



The value of the cultural and creative industries to the European economy

A REPORT PREPARED FOR THE ECCIA

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Executive Summary

Frontier Economics has been commissioned by the European Cultural and Creative Industries Alliance (ECCIA) to carry out a study examining the contribution to the European economy of those sectors supplying high end consumer products and services.

Europe is a global leader in the development and manufacture of luxury products and services. The biggest luxury brands are European, and European luxury products, which are deeply rooted in European heritage and culture, are exported across the world. They act as ambassadors for European manufacturing, showcasing Europe’s world class innovation, craftsmanship and manufacturing quality.

Luxury goods are often associated with personal consumer goods such as fashion, perfumes, jewellery and watches. However, in reality the European luxury sector is much wider than this. For example, the five industry associations that make up the ECCIA together represent approximately 300 of Europe’s leading luxury brands covering 14 different consumer product and service markets, which range from cars and yachts to publishing and furniture.

Because the luxury sector is made up of the high-end segments of so many industries, it is easy to overlook its collective importance to the European economy, and to fail to deliver the policy environment that is necessary to ensure the further growth and success of the sector. The aim of this study is therefore two-fold:

- To draw together and analyse the evidence base in relation to the economic contribution of the sector to the European economy; and
- To highlight the unique business model that underpins the sector, and to estimate the importance to the sector, and the wider European economy, of delivering policies that are conducive to further growth.

1.1 Contribution of the sector

Europe dominates the global luxury market. Collectively, European brands account for at least 70% of the global luxury goods market. This leads to the sector providing a very significant contribution to the European economy:

- The output of the sector in 2010 is estimated to be over €440 billion, which equates to approximately 3% of European GDP;
- The sector employs approximately one million workers directly, and at least a further 500,000 workers indirectly;

- The sector is a key exporter, with approximately 60% of output exported. Our estimates suggest that total exports for the sector are approximately €260 billion in 2010, representing over 10% of all exports from Europe;
- We estimate that the sector contributes in excess of €110 billion to the tax authorities through sales, corporate and export taxes and through the personal income tax paid by workers in the sector;
- The sector is a key driver of tourism in Europe, for example, according to Global Blue's most recent estimate, up to 50% of personal luxury goods sales in Europe are purchased by tourists;
- The sector provides significant spillovers to the wider European economy, to the benefit of both consumers and businesses. The sector is particularly supportive of SMEs and supports a diverse network of SMEs across Europe;
- In terms of growth, the sector has grown faster than the European economy over the last decade, and has markedly outperformed the European economy since the onset of the current economic crisis. Following a decline in sales in 2009, the sector has recorded double digit growth in the last two years; and
- The future prospects for the sector are strong, driven by the expected increasing demand in Asia and other high-growth economies over the next decade. Medium-term forecasts suggest the sector will continue to grow at between 7% and 9% per year. If this level of growth is realised, the sector will contribute between €790 and €930 billion to the European economy in 2020, and will employ between 1.8 and 2.2 million people directly.

1.2 A unique business model

While the luxury sector is made up of a diverse range of products and services, the pillars that underpin the luxury business model are common across the segments. The key pillars that underpin the European luxury business model are:

- Aura – it is well recognised that luxury products and services encapsulate more than the physical characteristics of the product. Maintaining the aura of luxury is a key driver of consumer behaviour, differentiates luxury products from mass-market sales and is essential to the ongoing success of the sector;
- Craftsmanship and creative people – quality and craftsmanship are at the heart of the luxury proposition. Access to an appropriately skilled and trained workforce is essential for the success of the sector;

- Substantial investment in industrial property – the luxury sector invests heavily in IP in terms of brand development but also in relation to design and innovation;
- Selective distribution – critical to the success of the sector is maintaining control of the distribution and retail of products to ensure that the products' brand and image are not damaged by inappropriate distribution and retail; and
- Developing new markets – the European luxury sector is a significant exporter, and prospects for the growth of the sector are predicated on maintaining fair and free access to high-growth developing markets.

The above points demonstrate the unique pillars that underpin the luxury business model and differentiate the luxury segment from the mass-market. They also demonstrate that, far more so than the mass-market, the key pillars of the business model are vulnerable to negative policy impacts.

1.3 A supportive policy environment is critical

An essential element of helping the sector continue to succeed and deliver on its growth potential of 6%-9% average annual growth will be ensuring that policies are in place that are supportive of the key pillars of the business model.

To demonstrate the importance of achieving the correct policy environment, Frontier has developed a scenario model to assess the impact on the sector if policies were to be implemented which undermine the pillars of the business model. The results are summarised in Table 1. The biggest effects relate to the impact of further increases in IP infringement and any substantive dilution in the sectors' ability to maintain control of distribution and retail. For these impacts we find that:

- A further increase in IP infringements, either in the online or offline environment, could result in an output loss of €43-€79 billion. This level of output loss would be associated with the loss of between 100,000 and 180,000 direct jobs within the sector, and losses to the tax authorities of between €14 and €26 billion.
- A 20% decline in output as a result of a substantial change to current policy towards selective distribution would result in the loss of 190,000 jobs and cost the tax authorities over €27 billion.
- A further increase in trade and non-trade barriers in key markets could potentially reduce output by between €2 and €3.4 billion and cost the tax authorities up to €1 billion.

