are going extinct and are fighting to remain prevalent in a world that no longer has a need for them.

[17] Warr, Richard. "Is the Music Industry Stuck Between Rock and a Hard Place? The Role of the Internet and 3 Possible Scenarios". Journal of Retailing and Consumer Services. p. 127

Chapter 2

Record Labels: Their Role and Failure to Adapt to Changing Environments

For as long as the music industry has been around, major record labels have been around to control the entire recording, distribution, and promotion system. Record labels have long been considered to go hand in hand with the music industry. For most people the music industry and the recording industry are one as for a large period of time the only music available to the public was that which was released by the major record labels. However, as the gap between record labels and the rest of the music industry continued to widen it is important to study record labels and their role within the music industry. Over time record labels have become obsolete, and it would seem as if there is no longer a place for record labels in the music industry.

The Recording Industry has for a long time been a major part of the US Economy. Music records and sales account for a significant portion of the US GDP. In 1920, the recording industry sold 150 million records in the United States. By 1978 that number had skyrocketed to 762 million records[18]. The music industry has grown exponentially as the technology available to the industry has contributed to the rapid development it has experienced.

The music industry has many different sources of revenue. As of 2003, the major music industry revenues by level of importance where: recordings, publishing activities,

[18] Welsh, Jared. p. 1502

and live performances[19]. Recordings are the actual songs that are sold to consumers, while publishing activities correspond to the promotion of music by radio stations both physical and online as well as other major distribution channels such as movies or television. These users pay royalties to the artists and record labels for the right to play their music. Since 2003, as recordings have started to fail, live performances have become the most prevalent revenue source for artists.

The major record labels have been responsible for collecting the majority of the revenues for the music industry until the 21st century. Therefore record labels have a very significant impact on the US Economy. When looking at record labels that control the copyrights of artists and musicians, it is tough to value the firm, as what they own is a copyright and not a physical tangible good. Record labels have therefore traditionally been valued by a going multiple of their projected cash flows "as determined by recent sales of similar properties and subtracting net debt[20]". As the Internet and file sharing have gained popularity, so has the uncertainty of cash flow projections for record labels. As consumers turn to alternate methods of acquiring their music, it is difficult for analysts to truly value the Recording Industry as cash flows have become extremely difficult to project.

Publications are a unique revenue stream for the music industry. Any publication source has to pay royalties for using the music of an artist or musician. When a radio show, television show, or movie uses a clip of a song during any part of the publication,

[19] Vogel, Harold. p. 196
[20] Vogel, Harold. pp. 217-218

they are required by law to reimburse the artist for their use. Since music copyrights are held by the record labels, they too are the beneficiaries of these royalty payments.

Two major firms control the collection of royalty payments. The American Society of Composers, Artists, and Producers as well as Broadcast Music Incorporated are in charge of ensuring that any one who commercially uses the music of an artist pays that artist and the record label the correct amount in royalty payments. These two firms account for 95% of all royalty payments in the United States[21]. The use of the Internet to broadcast music has posed as a major problem when determining the correct amount of royalties that a firm should pay.

As the Internet has become a major distribution channel for music, many consumers turn to Internet Radio and other online service providers to discover, find, and listen to new music. A major problem of "double dipping" has emerged when determining the royalty rates that these service providers should pay. The royalty collection agencies have been seeking royalties for both song reproduction and song performance from these service providers for every single play[22]. These agencies argue that because consumers are using the service as a way to listen to music and not just acquire music that the playing of the song constitutes performance as well as reproduction. These online services feel like they are being taken advantage of by record labels and the collection agencies. Many of these companies are very small and are deeply affected by this problem of double dipping.

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[21] Vogel, Harold. p. 202

[22] Keesan, Joshua. "Let it Be? The Challenge of Using Old Definitions for Online Music Practices". Berkeley Technology Law Journal. p. 362

To add to the problem of double dipping is the fact that royalty rates have been rising every year to compensate the losses from record sales. Royalty rates have been rising by a small percentage every year, which have significantly affected many of the small players in the music industry[23]. Many of the small radio broadcasters as well as other smaller organizations are more affected by the rising royalty rates than others. These smaller companies operate at much smaller profit margins than major radio stations and companies as they have a fairly small user base. The increased royalty rates, therefore, are affecting the ability of these companies and stations to remain profitable. Not only are these royalties hurting small companies and online service providers, but the artists themselves have been affected adversely by royalty collections.

When artists sign a contract with a record label, they expect to make a lot of money from the music they create. More often than not, they find themselves losing their money to the record labels. Traditionally, record labels have withheld a large amount of royalties from the artists that created the music. There are many different types of royalties that are withheld from artists. About 5-10% of the total records shipped are given out for free by record labels to retailers in order to ship a larger amount. Artists never get the royalties from those records. Royalties are also withheld for all the promotional records that are given out to radio stations. A percentage of royalties is also withheld from artists as a reserve against any record returns. Record labels also deduct for the usage of new formats such as digital downloads which are actually less costly to produce, meaning that the record labels keep more money in their pocket. The initial advance that record labels give an artist to produce an album is also repaid fully from the

[23] Keesan, Joshua. p. 367

first few royalty payments as well as any promotional and recording expenses incurred[24]. Artists have begun to find themselves frustrated by their relationship with record labels as more and more is withheld from them every year.

Artists constantly feel as if they are taken advantage of by record labels. Record labels vertically integrated the entire process of production and distribution of music giving them a lot of leverage against the artists. The dependence of artists on record labels has made them susceptible to the abuse by these major corporations. The typical breakdown of revenue payouts from record labels is quite shocking. On an album that gains the prestigious award of going Gold the breakdown is as follows:

500,000 Albums sold at a wholesale price of $12.05
Gross Revenue of $6,025,000
Typical Artist Royalty rate is set at 14% which equates to $845,000
Touring and Recording Expenses of $300,000 withheld
Total Payout to artist is only $100,000
Artist receives $0 in first payment due to reserve against returns[25]

Artists feel taken advantage of since their album, which is one of the most popular albums of the year, is only making them a fraction of the actual money it is making overall. Many of the most famous artists of the 90's made little money from their albums. For example, the world famous boy band of the 90's, *The Backstreet Boys*, who sold millions of records throughout the 1990s, received no money from record labels as royalty payments[26]. Artist distrust towards record labels has only been growing year after

[24] Welsh, Jared. pp. 1507-1508
[25] Welsh, Jared. p. 1508
[26] Welsh, Jared. pp. 1508-1509

year and slowly but surely artists are starting to move away from working with record labels.

Musicians and artists constantly find themselves losing more money from the major record labels. In fact, record labels have gotten quite creative in their method of making money at the artists' expense. In recent years, it has become an industry wide practice to decrease the royalty payouts to artists. For example, recording agreements now exclude all digital sales from "normal retail channels," which is where royalty payments are calculated. Digital sales actually decrease costs for record labels as many of the variable costs for producing physical copies of CDs are eliminated. However, the abuse by record labels does not end there. As digital sales have begun to grow and expand internationally, record labels also decided to decrease the royalty payments on international sales[27]. There is no difference in expenses between local and international sales due to the effectiveness and ease of the Internet and digital space as the major distribution channel. As costs and artist payouts decrease as well, record labels are able to hold on to a bigger piece of the pie and keep a majority of the profits to themselves. Do record labels deserve a bigger piece of the pie or are they merely taking advantage of artists that have no leverage to defend themselves?

The role of record labels has not changed much over the many years that record labels have controlled the music industry. Jared Welsh, an important lawyer in the music industry describes the relationship between artists and record labels as very unstable. "Ownership of the intellectual property has always been controlled by the industries that

[27] Welsh, Jared. pp. 1510-1511

exploit it rather than the individuals that create it[28]". Record labels are able to exploit artists' talents and keep a majority of the money for themselves.