Table 1. Summary of impact analysis

Pillar	Scenario	Output loss	Employment loss	Tax and welfare impact
Industrial Property	Impact of a 5% increase in IP infringement	€43 billion	98,000	€14 billion
	Impact of a 15% increase in IP infringement	€79 billion	180,000	€26 billion
Selective distribution	Reduced control over distribution leads to a 20% decline in output	€84 billion	190,000	€27 billion
Aura and Access to Craftsmanship and creativity	10% increase in the cost base	€12 billion	27,000	€4 billion
	20% increase in the cost base	€24 billion	54,000	€8 billion
	5% decline in demand as a result of reduced aura	€21 billion	48,000	€7 billion
	10% decline in demand as a result of reduced aura	€42 billion	95,000	€14 billion
Trade barriers	20% increase in price tariffs	€2 billion	5,000	€0.7 billion
	10% decline in imports as a result of non-price tariff increases	€3.4 billion	7,600	€1 billion

While the analysis of impacts is necessarily high level, as we are considering the spectrum of potential threats to the sector, it serves to illustrate:

- The range of threats that face the sector;
- The vulnerability of the sector to adverse policy actions (or in some cases inaction) at a European and global level; and
- The consequent impacts for the wider economy and tax authorities given the size and importance of the European luxury sector.

What appears clear from the analysis is that the key risks to the sector relate to the protection of investment in industrial property and continuing to ensure that regulatory and competition policy does not restrict the ability of the sector to control the distribution and retail of products and services, given the vital role that this plays in the overall value and image of the luxury good.

While cost impacts may be less important than in other sectors, their effects are still substantial, and there is a constant need to ensure that regulations aimed primarily at the mass market do not undermine the aura of luxury that is such an essential feature of the luxury business model. Finally, given the proportion of products and services that are exported, and the importance of export markets to the continued growth and health of the sector, it is vital that European policy continues to honour its commitments to free trade and to push other countries to take a similarly progressive approach to trade policy.

2 Introduction

Frontier Economics have been commissioned by the European Cultural and Creative Industries Alliance (ECCIA) to carry out a study examining the contribution to the European economy of those sectors supplying high end consumer products and services.

Europe is a global leader in the development and manufacture of luxury products and services. The biggest luxury brands are European, and European luxury products, which are deeply rooted in European heritage and culture, are exported across the world. They act as ambassadors for European manufacturing, showcasing Europe's world class innovation, craftsmanship and manufacturing quality.

However, because the luxury sector is made up of elements of many industries, it is easy to overlook its collective importance to the European economy, and to fail to deliver the policy environment that is necessary to ensure the further growth and success of the sector. The aim of this study is twofold:

- To draw together and analyse the evidence base in relation to the economic contribution of the sector to the European economy; and
- To highlight the unique business model that underpins the sector, and to estimate the importance to the sector, and the wider European economy, of delivering policies that are conducive to further growth.

The remainder of the report is structured as follows:

- Section 3 sets out our definition of the sector and describes the luxury business model;
- Section 4 outlines the contribution of the sector to the European economy;
- Section 5 highlights the potential risks to the sector and the wider European economy of policies that undermine the business model; and
- Section 6 provides some conclusions.

3 The luxury sector and the business model

This chapter sets out the luxury sectors that make up the European luxury industry and describes the key elements of the business model that underpins the luxury industry in Europe.

3.1 Defining the sector

There is no single universally used definition of luxury or of the segments that make up the European luxury sector. Luxury goods tend to make up a higher-priced tier of many product and service markets. For the purposes of this study our approach to definition has been to work with the Associations to identify the key segments that make up the luxury goods sector. To do so we took the practical approach of examining the key sectors in which the membership of the five industry associations operate. The associations together represent over 250 of Europe's leading luxury brands, and these brands operate across the following 14 market segments:

- Watches & jewellery;
- Fashion;
- Perfumes & cosmetics;
- Accessories;
- Leather goods;
- Gastronomy;
- Furniture & furnishing;
- Design household equipment;
- Cars;
- Yachts;
- Wines & spirits;
- Hotels and leisure experience;
- Retail and Auction Houses; and
- Publishing.

The first five of these sectors – watches and jewellery, fashion, perfumes and cosmetics, accessories and leather goods – make up what is commonly referred to as the personal luxury goods sector.

We have drawn on a wide range of data sources in carrying out this study. Key sources include:

- Independent analysis and research by Bain consulting carried out together with Altagamma;
- Company level data taken from annual reports;
- Analyst reports from a number of leading financial institutions, including JP Morgan, HSBC and Bernstein Research;
- Independent analysis conducted by the Boston Consulting Group for Comité Colbert;
- Independent analysis conducted by Roland Berger Strategy Consultants for Meisterkreis;
- Industry reports and analysis by McKinsey, PwC, Ernst and Young and KPMG; and
- A range of academic papers and studies from institutes such as INSEAD and the Harvard Business School.

3.2 The luxury business model

While the sector is made up of a diverse range of products and services, our review of the sector suggests that the pillars that underpin the luxury business model are common across the segments.

The key pillars that underpin the European luxury business model are:

- Aura – maintaining the aura of luxury is a key driver of consumer behaviour and differentiates luxury products from mass-market sales;
- Craftsmanship and creative people – quality and craftsmanship are at the heart of the luxury proposition. Access to an appropriately skilled and trained workforce is essential for the continued success of the sector.
- Substantial investment in industrial property – the luxury sector invests heavily in IP in terms of brand development and also in relation to design and innovation;
- Selective Distribution – it is essential to maintain control of the distribution and retail of products to ensure that the product’s brand and image is not damaged by inappropriate distribution and retail; and
- Developing new markets – the European luxury sector is a significant exporter, and prospects for future growth of the sector are predicated on maintaining free and fair access to high-growth developing markets.