Traditionally a record label has 3 major functions. The first major function of a record label is to sign a recording contract with an artist. Record labels need to find new artists and sign them to a contract to produce a new album. The record label will agree to provide many resources for the artist to assist in the creative process. The second role of a record label is to advance money to an artist and arrange for the recording of an album to take place. The record labels provide what is essentially a loan to the artist to cover the upfront costs of producing an album. Record labels withhold the first royalty payment in order to recover this loan that they gave out to the artist. The third and final role of a record label is to handle the entire distribution, sales, marketing, and promotion of the album[29]. Essentially a record label has become a one-stop shop for the entire recording process from beginning to end. An artist contributes the creative talent while the record labels handles the financing, arrangements, marketing, production and distribution.

In its traditional form, a record label contributes a very large amount of capital and resources to produce an album with an artist. It is because of this role that the record label can demand to keep such a large percentage of the revenues from album sales. Record labels were the link between an artist and his fans that buy the music. An artist signs a contract with a record label in order to leverage on the core competencies of the record label such as marketing and distribution. The artist, after signing the contract,

[28] Welsh, Jared. p. 1505
[29] Welsh, Jared. pp. 1502-1503

records the album, after which the record label can produce the album onto a CD. Retailers then buy CDs and other media forms directly from the record labels. Consumers receive the end product album directly from the producer[30]. With this business model, artists only receive a very small percentage of sales while the record labels keep the bulk of the revenue.

Over the years many record labels have appeared, but over time these companies all merged into and became The Big Five of the music industry. As record labels grew into corporate giants, they needed to increase their resources and therefore many of the older record labels consolidated in order to maximize their economies of scale. The Big 5 in the music industry consist of BMG, Warner, Universal, Sony, and EMI. With the recent Sony and BMG merger, the record label giants are now referred to as the Big 4. Record labels were caught in a price fixing scandal where their albums were overpriced in order to maximize their return. From 1999-2001, the average price of a CD rose 7.2% from $13.04 to $14.19[31]. At the same time, new album releases were rapidly decreasing making it extremely difficult for these record labels to match the revenues that they had seen in previous years.

Record labels need to keep a bulk of the revenues from CD sales in order to remain profitable. Only about 10% of major album releases are profitable for record labels, and this 10% must be able to offset the losses from the other 90% of releases.

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[30] Lam, Calvin K.M. and Bernard C.Y. Tan. "The Internet is Changing the Music Industry" Communications of the ACM.

[31] Janssens, Jelle, Stijn Vandaele, and Tom Vander Beken. "The Music Industry on (the) Line? Surviving Music Piracy in a Digital Era." European Journal of Crime, Criminal Law and Justice. P. 80

Albums typically have a very small profit margin due to the high cost of distributing and producing many CDs. Record labels have been raising the prices of albums to try to raise the profit margins on CD sales. In fact, the Federal Trade Commission has founds record labels liable for overcharging consumers in their price fixing scheme[32]. As a result of this pricing, consumer sensitivity to price is eroding as a majority of music fans feel that the record labels are grossly overpricing music[33]. This has made many consumers to adapt their habits and find alternatives to finding new music thus beginning the path that has lead to making record labels a thing of the past.

The advancements in technology would eventually lower many of the costs associated with distribution and production as the market began to go digital. This shift has made the role of record labels shrink. Record Labels have become inefficient due to their low profit margin, and the fact that 90% of their releases end up costing them money rather than returning a profit. Record labels have a broken market structure for several reasons. Firstly, record labels have created an inefficient monopoly, as they only benefits a few major corporations at the cost to both the artists and consumers. Record labels have also become very inflexible and conservative to adapting new technology, leaving them behind the rest of the music industry as artists and consumers have both adopted newer technologies.

With the adoption of new technologies, the music industry has been able to lower many of the costs of distribution and production that had previously limited the industry as a whole. The advancement in Internet and MP3 technology have made it possible for

[32] Welsh, Jared. p. 1522
[33] Warr, Richard. p. 129

artists to distribute their own music just as efficiently as record labels do, at a fraction of the price. Record labels are constantly losing artists due to the new ability and ease for these artists to become independent. Artists are able to make and distribute their own albums and music through the use of the Internet. So the question remains: Is there room for Record Labels today? The simple answer is that labels cannot maintain their control over the music industry in its traditional role. There is one key role that record labels could continue to hold as technology continues to advance and that is the role of marketing. Record labels still have a lot of experience and resources, and can offer their expertise to artists to help intensely market their new music to wider audiences. However, the era of record labels holding a monopoly over the entire creative process is over thanks to new technology. These new technologies have helped erode the control of the record labels on the music industry.

Chapter 3

The Internet and Adoption of MP3 Technology

At the beginning of the 21st century, record labels were caught committing their price fixing scheme. Artists and consumers were being taken advantage of by these corporate giants. The adoption of newer technology made it possible for these consumers and artists to fight back. Through the use of newer technologies, artists were able to get a closer link to their fans and circumvent record labels at the same time, thus making them irrelevant in the business process. As the music industry began to move towards the digital market place, it made alternate pricing strategies possibl,e that helped artists and consumers gain leverage against the record labels. Artists began utilizing the Internet to give away free music to their fans in order to grow fan loyalty[34]. The Internet provided artists with alternative means for releasing their music.

The Internet not only provides for a closer link between artist and fan but it also allows artists to bypass the traditional recording route that is dependent on record labels. "In theory, the technology also makes it possible for an artist to circumvent the distributor, maintain control of the master recording, and capture a significant part of the distributor's margin[35]". The Internet has become a major distribution method for music, which is readily accessible to every consumer and artist, and places a direct link between the artist and fan that was previously held together by record labels.

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[34] Vogel, Harold. p. 211
[35] Vogel, Harold. p. 211

There have also been other major impacts that the Internet has had on the music industry. More artists are able to penetrate the music industry than ever before thanks to newer technology. The new distribution channel made possible by the Internet has lowered the barriers of entry to the music industry and has made it possible for anyone with a computer to distribute music online. New entrants in the music industry are outpacing traditional labels ability to find new artists[36]. This has also made it possible for the music industry to become globalized at the same time as the rest of the world. In 2012, of the top ten singles that were purchased, the artists that created the music were from Australia, Brazil, Canada, South Korea, Trinidad, and the United States[37]. The Internet has made it possible for international artists to become global hits in just a short period of time.

Digital marketplaces also have been created as a result of the advancements of the Internet. A digital hub has been created, allowing consumers to acquire their music over the web, as opposed to buying a physical copy. The digital marketplace has been the fastest growing method for acquiring music since the turn of the 21st century. By 2008, online music sales accounted for 33% of all music sold in the United States[38]. This number has been growing and by 2012, digital sales of music accounted for nearly 50% of the total revenues for the music industry in the US[39]. 2012 saw a year of major growth in digital sales of music. Total sales were up 12% from the previous year with single-

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[36] Lam, Calvin K.M. and Bernard C.Y. Tan. "The Internet is Changing the Music Industry"
[37] IFPI Digital Music Report 2013
[38] Styven, Maria. "The Intangibility of Music in the Internet Age." Popular Music and Society. p. 54
[39] IFPI 2012 Let's Play Report p. 3

track sales rising 8% and album sales rising 17%[40]. The digital marketplace for music is overtaking the physical one as consumer have turned to the Internet instead of retailers for their music needs.

Consumers are turning to the Internet as the source for discovering and acquiring new music. A recent study on consumer interactions found that 25% of young people aged 15-34, and especially males, tend to discover new music primarily through the use of the Internet[41]. As record labels began to catch on to the shifting trend towards the web, efforts were made to adopt this technology.