Below we describe each of the pillars in more detail, focussing on their importance to the overall success of the luxury business model.

3.3 The aura of luxury

An essential element of the luxury business model is the creation of an ‘aura of luxury’ that goes beyond the physical product. The concept of aura and its importance to the sector has been recognised by the Courts. For example, in the recent Christian Dior case, the Court found that *“The quality of luxury goods is not only the result of their material characteristics but also of the allure and prestigious image which bestows on them an aura of luxury”*.

In terms of practically defining the luxury aura, the following factors have been identified as being essential:

- The cultural and artistic dimension of the product;
- The quality and craftsmanship of the product;
- The excellence of materials used;
- The symbolic value of the product;
- The way products are presented and communicated;
- The external presentation of products;
- The way products are offered to consumers (the retail experience);
- The way the customer relationship is maintained both in terms of the sales experience and the after-sales service; and
- The way consumers are allowed to access products.

3.4 Craftsmanship and creativity

At the centre of the luxury proposition is the development and manufacture of products that meet the highest quality standards and consumer desire for excellence. For the European brands, this quality and craftsmanship is deeply engrained in the DNA of the brands and is closely associated with a European reputation and heritage for high quality in manufacturing. Indeed, a number of consumer studies have highlighted the importance of the ‘Made in France’, ‘Made in Italy’, ‘Made in Spain’ ‘Made in Germany’ ‘Made in UK’ etc. labels to European luxury goods, and cite it as a key entry barrier to luxury brands from other regions (for example, in China customers exhibit a willingness to pay for the ‘Made in France’, ‘Made in Italy’, etc. label that would not be the same for a ‘Made in China’ alternative).

It is therefore of central importance to the business model to maintain the skills, quality and craftsmanship of the European manufacturing workforce. For example, companies like IWC Schaffhausen or Montblanc are able to produce very large volumes of product while maintaining the highest quality standards and manufacturing tradition with highly skilled specialists.

The leading luxury brands all invest heavily in training and developing their skilled workforce, and invest heavily in developing world-class manufacturing facilities. Analysis suggests that luxury goods companies spend over €700 per employee on training. Given the size of the European luxury workforce, this suggests that the sector spends over €700 million per year on training.

Examples of investment in training and development include:

- The Bocconi Business School's Masters in Fashion, Experience and Design Management. This programme is partnered by Fondazione Altagamma and 20 Altagamma member companies;
- The Bocconi Business School's Masters of Management of Food and Beverages. This programme is partnered by Fondazione Altagamma and five Altagamma member companies;
- The Polimoda International Institute of Fashion Design and Marketing which is partnered by Gucci, Emilio Pucci and Salvatore Ferragamo;
- WHU Otto Beisheim School of Management, executive education in luxury management. This programme is partnered by Meisterkreis;
- The Colbert International Design Workshop initiated by the Comité Colbert with the design school Ecole Nationale Supérieure des Arts Appliqués et Métiers d'Art (ENSAAMA);
- In 2011, Louis Vuitton opened three new workshops, including one in Marsaz (Drôme region of France), which will employ 250 craftspeople. Louis Vuitton is also preparing to open a jewellery workshop in Place Vendôme, Paris;
- A. Lange & Söhne have established their own school for watchmakers;
- Mercedes, BMW and Porsche are cooperating closely with universities and academic institutions like the Max Planck Institute to develop knowledge provide appropriate training and development; and
- Richemont supports The Creative Academy, the Milan-based postgraduate school created by the Group in 2003, which offers students a Master's programme in Arts and Design.

3.5 Industrial property

A key feature of luxury is that the price of luxury products often substantially exceeds the value of their component costs (for example, the price of luxury perfumes far exceeds the cost of the chemicals involved in their creation). A key driver of the difference between the costs of these inputs and the final retail price is investment in IP. Luxury businesses invest extensively in IP in many forms:

- Investment in brand and symbolic value;
- Investment in cutting-edge design; and
- Investment in innovation, research and development.

Brand and symbolic value

It is well recognised that luxury consumers are not just buying a physical product or service, they are also buying into the brand and symbolic value of the product. Companies must invest substantially in creating the brand and symbolic value of the product in terms not just of the quality of the product, but also in terms of the packaging, retailing, advertising sponsorship, etc.

Cutting-edge design

Luxury products are perceived to be at the cutting-edge in design terms, and are associated with the creation of iconic products (for example, the outline of Porsche's design icon, the 911, has not changed in over 50 years). Luxury brands invest substantially in identifying and developing creative talent. These individuals, and the creativity of the designs they create, are central to the success of the luxury model.

Investment in R&D

Many luxury manufacturers also invest heavily in traditional innovation, research and development. In the auto sector, for example, R&D and product development is critical to the continued relevance and success of luxury marques. For example, luxury cars are often the first to bring break-through innovations to the market, before migrating to the mass market segments. Anti-lock braking system (ABS), night vision displays and parking assistance were all first introduced in luxury cars.

This is reflected in the spending for research and development. In cosmetics, LVMH has spent over €150 million on R&D over the last 3 years. LVMH employs approximately 270 scientists, researchers, chemists, biologists, physicians and pharmacists in laboratories in France in Saint-Jean de Braye. In textiles, in 2010, Ermenegildo Zegna presented a new water-repellent material, based on microspheres, which was different in its fabric and its look from the traditional water-repellent tissues. In 2012, Stone Island developed a new tissue, the

Prismatic Muslin: a light cotton muslin joint with a transparent polyurethane film. In automotives, Mercedes-Benz had an R&D budget of around €5.6 billion in 2011.