In a late response to the digital shift in music, record labels attempted to create a marketplace for purchasing music but it was too little too late. 3 of the 5 major record labels provided a service for some time to purchase music directly from them. In December of 2001, MusicNet was set up by Warner, EMI, and BMG as a hub to purchase any of the music released by those three record labels. Sony and Universal followed suit immediately with their release of PressPlay. Due to their late entrance into the Internet, these services failed to gain much market share. Both of these services were subscription based, which allowed subscribers to stream the music directly from the application. The number of users never grew to a prominent number and eventually these services were shut down.

There were several reasons as to why these services failed to gain control of the digital space. The choice of music on these services was extremely limited as each

[40] IFPI Digital Music Report 2013
[41] Warr, Richard. p. 127

service could only provide music that was owned by the record label. This excluded many independent artists, as well as those of the other record labels. Also, given the Big 5's fear of piracy, these services were given many technological restrictions that limited the amount of downloads and the length of time that downloads were kept. This angered many consumers, as they were unable to truly own and keep the music that they were acquiring through these services.

While the restrictions were increasing within the record labels, a new technology began to emerge the eliminated many of the restrictions and eased the process of acquiring music from the consumer point of view. The emergence of MP3 technology allowed for music to be shared instantly with no restrictions or security figures. MP3s also compressed audio files with no loss in quality making music downloading much faster and more efficient[42]. The emergence of the MP3 made file sharing possible and made the record label's subscription based services lose their competitive advantage. As MP3s had no security restrictions, they could be transferred between people at minimal cost, making it the obvious choice for a consumer over the record labels' heavily restricted services.

MP3 technology allowed for music to be transferred for free amongst consumers. However, the problem arising within the music industry was not with the open standard that MP3 provided, but rather with the Internet, that facilitated a free distribution center that shifted the control of the industry from record labels to consumers. The technology advancements of the MP3 shook the entire music industry and leveled the playing field

[42] Jansens Jelles, Stijn Vandaele and Tom Vander Beken. p. 90-92

for all the players. Record labels could no longer hold their competitive advantage and lost their prominent role in the industry.

MP3 technology was created in the late 1990s at the Frawnhofer Institute in Germany. Dr. Karlheinz Bradenburg worked within the Institute for Integrated circuits and was experimenting with different methods of compressing audio and video. In his experimenting, Dr. Bradenburg created this astonishing technology known as MP3 that would soon transform the entire music industry. MP3 is short for MPEG 1, Layer 3 compression that is the method discovered by Dr. Bradenburg. The compression process begins with computer hardware and an optic driver that will convert physical CDs into MP3 files[43]. These MP3 files can then get played on a computer through a 3rd party music player that were available at the time such as Winamp or Windows Media Player.

By running uncompressed audio files through an MP3 encoder, a user can shrink a music file to 10% of its original size while maintaining a majority of the quality. This is done by getting rid of all the sound waves and frequencies from the file that cannot be recognized by a human ear, thus only leaving behind that which will be useful for a human ear. Through this encoding process, a CD, which could previously only hold 72 minutes of uncompressed audio, could now hold between ten and eleven hours of music[44]. This compression would soon allow consumers to hold larger quantities of music, increasing their demand and consumption of music as a whole.

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[43] Gunduz, Ugur. "Digital Music Format MP3 as a New Communication Technology and the Future of the Music Industry. The Scientific Journal of Humanistic Studies. p. 202-204

[44] Gunduz, Ugur. P. 202-204

Compressed MP3 files have many benefits to consumers. MP3s allow for music to be transferred between people and computers at a faster and more feasible rate. This made downloading music online a quick and easy option for consumers as a song could be downloaded in minutes or even seconds. MP3 files can also be copied an infinite amount of times without the degradation in quality that would occur with all previous file formats[45]. As is the case with any good that is non-excludable and non-rival in consumption, a free-rider problem began to emerge with the adoption of MP3 technology. Since MP3s could be downloaded an infinite amount of times and the quality would remain the same, consumers could download a song for free and not take it away from anyone else in society. MP3 technology made free music downloading possible and acceptable as consumers came to realize that their consumption of music would not hurt anyone else.

Another benefit of MP3s is that it is an open standard, meaning that nearly anyone could gain access to an encoder and create their own MP3. The invention of the MP3 is similar to that of the printing press. The Guttenberg Bible, made possible by the printing press, allowed for every person to own a bible in the common tongue. Prior to the printing press, only the Catholic Church had a copy of the bible and it was in Latin. The control of the bible and religion shifted from the Catholic Church to individual people as the Guttenberg Bible soon became available to all. The same is the case with MP3s and the music industry. Prior to this technology, only record labels could own and control the content that was recorded onto a CD. With the adoption of MP3s, consumers could now own and control a copy of any song that wanted.

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[45] Welsh, Jared. p. 1513

The music industry, and the record labels were bewildered by MP3 technology and sought ways to fight the open source. A number of proprietary audio codes emerged with higher security features such as a2b and Liquid Audio[46]. None of these audio codes were able to gain significant market share as the open code of the MP3 proved to be too popular to overcome. Even though record labels fought to change the file format, consumers and artists were not going to change their consumption of MP3s to a more restrictive technology.

MP3 technology also allowed newer artists to distribute their music online quickly and efficiently without the use of record labels. Established artists also created a direct link to their fans through the Internet as a result of the increasingly popular MP3 format. The introduction of new products such as the Apple iPod and other MP3 devices began to emerge, allowing consumers to hold thousands of songs on a single device thus further encouraging consumers to download MP3 music files[47].

MP3s also made peer-to-peer file sharing software possible as the compressed size of an MP3 made the transfer of music that much faster. This allowed programs like Kazaa, Morpheus, I-Mesh, Gnutella, Win-MX, Soulseek, Limewire, and Napster to exist as the technology allowed consumers to get music for free through this software instead of purchasing overpriced music from record labels. As consumers started turning to these technologies to get free music, it pressured the recording industry to respond. All record companies entered the e-commerce world with their streaming services in order to try to

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[46] Easley, Robert F. John G. Michel, and Sarv Devaraj. "The MP3 Open Standard and the Music Industry's Response to Internet Piracy." Communications of the ACM.
[47] Gunduz, Ugur. p. 202

monetize the digital market. The record labels were too late to respond and MP3s made record labels lose a large portion of the revenues from CD sales. The record labels were too little too late to enter the digital world and by the time they got there it was too late to stop consumers from acquiring their music for free through these file-sharing programs.

The introduction of MP3 technology transformed the music industry and there were many winners and losers from this change. The record labels were the obvious losers as they were rapidly losing revenue, as music was being "stolen" and downloaded for free. Record labels were also losing artists who had decided to remain independent as they could now fulfill many of the roles of the record labels on their own. However, while record labels suffered, it seemed as if consumers and artists were both benefitting from this shift. Artists benefitted in several ways. The barriers of entry were lowered on the music industry as a whole, as any artist with a computer, encoder, and file sharing software could distribute their music online without an intermediary such as a record label. Artists also were able to gain a closer link to their fans through the use of MP3 and the Internet through the use of fan loyalty gifts of free music. The other beneficiary of MP3 technology and the increased prevalence of the Internet were the consumers. Consumers gained from these new technologies, as they now were able to access a much larger and greater variety of music as well as access it for free. Users not only were paying less for their music but were also increasing their consumption of music as a result of MP3s.

As record labels looked to combat this trend and save their business model, the buzzwords that began to be thrown around were "piracy" and "stealing". Record labels

felt like these newer technologies were allowing consumers to steal from them and deny them their hard earned money. While artists and consumers were clearly benefitting from these advances, record labels were being significantly hurt and they were not about to go down without fighting for their cause.

Chapter 4

Piracy and P2P Software Destroy the Record Label Industry

As the technology in the music industry advanced to a level that allowed consumers to access music for free, online piracy and file sharing emerged as the biggest issue the music industry would have to face. As consumers and artists were benefitting from these newer technologies, the record labels were struggling and fighting to stay relevant. In fact, record labels have recognized piracy as the biggest cause to their loss in revenues since 1999.

The effects of online piracy on the music industry appear to be huge. According to a report released by Forrester, as of 2004, music piracy has denied record labels an estimated $700 million in revenues[48]. Music sharing and free downloading has hurt the record labels ability to make money. According to the IFPI, global CD sales dropped 19.8% from 1999-2002[49]. It is evident that the Internet has had a tremendous affect on the music industry as a whole, as upset consumers have turned to alternative measures to get music.

Online piracy has quickly been becoming the norm in the music industry. Piracy is most popular amongst college students who feel that downloading music is not morally

[48] Hajdu, David. "The iPod Blues"
[49] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. P. 79

wrong, despite the claims being made by the record labels[50]. Consumers got tired of paying for overpriced albums that record labels were selling, and therefore acquire their music illegally for free. "Music will be bought legally when the price is worth the differences in ethical consideration, (expected) quality, and (perceived) risks[51]". As there seems to be little risk and no downgrade in quality from acquiring music illegally, consumers will continue to download music for free over the web.

Since music downloading began to gain popularity in 1999, it has quickly grown as the fastest growing method of acquiring music. According to the IFPI, only 37% of music acquired by US consumers is actually paid for. This means that just under two thirds of music is downloaded illegally in the United States. It is estimated that from 2004 until 2009, thirty billion songs were illegally downloaded[52]. It is unclear how much effect illegal downloads have had on global sales, but it certainly is the case that CD sales have dropped since downloading became popular in 1998 when the first file sharing program, Napster, emerged. A look at the top 10 albums of the year before and after file sharing emerged show that CD sales have suffered. In 1999, the top 10 albums of the year sold a combined 54.7 million copies. Ten years later in 2009, the top 10 albums of the year only sold 21.4 million copies, which is less than half of the original amount[53]. Music downloads have only grown in popularity due to the ease and convenience that technology has allowed it to become. File sharing software began to emerge in 1999 with the first P2P program called Napster.

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[50] Warr, Richard. p. 129
[51] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 93
[52] IFPI 2012 Lets Play Report. p. 10
[53] IFPI 2012 Lets Play Report. p. 11

Since 1998, when Shawn Fanning created the program, Napster, file sharing and downloading music have increased exponentially in popularity. Made possible by the new MP3 technology, Napster allowed users to share files through the web at high download speeds. Given the small size of MP3 files, Napster allowed for songs to be shared amongst users in just a couple of minutes. Napster is the first peer-2-peer network that emerged throughout the 21st century. Napster operated by using a central indexing server that bookmarked and created a catalog of every user and song title available on the server[54]. At its peak, Napster has 80 million registered users and over 250,000 daily downloads on its server[55]. The average user would be able to access around 220 new songs at any given moment. Napster was the first of many file-sharing networks that would emerge at the beginning of the 2000s.

Napster's downfall came as a result of its technology. The use of their centralized server was enough to deem the company responsible for all of the content that went up on their network. Record labels, therefore, were able to get Napster shut down as the court system found Napster liable for assisting in copyright infringement. In Napster's ashes, a new network, named Grokster, emerged that introduced a new technology that ultimately allowed all file sharing networks to survive the court system in the long run. Grokster developed a completely decentralized system over which it had little supervisory power

[54] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 91
[55] Lam, Calvin K.M and Bernard C.Y. Tan. "The Internet is Changing the Music Industry".

over the content on the network[56]. This decentralized network is what kept these P2P networks alive as no liability could be found on the service's part.

Yet another technological advancement in file sharing software emerged after Grokster. This newest advancement is still used to this day as the most complex file sharing system available. The next big file sharing software to emerge was BitTorrent. Torrenting music files is the newest and current method to acquire new music. Many different file sharing software exists that uses the technology introduced by BitTorrent. The new technology introduced by BitTorrent was a highly complex system that shares only pieces of media files from one source but uses many different users and sources to download the final copy[57]. This technology also allows for many different forms and sources of software to be used which has allowed programs like UTorrent, Vuze, and Torrentz to emerge.

The record labels did not take kindly to the emergence of these file-sharing networks that were hurting their ability to collect revenues from music sales. There were two major responses taken by the recording industry to combat the rise in P2P networks. The first response was to create a strong awareness campaign to dissuade people from "stealing" music. However, most people did not feel that an ethical dilemma existed or that they were even stealing when downloading music. The next response by the music industry, once the awareness campaigns were deemed ineffective, was to scare people with legal action. The record labels did this by targeting three main groups.

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[56] Welsh, Jared S. pp. 1517-1518
[57] Welsh, Jared S. pp. 1518-1519

Record labels sought legal action against the file sharing platforms for their promotion of illegal downloads. The record labels also raised legal action against Internet Service Providers to force them to release the names of all the users of their sites to find the individuals downloading music. Finally, the record labels also began to pursue individual P2P users for downloading music, however, this method was the least effective, as the amount of users was growing exponentially daily.

The Recording Industry was initially most effective in pursuing legal action against the file sharing platforms. In March 2001, the Recording Industry Association of America (RIAA) won its lawsuit against Napster, forcing it to filter the items on their server. The court found that Napster has materially contributed to infringing activity by providing the support services through the use of their Central Indexing System, which allowed users to search for, find, and distribute content[58]. By April 2001, the swapping of MP3s on Napster's platform had decreased by 36% as a result of the lawsuit[59]. However, as seen earlier, this did little to dissuade new entrants to the market that was created by Shawn Fanning. Today, more P2P services exist that ever before and are more difficult to shut down. The progress in technology coupled with the growth in consumer broadband speed only helped promote the shift toward file sharing platforms. All subsequent platforms found ways to limit their liability starting with Grokster, which had a decentralized server.

In September of 2003, the RIAA sued 261 individuals for copyright infringement. By 2005, that number had grown to 9,000, as the RIAA was trying to intimidate the

[58] Welsh, Jared S. p. 1516
[59] Lam, Calvin K.M. and Bernard C.Y. Tan

public in hopes of scaring people into stopping their copyright infringements[60]. It seems strange that the record labels were suing for copyright infringement and not the artists that actually created the songs. Why are the record labels the one suing and an even better question is why aren't the artists? It seems peculiar that no outcry has really been made from artists regarding copyright infringement for downloading their song. "The practice of having businesses exploit copyrights was so widespread that the Copyright Act of 1909 permitted business entities the right to be designated as the author/owner of creative work[61]." Record labels are the business entities that control the rights of these artists' music.

Artists and musicians agree to transfer the ownership of their music when signing a recording contract with a label. When a band or artist makes a song, there are 3 different products that are created. The first is the song itself; the musical composition. This song is what is actually performed by the artist, the notes themselves. The second is the audio recording, which is the phonorecord or physical medium that the song is attached to. An example of this is a vinyl, tape, or CD. This is owned by the record label and sold to retailers who then sell the item directly to consumers. The final piece is the sound recording itself, which is not held as a tangible good[62]. When someone hears about the copyright infringement lawsuits from the music industry it is referring to this third aspect, the sound recording. Copyright Law indicates that the record labels own the exclusive right to record and distribute these sound recordings.