3.6 Selective distribution

Selective distribution is essential to the luxury business model. The purchase of a luxury product or service is about more than the product itself, and the way in which the product is distributed and retailed adds considerably to the consumer experience and to the value of the luxury brand.

In practical terms, key factors that brands need to control with respect to distribution and retail of their products includes:

- The quality and exclusivity of the retail outlet – it is vital that the setting in which luxury products are sold match the luxurious and exclusive image of the product being sold;
- Provision of sales advice and after-sales service – the sales advice and levels of customer service are essential elements of the purchase of a luxury product, and retailers have significant influence over the customer purchase decision, depending on the level of effort they make in relation to provision of sales advice. For all luxury products the after-sales service is also a critical element of the overall consumer purchase decision; and
- The breadth of product carried by retail outlets and the level of inventory carried by the outlet.

A particular challenge faced by brands is that of ‘free riding’ whereby rival retailers fail to invest in the quality of facilities and service required of a luxury product, but seek to offer the product at a significant discount. This reduces the incentives for all retailers to invest in their retail outlets and to diminish the quality of sales service and after-sales service they provide. In the longer term this has a significant negative impact on the luxury brands, and results in diminished consumer demand. A particular challenge in this regard has been the increasing growth of online retail. While the luxury brands have embraced the online retail market, and invested substantially in developing their online presence, it is also the case that online retail creates a greater tension with respect to free rider issues.

The importance of selective distribution to the sector has been recognised by the Courts (for example, in the Yves Saint Laurent Parfums case and the Copad v Dior¹ case) and by the Commission in relation to the 2010 Vertical Restraints

¹ *Copad SA -v- Christian Dior SA* (Case C-59/08), 23 April 2009

Block Exemption, which continued to recognise and allow for the use of selective distribution, and in particular, which allows luxury brands to require distributors to have a physical presence as well as an online presence.

3.7 Trade and new markets

As we noted earlier, the European luxury sector is a significant exporter, with exports of €260 billion per year. The sector is also predicted to grow substantially over the coming decade, with growth estimates of between 7% and 9% per year. However, much of that growth is likely to take place in markets outside of Europe (growth in Europe is likely to be considerably more modest). In particular, the market in Asia and in the BRIC economies is estimated to be the key driver of growth over the next decade, as continued strong economic growth and development in those economies increases overall income levels and the proportion of high net worth individuals in each economy.

In consequence, continued access on fair terms to these growing markets is essential to the continued success of the luxury sector. Continued progress in reducing trade barriers and increasing trade integration across these markets is therefore fundamental to the luxury business model.

4 The economic contribution of the European luxury sector

This chapter sets out the economic contribution of the luxury goods sector to the European economy. In doing so, it provides:

- A quantitative assessment of the value of the sector, in terms of output, employment and exports;
- A qualitative assessment of the wider benefits of the sector to the European economy; and
- An assessment of the future growth prospects of the sector.

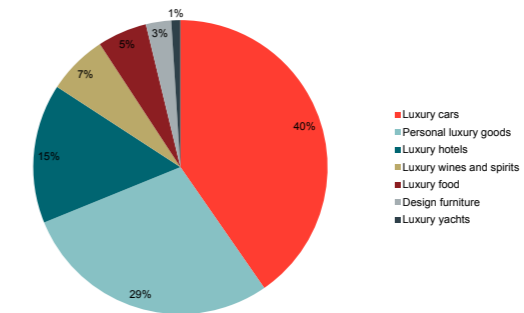
4.1 The economic contribution of the sector to the European economy

The most recent data for the sector² shows that the global market for luxury goods was worth approximately €600 billion in 2010. We note that this figure does not currently include a global estimate of the value of the retail, auction house and publishing sectors, and so will under-estimate the total value of the global luxury market.

The Figure below shows the breakdown of the market into the key sectors. This shows that together, personal luxury goods and luxury cars account for almost 70% of the value of the global market. Both the luxury cars and personal luxury goods sectors are dominated by European brands.

² Bain/Altgamma Worldwide Market Monitor 2011.

Figure 1. Breakdown of total luxury output by luxury segment



Source: Altgamma/Bain

The Table provides a breakdown of the value of sales of European brands and non-European brands. The value to the European economy of luxury goods and services in the sectors covered by the Bain/Altgamma analysis is €428 billion. This is over 70% of the global value of the sector.

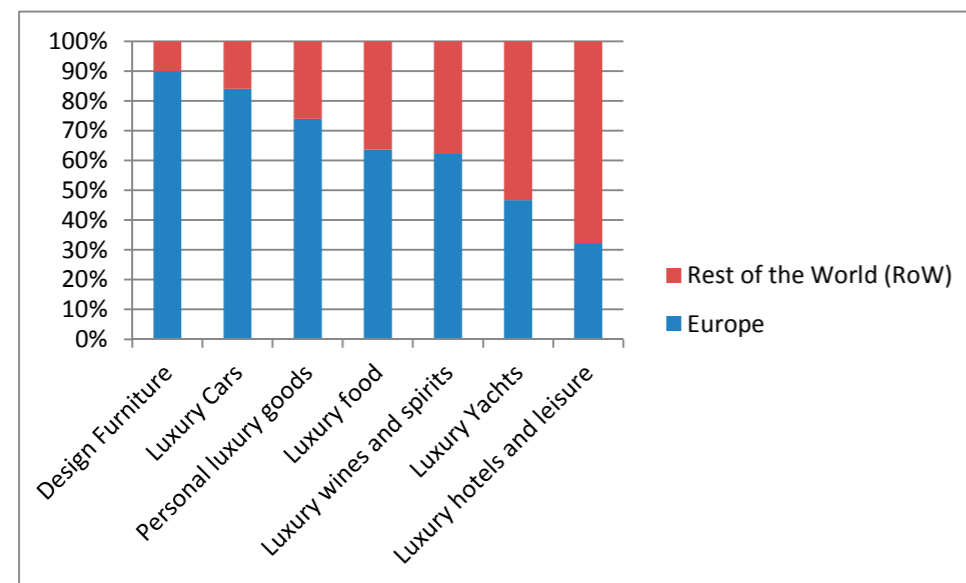
Table 2. Breakdown of value by geography