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[60] Welsh, Jared S. p. 1519
[61] Welsh, Jared S. p. 1506
[62] Welsh, Jared S. p. 1500

As issues of piracy began to develop and emerge in the 1970s several revisions of copyright law were made to further protect the record labels. The 1976 revision of copyright law granted copyright owners (the record labels) the exclusive right to be the first to record and distribute any creative content that they owned[63]. This revision granted the copyright holder with six exclusive rights. Copyright owners had the exclusive right for reproduction, preparation of derivative work, distribution, public performance, public display, and the right to public performance "by means of digital audio transmission[64]." The issue of right to distribution is what has arisen in the case of most of these lawsuits, as piracy results from acquiring the music from someone other than the record label themselves. As technology advanced and the music industry moved to a digital space further revisions where required of copyright law.

As file sharing and P2P networks started gaining popularity and MP3 technology made it possible to store high quantities on music, record labels again pressured the government to further revise copyright law to protect their content in the digital space. The Digital Millennium Copyright Act of 1998 extended the rights provisioned in the 1976 revision to sound recordings on the Internet[65]. It is under this provision of Copyright law that allows the record labels to pursue legal action against anyone that downloads a song over the web illegally.

Many defendants and opponents of copyright argue, however, that copyright law does not protect the artists from getting their work stolen but is rather a system put in

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[63] Vogel, Harold. p. 203
[64] Welsh, Jared S. p. 1499
[65] Lam, Calvin C.K and Bernard C.Y. Tan

place to protect one of the biggest monopolies in the world, and therefore these copyrights should not be enforced. "It is, after all, the purpose of copyright to promote the creation and dissemination of expression in the marketplace, not to protect large, existing industries from new competition.[66]" It would be premature to think that copyright is totally unnecessary. Copyright laws were important in helping to start and grow the music industry. "In all, copyrights and the protection of intellectual properties from counterfeiting and piracy, have played an important role in the growth of the music business. But royalty income losses from piracy remain substantial and widespread[67]." Regardless of what copyright law is, the issue of piracy remains a big one, and so far the use of lawsuits has done little to deter consumers from downloading music.

The lawsuits by the RIAA did little to stop P2P networks and also hurt the image of the music industry as it was seeking to pursue legal action against its own customers. This drove more people to file sharing and P2P networks as they looked to fight against the monopolistic record labels. Since the emergence of Napster, many more programs have emerged to allow users to share music and other files over the web. Users of KaZaA, another program similar to Napster, download more than 160 million songs each month[68]. Also, as of June 2009, another program, Morpheus, had been downloaded 173 million times and Limewire had been downloaded 181 million times[69]. As file sharing has grown exponentially as the go to source for consumer to get music, the record labels have failed to maintain a presence in the industry. Since the emergence of Napster in

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[66] Welsh, Jared S. p. 1497
[67] Vogel, Harold. pp. 203-204
[68] Hajdu, David. The iPod Blues
[69] Bender, Mark T. and Yongsheng Wang. "The Impact of Digital Piracy on Music Sales: A cross-country Analysis" International Social Science Review. p. 158

1999, music sales in the US have dropped 47% from $14.6 Billion to about $7.7 Billion. Most consumers find it easier and more efficient to get their music online through these services that pay for a CD in a store.

File sharing and P2P networks are often looked at in negative light due to its crippling effect on the music industry. However there are several other effects that result from file sharing and downloading music. The first of these effects is the substitution effect, which is the main argument for as to why the record labels have been suffering. The substitution effect is that consumers who download music will no longer buy the CD as they have gotten their product from a different source. However, it seems unlikely that each music download will displace 1 sale so there are arguments that the substitution effect has minimal impact on the music industry. The sampling or exposure effect also plays a major role in response to file sharing. The sampling effect states that users want to sample or try music that they otherwise wouldn't listen to[70]. Consumers will download songs that they do not value enough to purchase but are interested enough to listen to. The sampling effect has a positive impact on the music industry as overall consumption rises, where consumers are able to listen to a higher quantity of music due to their ability to access it at a lower cost.

The studies done on the effects of file sharing have been extremely unambiguous. Some research has shown the effects of piracy to be extreme and have many implications for the music industry as a whole while other studies have described the effects to be more positive. Market statistics from the International Federation of the Phonographic

[70] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 91

Industry (IFPI) show that worldwide music sales have fallen with the blame being solely placed on P2P software[71]. Whether or not file sharing and P2P networks actually hurt the music industry is a big argument in the music industry, but the effects since the emergence of Napster on the music industry appear to be tremendous. One study found that Internet Piracy actually did have a weak effect on CD sales. This study found a casual relationship between the number of P2P networks available and the decline in CD sales[72]. Another study done by Leibowitz found that between 2000 and 2003 online file sharing reduced CD sales by as much as 30% or about $4 billion annually[73]. Many other studies exist that comfirm that P2P networks have decreased CD sales.

There have also been several studies that have argued that P2P networks have had very little impact on CD sales. In fact, one study done by Anderson and Frenz found that P2P networks actually increased music sales overall due to the sampling effect and other factors[74]. Yet another study done by Felix Oberholzer and Koleman Strumpf had some interesting results. Their study attempted to look at the impact of file sharing on CD sales and collected their dataset from 0.01% of all downloads from 11/23/02 until 12/2/02. Their findings were that file sharing had limited impact on record sales and suggested that 5,000 music downloads are required to displace 1 CD sale[75].

Another study done by Rafael Rob and Joel Waldfogel examined data on album purchases and music downloads amongst college students in 2003. This research study

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[71] Bender, Mark T. and Yongsheng Wang. p. 157
[72] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 82
[73] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 82
[74] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 82
[75] Bender, Mark T. and Yongsheng Wang. p. 159

attempted to assess college students' habits in music consumption. Their results indicated that downloading music reduced CD purchases by 9% but that downloading music also mitigated the deadweight loss due to monopolistic allocation inefficiency and price discrimination[76]. The study also contends that the sampling effect is a major factor and that downloading music occurs primarily on low valued CD's, and that therefore sales displacement is not a prevalent factor because most albums were never actually intended for purchase. Most consumers are not willing to pay the high price for an album that they do not value, and since the only alternative to this high price is to download the album, they choose to do that instead. The study by Rob and Waldfogel is one of the most groundbreaking in research done on the music industry.

Yet another study was done by Zetner to study the macro effects of file sharing and piracy on music sales. Zetner's study found that countries with the highest levels of P2P usage also experience the greatest reductions in music sales. The study calculated that a 1% increase in the piracy rate resulted in a 0.6% decrease in music sales. Zetner also found that a 1% increase in the Internet penetration rate would result in greater than 1% decrease in music sales[77]. This study shows that Internet penetration has 60% higher impact on record sales than the piracy rate. Zetner argues that the increased prominence of the Internet was the leading factor in displacing sales, as it was the most efficient distribution channel for music. The Internet heavily lowered the cost of producing music and the lack of a price shift made consumers seek their own change rather than pay for overpriced albums.

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[76] Bender, Mark T. and Yongsheng Wang. p. 160
[77] Bender, Mark T. and Yongsheng Wang. p. 165

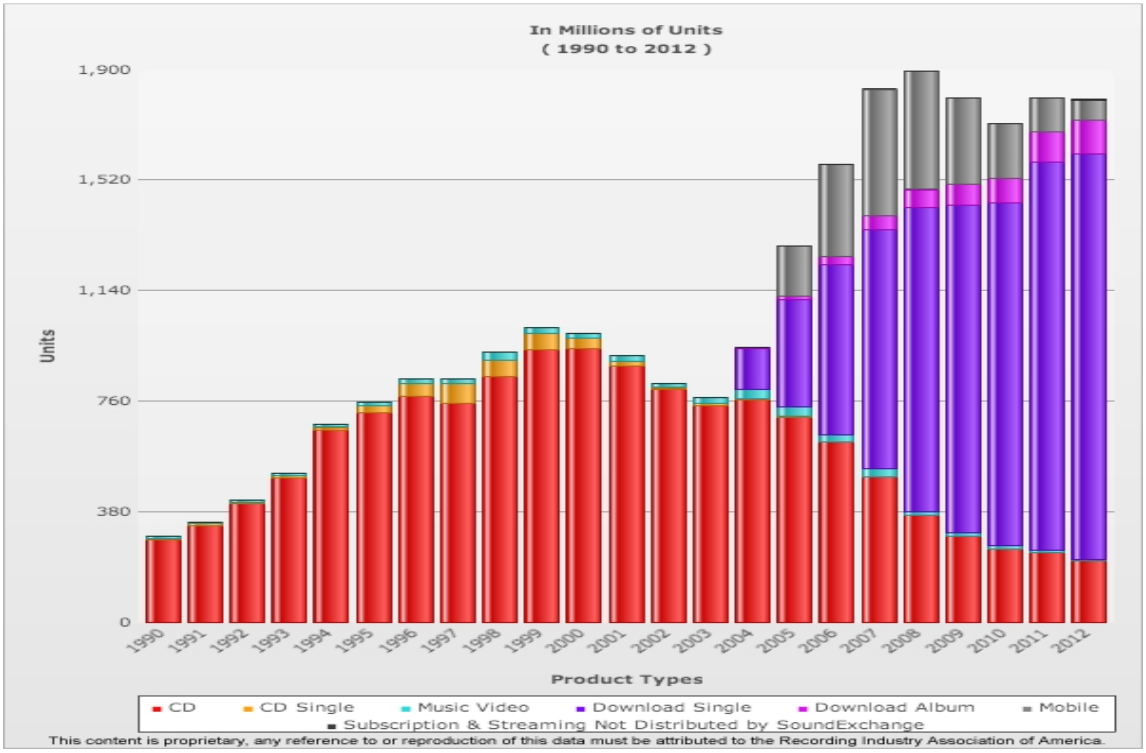
One final study that had a huge impact on the knowledge of piracy and the music industry was a regression analysis done by Patrick Mooney, Subarna Samanta and Ali H.M. Zadeh. This study attempted to run an econometric regression analysis with controls for every variable and factor that has impacted the music industry. The results of this study are very interesting. Mooney, Samanta, and Zadeh found that piracy had a minimal effect on CD sales but there were other factors that had a huge impact on the recording industry. According to the study, vinyl singles had the largest negative impact on CD sales and are the main reason for the decrease in CD sales. Medium income was also found to have a slight positive effect on CD sales. Another factor that had a significant positive impact on CD sales was time. CDs became immensely popular and were heavily purchased for a certain period of time before technology outgrew them, which caused the heavy decline in CD sales. The study found that time was a huge variable as CD sales numbers from the early 1990s were heavily inflated due to the widespread movement to update individuals' multimedia libraries. The final factor that had any significant impact was the emergence of iTunes and the sale of digital music through their iTunes Store that displaced a large portion of CD sales[78]. The empirical study concludes that the recording industry cannot place the full blame of declining CD sales on illegal downloads and that rather it was vinyl single sales that had the largest influence on declining sales as it became the favorite substitute for CDs.

The RIAA has shipment numbers on all of the different media formats for the music industry. These numbers show the unit sales and total revenues for the music

[78] Mooney, Patrick, Subarna Samanta and Ali H.M. Zadeh. "Napster and its Effects on the Music Industry: An Empirical Analysis". Journal of Social Science. pp. 307-308.

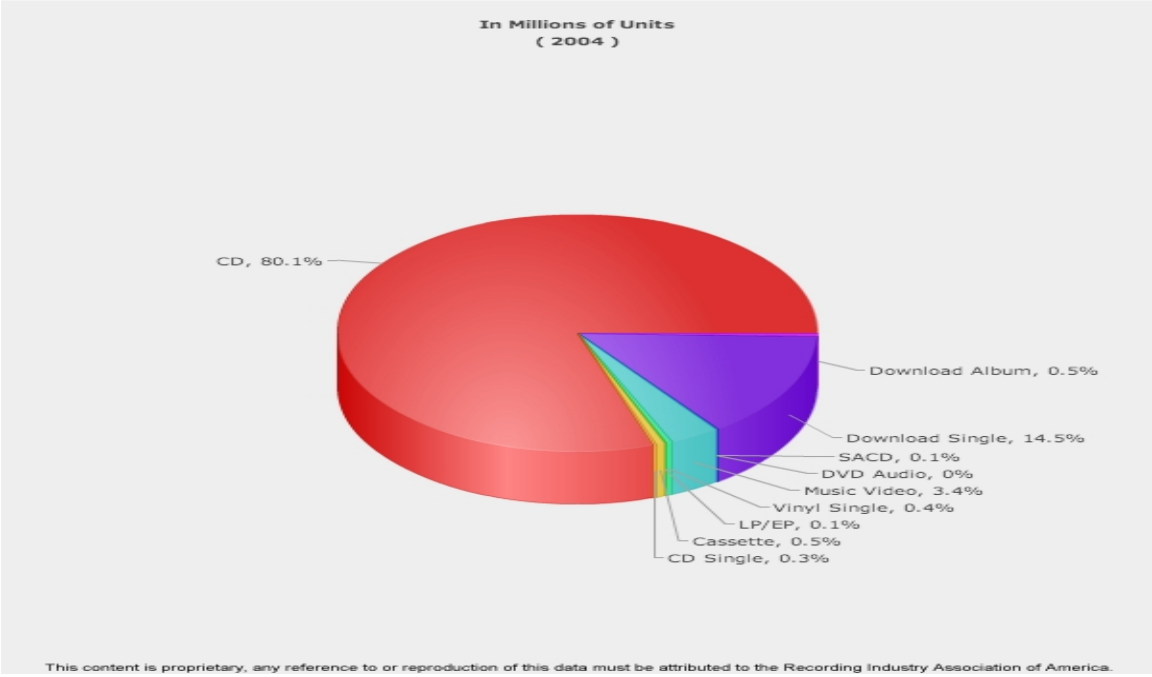
industry broken down by music format. A look at the shipment numbers show the rapid growth of CD sales as a result of the movement to update individuals' music libraries and then the decrease in CD sales as P2P networks became popular. A look at the graph below shows the total unit sales for the music industry from 1990 until 2012[79]. As you can see, the actual units of CDs sold stays pretty level until 2005 when downloading music really takes off as the biggest method to acquire music. Also, as downloading music and streaming music take off in popularity one can see the sampling effect as the total consumption of music units rises. In fact in looking at the total units sold in Exhibit 1, in 1999 when P2P first became available, there was a total of 1.16 billion units of music sold while in 2012 there was 1.819 billion units sold. This change has resulted in a 56% increase in total consumption of music since the introduction of P2P networks.