	Global Value € billion	Europe € billion	Rest of the World € billion
Luxury Cars	245	206	39
Personal luxury goods	173	128	45
Luxury hotels and leisure	93	30	63
Luxury wines and spirits	40	25	15
Luxury food	33	21	12
Design Furniture	17	15.3	1.7
Luxury Yachts	6	2.8	3.2
Total	607	428.1	178.9

Source: Altgamma/Bain

The Figure below shows the proportion of global sales accounted for by European brands, and brands in the rest of the world. This shows that in all sectors except hotels and leisure and yachts, Europe accounts for over 60% of global sales. In personal luxury goods Europe accounts for over 70% of sales, and in both luxury cars and design furniture, Europe accounts for over 80% of global sales.

Figure 2. Proportion of sales by geography and sector



Source: Altgamma/Bain

As noted above, the Bain analysis does not cover the luxury publishing, retail or auction house sectors. To provide an estimate for these sectors, we have used individual company level data to estimate the value of these sectors. This analysis suggests that these sectors may add a further €10 billion to the value of the European luxury sectors³. This suggests that when combined with the Bain/Altgamma estimate for the other sectors, the European luxury sector contributes approximately €440 billion to European output.

³ We note that this is an initial estimate of value based on our assessment of the luxury perimeter for each sector. As such, this estimate may require further testing with industry to assure its validity. To be conservative, therefore, when carrying out the impact analysis described later in this pack we have not included data for these sectors.

To put this figure in context, it suggests that:

- The sector, at €440 billion, is valued at over 3% of European GDP. By comparison the European energy sector, which is often considered to be a potential driver of growth, is valued at €620 billion⁴;
- The luxury goods sector in aggregate is larger in size than the Swedish economy, which is the 10th largest economy in the EU.

4.1.1 Contribution to employment

To develop an estimate of direct employment for the sector we have:

- Identified the ratio of employment to turnover for a sample of companies in each sector that we considered; and
- Applied that ratio to the output figures for each sector.

On the basis of this approach, we estimate that direct employment for the luxury goods sector in Europe is approximately 990,000.

We note that this figure does not include the indirect employment effects that the sector is also likely to generate. A 2008 report by Boston Consulting Group for the Comité Colbert considered the indirect employment effects for the personal luxury goods sector. The report found that for every job in a luxury company two to three jobs are generated indirectly. It identified two categories of indirect employment:

- A 'first line eco-system' made up of the supply chain of suppliers, distributors, franchisees and resellers; and
- A 'second line eco-system' made up of tourism, fashion magazines, promotions industry (marketing, photography and communications), culture, education and design and architecture.

It identified that these two categories combined employed between 500,000 and 600,000 employees. It is likely that there is overlap between the indirect employment created by the personal luxury goods sector and by the other luxury sectors, and so it would not be appropriate to scale up the indirect employment effects. However, we note that the figure of 500,000 to 600,000 is likely to be a highly conservative estimate for the indirect employment effects of the entire European luxury sector.

Even using this conservative figure, however, suggests that the European luxury sector provides employment for over 1.5 million people, a similar level of employment to the energy sector.

⁴ European Commission, "Background on energy in Europe – information prepared for the European Council", February 2011

4.1.2 Contribution to exports

Finally, turning to exports we see that the luxury goods sector is a key contributor to Europe’s export performance. Recently published research by HSBC Global Research shows the breakdown of sales for a number of Europe’s leading luxury brands. This shows that 62% of sales of goods manufactured by European luxury brands are outside of Europe. Applying this figure to the European luxury brands’ total output of €440 billion, suggests that exports from Europe would be in the region of €260 billion. Given that European exports in total are approximately €1,800 billion per year, this suggests that luxury goods exports account for over 10% of all European exports.

Table 3. European sales of leading European luxury brands (percentage)

European luxury brand	Proportion of total company sales outside of Europe
Luxottica	77%
Ferragamo	76%
PPR	68%
LVMH	67%
Burberry	66%
The Swatch Group	66%
Porsche	66%
Richemont	65%
Hermès	63%
Hugo Boss	40%
Tods	30%
Average	62%

Source: HSBC Global Research and Frontier analysis

4.2 The wider contribution of the sector

The contribution of the sector to the European economy goes beyond the purely quantitative assessment set out above. A qualitative assessment of the sector

demonstrates that it has a number of key features that make it a highly valued sector of the European economy.