[79] RIAA Shipment database

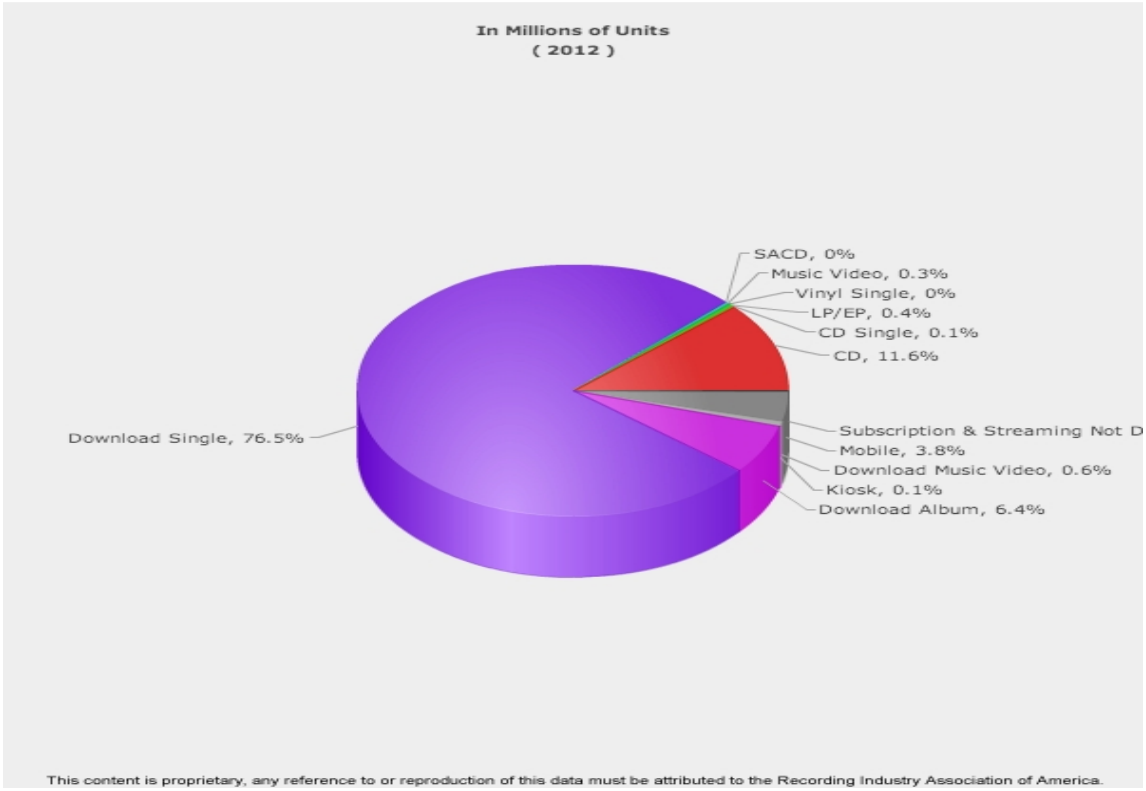


Music Unit Sales by Product Type from 1990-2012

Another interesting thing to note from the RIAA shipment number is the shifting trend towards acquiring music in the digital space. Whether it was due to P2P networks, the introduction of vinyl singles, or digital downloads through iTunes, a movement to download music began in 2003 and has only grown since. As you can see in the graphs below depicting the breakdown of how music was purchased in 2004 and then in 2012, it is interesting to note how CD sales went from being 80.1% of music sales in 2004 to merely 11.6% of 2012 sales. Downloading music took over as the primary method to acquire music and by 2012, 76.5% of music was acquired by a download. The shifting trend to the digital space was further encouraged by the introduction of products like MP3 players, iTunes, and the increasing amount of available memory in personal computers, which allowed consumers to hold more songs.



2004 Music Unit Sales broken down by media form



2012 Music Unit Sales broken down by media form

Whether or not the decrease in CD sales and increase in downloads is a result of piracy or not, the fact remains that the sale of music has shifted from CD to downloads. It has also become clear that music is valued at a lower price per unit since the introduction of file sharing. After adjusting for inflation there is still a huge decrease in the value per unit of music sales. At its peak, consumers valued their music at $18.72 per unit in 2002, just prior to the introduction of iTunes. In 2012, music was only valued at $3.88 per unit, a 79% decrease since 2002[80]. Consumers will not pay record labels the high amount that they are seeking as over time consumers have valued music at a lower amount. Since the price offered by record labels does not correspond with the value consumers have for music, the record labels have been left behind as an irrelevant part of the music industry. The adoption of the Internet and newer technologies lowered the value of music, as consumers were willing to pay less for music or even nothing at all.

Despite the revisions to copyright law and the increased attempt by record labels to pursue legal action against copyright infringers, the music industry did not hesitate to continue to shift towards a digital market. As the record labels refused to initially move into this new market, entrepreneurs and businesses decided to do so first in order to alleviate the problems with overpriced music. While there are very unambiguous reports as to what the actual effects of piracy has been, music has shifted to a digital market and total consumption of music has risen since 1999.

[80] Exhibit 1

Putting aside the ethical issues of downloading music illegally, P2P networks are here to stay and consumers will continue to download music over the web at minimal cost. That being said, there needs to be some sort of revision to copyright law as it is extremely inefficient in its current state and has done nothing to deter people from downloading music. Perhaps the problem isn't from the consumer side, but rather the law must change to better benefit the artists and consumers who are the primary beneficiaries of the music industry. Copyright law as it is, only benefits a few giant corporations that wish to continue to hold their monopoly over the music industry. Copyright law should not exist to deter new entrants and competitors in the market and so far it hasn't.

The problem with the music industry is not the artists or the consumers who have both benefited since the introduction of MP3 technology and file sharing. The only victim of the changing market has been the record labels. It seems as if the advancements in technology have made the music industry outgrow record labels and some might even question if there is even a role for record labels today in the music industry. There have been many different solutions proposed by both the players in the music industry and independent entrepreneurs to help solve some of the issues in the music industry and better adapt to the new environment. These solutions have further pushed record labels away from playing an active role in the music industry today.

Chapter 5

Solving the Problem of Record Labels

As the recording industry has struggled to recover since the adoption of MP3 technology and the emergence of file sharing, many have questioned the role of record labels moving forward. Many solutions have been proposed to fix or improve the music industry and help get rid of some of the biggest inefficiencies in the market. Laws that were written in the 20th century, even though they have been updated over the years, cannot dictate the way the music industry is run as it has changed so radically over the last 10-15 years. Many different attempts have been made by entrepreneurs to privately solve the problems that the music industry has faced because the record labels failed to act. It is thanks to some of those innovations that the record labels have even survived this long.

There are three major solutions that have been proposed to fix the music industry. The first of these solutions is the Administrative View. Under this approach, a government agency would be created to track, monitor, and administer royalties for music distribution but would incentivize free distribution to consumers who don't publish or use the content for a profit. Another component of this solution is for the government to tax complementary products for music such as iPods and other MP3 players and

distribute the tax revenue amongst the record labels[81]. This solution creates a more efficient way of tracking royalty rates as the current method is very vague and the issue of double dipping still exists.

The second major solution proposed for the music industry is called the Free Market View. The Free Market view is that the system will eventually adapt of its own accord. Consumer friendly technology will slowly emerge that will lure users away from illegal downloads[82]. This wait approach, believes in the capitalistic model in the United States and the idea of Adam Smith's invisible hand, as the market will dictate where the music industry goes. This solution also argues for the shift towards free music. This solution lacks appeal from the recording industry, as it would result in the imminent death of record labels. The free market solution argues that due to the record label's inability to adapt and slow adoption of technologies that it has been left behind the music industry and is no longer a necessity. Private entrepreneurs and investors have stepped in to take over where the record labels were slow to enter. These businesses will continue to adapt to the market and will overtake the record labels as the major players in the music industry.

The third major solution is the Statutory Change View. This solution claims that the system holding the music industry together right now is broken and institutional changes are needed to account for the changes that have occurred since the initial copyright law was written. This solution contends that copyright law must be updated

[81] Welsh, Jared S. p. 1528
[82] Welsh, Jared S. p. 1529

and changed. Copyright law should be streamlined and weakened[83]. This solution agrees that copyright law is currently only protecting a few large corporations instead of the true players in the music industry. This solution will allow for copyright law to actually protect the artists from copyright infringement instead of a few corporations. This solution also calls for a privately administered tax distribution system similar to that of the Administrative view to help allocate royalties accurately and efficiently. While all three of these solutions have been proposed ,no action has been taken by the government and record labels to fix the music industry and as such, private solutions have emerged to mitigate the inefficiencies in the music industry.