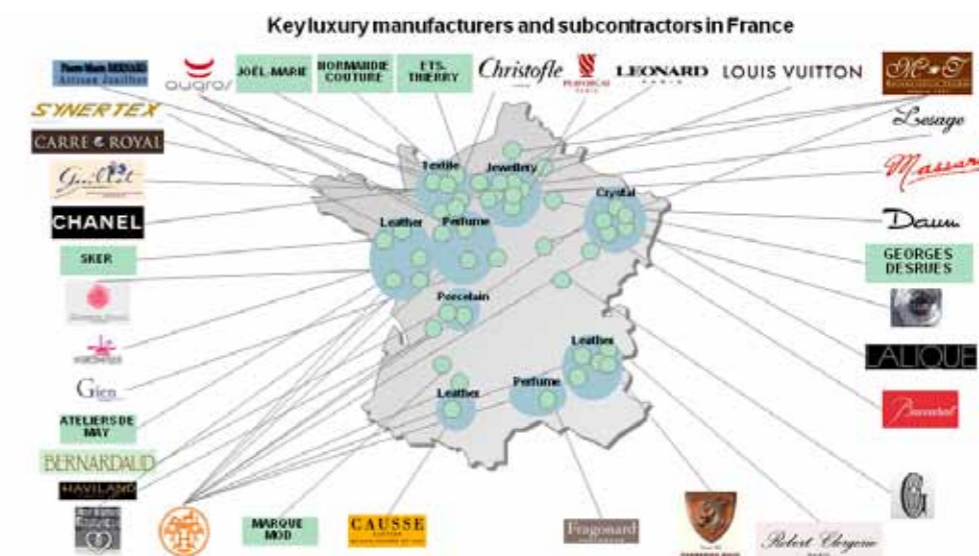
We discuss these in turn below in relation to:

- Employment footprint;
- Spillovers;
- Growth;
- Contribution to government revenues; and
- Tourism.

4.2.1 Employment footprint

In addition to the direct employment benefits, the European luxury sector invests substantially in maintaining and developing Europe’s manufacturing heritage. This has important implications not just for the volume of employment but also for the location of that employment. To illustrate the importance of this locational impact we have drawn together a number of examples of geographical clustering. The Figure below was developed by the Boston Consulting Group for the Comité Colbert and shows the breadth of the luxury sector in France.

Figure 3. Geographic clustering of the luxury sector in France



Source: Comité Colbert/Boston Consulting Group

Similar clusters exist in other European countries. For example:

- In Italy, the leather goods and accessories sectors are a major employer in the Veneto and Marche regions, Florence and Tuscany⁵;
- In Italy, the luxury cars and motor cycles sector is a strong presence in the Emilia Romagna region;
- In the UK, there is a strong tradition of leather work and skills in the Midlands, textiles, in particular, cashmere in Scotland, and china and porcelain production in Staffordshire⁶;
- In Southern Germany (Bavaria and Baden-Wurttemberg), there is a cluster of leading car manufacturers such as Mercedes-Benz, BMW, Audi and Porsche; and
- In Eastern Germany, after the breakdown of the GDR, Glashütte, the former centre of luxury watch-making was revitalised and today is the home of numerous brands including A. Lange & Söhne and Glashütte Original.

The luxury sector has also played a key role in supporting employment in economically depressed regions. For example, Givenchy purchased an existing manufacturing plant in an economically depressed area that was about to close rather than open a new one. This preserved a site dating from the beginning of the last century⁷.

The role played by the sector in preserving Europe's manufacturing heritage is recognised by European citizens with 71% believing the industry plays an important role in the preservation of craftsmanship in Europe⁸.

4.2.2 Spillovers to the wider economy

The European luxury goods sector generates considerable spillovers for the wider European economy. We have identified four categories of spillover which we discuss below:

- Creativity and innovation;
- European supply chain;
- Reputation of European manufacturing; and

⁵ Comité Colbert "Luxury: A Growth Driver for 21st-Century Europe

⁶ Walpole, submission to European Commission Green Paper

⁷ LVMH submission to European Commission Green Paper

⁸ TNS Sofres, European Perceptions of the Luxury Goods Industry

- European network of SMEs.

Creativity and innovation

In many sectors (for example, fashion) luxury brands play a key role in determining consumer trends and product lifecycles that are followed by the mass-market, as mainstream producers often follow the overall design trends and styles determined by the luxury segment (note this spillover is different to copycatting, where mass-market retailers produce products that are almost identical to luxury designs). By investing in creativity and design the luxury sector therefore helps to boost overall industry demand (not just demand in the luxury segment), to the benefit of both consumers and mass-market producers. Consumers in particular benefit from this investment in innovation and creativity.

The European supply chain

The luxury goods sector is a key customer for a number of traditional European manufacturing sectors such as textiles, fabric and leather. Given the strength of the European luxury sector globally, this demand for quality has had a significant positive impact on the sustainability and growth of these traditional European sectors, many of which provide employment in areas of Europe that face significant employment and growth challenges (see section above on the sector's employment footprint). In the absence of the European luxury market it is unlikely that these upstream industries would have as strong a presence in Europe with consequent impacts in terms of European employment and output.

Reputation of European manufacturing

The European luxury sector has a global reputation for delivering the highest quality standards in manufacturing. It is highly likely that this reputation has positive reputational impacts for European manufacturing more generally, as consumers' perceptions of quality in luxury manufacturing are likely to influence their perceptions of quality in other sectors. This suggests that all European manufacturing may benefit from a positive externality from the luxury sector. Moreover, it is likely that the significant investment in promoting skills and craftsmanship in the sector has positive spillovers in the mass-market sector, as skilled labour from the luxury sector migrates into product design and production in the mass-market sector.

European network of SMEs

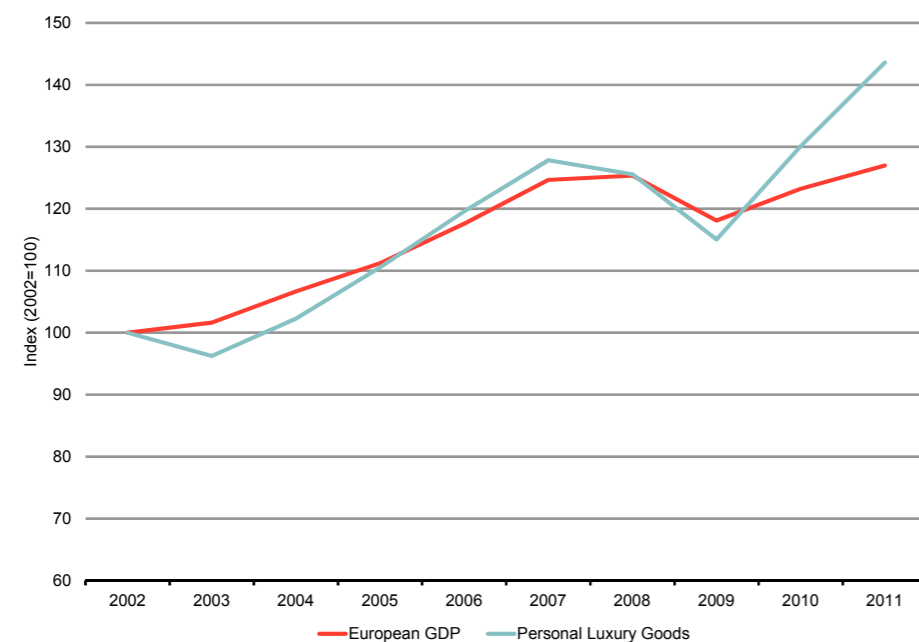
Finally, the luxury sector is particularly important for SMEs. While luxury is often associated with large European companies much of the industry is dominated by small firms that are often either family businesses or have only two or three employees. For example, the Comité Colbert suggests that in the French

Haute Couture sector, 80% of companies have less than four employees, while the French jewellery industry covers 3,400 firms with about 12,000 employees in total.

4.2.3 Growth performance

The luxury goods sector is a high growth sector relative to the wider European economy. The Figure below shows an index of European GDP growth and personal luxury goods output growth over the last decade. As can be seen from the chart, since 2005 output growth in the personal luxury goods sector has outperformed the growth in European GDP. Moreover, despite a downturn in performance in 2009, the sector has proved remarkably resilient to the economic crisis, and has delivered double digit output growth in 2010 and 2011, which has left it significantly ahead of the wider European economy in performance terms.

Figure 4. Comparative growth performance of the personal luxury goods sector and European GDP



Source: Frontier analysis of Altgamma/Bain and Eurostat data

4.2.4 Contribution to government revenues

Given the size of the European luxury goods sector, it is a strong contributor to government tax revenues across Europe. This is both through direct business taxes such as VAT and corporation tax, and also through the personal income taxes paid by the almost 1 million employees working directly in the sector.

While it is difficult to estimate the exact contribution of the sector, based on the economic model we have developed, we believe that a conservative estimate is likely to be in the order of €110 billion per year across Europe.

4.2.5 Tourism

The European luxury goods sector contributes strongly to Europe's positioning as a key tourist destination. HSBC analysis shows that European consumers account for 15% of sales by European brands. Even taking into account exports from Europe, this suggests that tourists account for a large proportion of luxury purchases in Europe. Research by Global Blue⁹ suggests that tourists may account for up to 50% of personal luxury goods sales in Europe.

Research by Meisterkreis/Roland Berger found that luxury affiliated tourists typically have high expenditure in relation to hotels, gastronomy and personal luxury. The research also noted that expenditure per head has been increasing substantially for tourists from the BRIC economies, with average expenditure per head 60% higher for Russian tourists in 2011 compared to 2010, and 40% higher for Chinese tourists in 2011 compared to 2010.

4.3 Future growth of the sector

The luxury sector has proved to be remarkably resilient to the current economic crisis in Europe, and has recorded double digit growth over the last two years. In the medium-term, that strong growth performance is expected to continue:

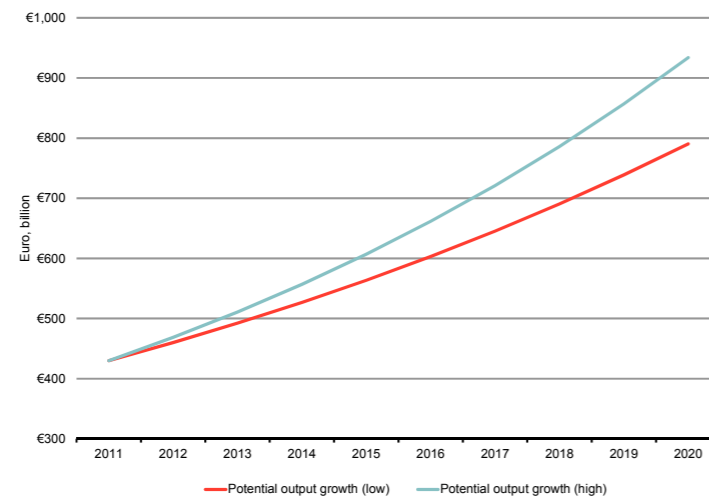
- Altgamma estimates annual growth of 7%-9% per year to 2014;
- HSBC forecasts that the sector will grow at 10% in 2012 and 9% in 2013; and
- Goldman Sachs estimates that the sector could see annual growth rates of 9% to 2025.

We note that at a country level some countries may exceed even these growth levels. For example, Meisterkreis estimates that the German luxury sector will continue to deliver double digit growth rates in the medium term.