All of the private solutions to the problems the music industry face. focus on capitalizing in the online market. It is agreed upon that the future of the music industry is in the digital marketplace, and that online distribution is the best option as it lowers distribution expenses, coordination costs, and production costs. Most private solutions also believe that P2P networks should be allowed due to the positive impact it has on the music industry such as the sampling effect. The value proposition of these new private solutions will be large enough to draw most users away from illegal downloads and to their services as it will be more convenient and allow for a better interaction with the user.

The first major private solution for the music industry came in 2003, when Steve Jobs of Apple Inc. announced the introduction of iTunes and the iTunes store. iTunes would allow users to purchase single tracks for $0.99 and would have a large library of

[83] Welsh, Jared S. pp. 1530-1531

music that was not limited to just a few record labels. Anyone can sell his or her music through the iTunes store. iTunes introduced a new breakthrough in the music industry, as it was the first time that consumers could purchase single songs instead of entire albums. iTunes breaks down the continuity of a full album and shifts the control of creating playlists to the consumer instead of the record labels. iTunes was the first innovation that has lead to the destruction of the control that record labels used to have. iTunes became immediately popular and has since become the fastest growing marketplace in the music industry.

iTunes quickly became the primary marketplace for consumers to download music. An IFPI report of music downloads shows that there were 160 million songs downloaded from iTunes in 2004, its second year of existence. Two years later, in 2006, about 795 million songs were downloaded[84]. iTunes quickly became a market leader in the music industry. Apple realized that digital music sales would most likely never offset the decline in CD sales that the industry had experienced. The challenge the music industry faced was not to regain those lost revenues but rather to compete with P2P networks in the digital space for market share. iTunes quickly became the main competitor to file sharing as it provided the best alternative to consumers.

The introduction of iTunes further accelerated the downfall of the CD. Legal downloads not only compete with P2P networks but they also negatively impact CD sales[85]. Consumers prefer to download music whether legally or illegally to CD sales, and the movement towards downloading music is a result of the shift in technology that

[84] Jansens Jelle. Stijn Vandaele, and Tom Vander Beken. p. 92
[85] Mooney ,Samanta, Zadeh. p. 3-8

has allowed people to hold all their music on their computers. The popularity of iTunes was almost instant, as within a couple of years Apple would control the market for online music purchases. According to PC World, iTunes holds a 70% market share of online music purchases[86]. iTunes is highly considered the best solution and savior of the music industry but many other solutions have emerged in recent years. These solutions look to step in where the record labels failed to find ways to capitalize on the digital marketplace for music.

Another major solution that has emerged in the music industry is the idea of streaming music. Recent companies like Pandora Radio, Slacker Radio, and Spotify have emerged that offer streaming services for music. Many consider streaming to be the savior and future of the music industry. The idea of streaming stems from the thought that music should be thought of as a service rather than a product[87]. These services bank on the idea that people do not need to own their music but rather need to be able to access it and listen to it any point in time. These streaming services allow users to listen to and access music from any and all of their devices but do not transfer ownership of the music. Consumers pay a monthly fee to use these services and this money is used to pay the royalty rates for broadcasting and streaming the music that they access.

Yet another private solution that has emerged is the Amazon model as an online music retailer. Shortly after Apple announced the release of iTunes, Amazon worked hard to create a retail space for music. Amazon music was releases a few years after iTunes but provides a different value than Apple. Using the Amazon marketplace to buy

[86] Styven, Maria. P. 59
[87] Styven, Maria. P. 56

music allows Amazon to use cookies and data mining techniques to create customer profiles[88]. Amazon can then use this information for two different purposes. The first of these is to recommend new music to customers and help expand peoples' libraries. The second use from these customer profiles is that it allows for focused marketing efforts by the record labels. As Amazon was one of the first services to profile their customers through the use of data mining they were able to provide a lot of information on customer purchase habits that allow marketers to target specific customer groups. This in turn allows for a new revenue source for Amazon that not only makes money from selling music but also has become a growing space for advertising through their introduction of customer profiling.

The use of social media has also emerged as a major player in the music industry. Every artist has a Facebook page and uses their page to give out free music in return for customer loyalty. Social media networks also provide a huge infrastructure for new solutions to emerge in the music industry. It is difficult for new platforms to be built from scratch and attract a lot of users in a short period of time. However, through the use of Facebook's 3rd party app ability, new apps can be built and leverage the large user base of social media sites like Facebook and Twitter to attract its customers. In September of 2012, Facebook has 163 million unique visitors[89]. Leveraging this large user base has made Facebook a popular destination for any entrepreneur who wishes to provide a new service through the use of Facebook apps. For example, market leading ticket vendor, Ticketmaster, has already started using Facebook's capabilities. Ticketmaster has been

[88] Lam, Calvin K.M. and Bernard C.Y. Tan
[89] Bylin Kyle, Louis Hav and Glenn Peoples. "Building Digital Businesses around Music and Rights"

utilizing the use of Facebook's Graph Search to maximize their marketing efforts and social features to there ticketing services. Ticket companies have also begun using social media to sell tickets as the use of word of mouth can greatly increase ticket sales.

The music industry has begun to thrive as the amount of private solutions has grown. The private sector has taken it into their hands to revive the music industry and capitalize on the missed opportunities that led to the demise of the record labels. The globalization movement has also helped spark the music industry, especially for these private solutions. At the start of 2011, the major digital music services, iTunes and Spotify, were only available in 23 countries. Today these services are available in more than 100 countries[90]. As the Internet penetration rate has risen in emerging markets, the music industry has been able to quickly expand to parts of the world that had previously remained outside of the music industry. This provides for a growth in opportunities in the music industry.

As private solutions have become the source for innovation and entrepreneurship within the music industry the question remains: Is there a role for record labels in todays music industry? In their current form, there is no way that record labels will survive much longer. All record labels have been doing for recent years is to fight and resist the changes that have occurred. Rather than becoming flexible and adapting to the changing environments, record labels decided to stay put and have utilized the legal system to force others to stay within their confines of the music industry. It is the record label's inability to act and adapt that ultimately led to its demise. Record labels are no longer the primary

[90] IFPI 2013 Digital Music Report

distributors of music and more and more artists are leaving record labels to work independently. The use of technology has made it extremely easy for artists to perform all the functions of the record label directly from their own laptops. In the absence of innovation from record labels, businesses were formed in the digital space to take over the digital space and the record label's late entrance into the digital space will be seen as their failure. Record labels have become obsolete and are no longer a necessary part of the creative process and therefore no longer fulfill a role within the music industry.

The music industry has transformed as a result of technology and has since become leaner. The age of large production plants and distribution centers are over as one individual with a computer can do every function of a record label. Artists grew tired of receiving just a small share of the revenues from music sales and their unhappiness with the record labels drove them away and led them to becoming independent. This freedom will ultimately support and spark artist creativity as their revenues will grow with the fall of record labels. Artists were forced to find new ways to make money, and now the major revenue for musicians and artists comes from touring and merchandise. Tracks and an artist's music help promote these live tours as seeing live shows has grown in popularity over recent years. Music will continue to shift towards becoming free, as they will be used to promote artists and help bring people to live shows. Very little can be done to stop consumers from seeking to pay a minimal amount for music as technology has made it possible and even probable that they acquire their music for free.

Ultimately it was the failure of record labels to adapt that will lead to their demise. While record labels might not disappear altogether, their reign as the major player in the music industry has come to an end. Record labels might be able to survive if they stay as a consultant service and use their resources and expertise to help market music to the right audiences, but record labels will never again be the major producers and distributors of music. As technology has advanced and the music industry has moved forward with innovations that benefitted the artists and consumers, record labels were left behind and are now closer than ever to becoming extinct.

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