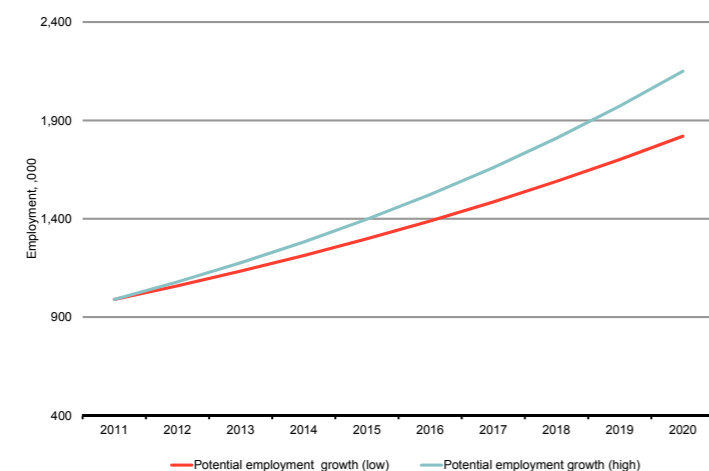
Much of this growth is predicated on the continued strong growth of the Asian market, and increasing growth in the other BRIC economies.

The Figures below illustrate potential output and employment growth to 2020 for the sector based on the range outlined above for the sector. This shows that by 2020, output for the sector may be between €790 and €930 billion, and direct employment in the sector may be between 1.8 and 2.2 million.

⁹ Global Blue, 2012

Figure 5. Forecast of potential output growth

Source: Frontier Economics

Figure 6. Forecast of potential employment growth

Source: Frontier Economics

4.4 Conclusions

Europe dominates the global luxury market. Collectively, European brands account for at least 70% of the global luxury goods market. This leads to the sector providing a very significant contribution to the European economy:

- The output of the sector in 2010 is estimated to be over €440 billion, which equates to approximately 3% of European GDP;

- The sector employs approximately one million workers directly, and at least a further 500,000 workers indirectly;
- The sector is a key exporter, with approximately 60% of output exported. Our estimates suggest that total exports for the sector are likely to be around €260 billion in 2010, representing over 10% of all exports from Europe;
- We estimate that the sector contributes in excess of €110 billion to the tax authorities through sales and corporate taxes and through the personal income tax paid by workers in the sector;
- The sector is a key driver of tourism in Europe, for example, up to 50% of personal luxury goods sales in Europe are purchased by tourists;
- In terms of growth, the sector has grown faster than the European economy over the last decade, and has markedly outperformed the European economy since the onset of the current economic crisis. Following a decline in sales in 2009, the sector has recorded double digit growth in the last two years; and
- The future prospects for the sector are strong, driven by the expected increasing demand in Asia and other high-growth economies over the next decade. Medium term forecasts suggest the sector will continue to grow at between 7% and 9% per year. If this level of growth is realised, the sector will contribute between €790 and €930 billion to the European economy in 2020, and will employ between 1.8 and 2.2 million people directly. The sector will therefore create up to 1.2 million jobs over the next decade.

5 The economic impact of undermining the business model

Chapter 3 highlighted the key elements of the luxury business model, and highlighted that the pillars that underpin the luxury business model are very different to those that underpin the mass-market. Ensuring that policies are in place that are supportive of the luxury business model will be an essential element of helping the sector continue to succeed and deliver on its growth potential of 7%-9% average annual growth.

To assess the importance of getting the policy environment right, Frontier has developed a scenario model to assess the impact on the sector if policies were to be implemented which undermine the pillars of the business model. This chapter sets out the key findings from the analysis.

It is structured as follows:

- Overview of approach and key assumptions;
- Scenario definition and impacts; and
- Discussion of the key results.

5.1 Overview of approach and key assumptions

The objective of our modelling work is to seek to quantify the impact on the sector and the wider economy of policy actions that could impact negatively on the key pillars under-pinning the business model.

Given that we are not examining any particular or proposed policy intervention or action, we have sought to use scenario analysis to highlight the potential magnitude of impacts of different types of policy action (or inaction).

We have based our scenario analysis around a partial impact analysis. Typically, when undertaking this type of work one can either undertake:

- **Welfare analysis**, which seeks to measure changes to both overall consumer and producer surplus to identify the overall impact on social welfare; or
- **Partial Impact analysis** – which seeks more tangible measures of the direct and indirect impacts of an event.

In this study we are focussing on a partial impact analysis, which is seeking to identify the impact on the luxury goods sector in the event that a number of the key pillars that underpin its business model were threatened.

We believe that this approach is more appropriate given that:

- Full welfare analysis is complex and data intensive, and would be impossible to complete within the timeframe of this study; and
- Welfare analysis tends to produce quite conceptual outputs – an estimate of the overall welfare impact of an event. Impact assessment provides more tangible estimates e.g. sales losses, employment losses, tax losses that are more easily interpreted.

In terms of the impact analysis, the model we have developed measures the following direct and indirect impacts on the sector:

- **Sales loss** – we estimate the impact of negative shocks to the pillars on total sales for the luxury segment;
- **Employment losses** – using an estimated relationship between sales and employment, we measure employment effects; and
- **Tax/Welfare impacts** – we will look at the tax losses and higher welfare payments accruing to European governments as a result of reduced sales.

5.1.1 Key assumptions

In carrying out the analysis we have made some key assumptions with respect to:

- The scope of the analysis;
- The shape of the demand curve for the luxury sector;
- The types of impact we model; and
- Key data sources.

The scope of the analysis

In identifying the scope of the analysis, we are making the following two assumptions:

- **We include Switzerland in the analysis:** While Switzerland is not in the EU, Swiss companies form a significant portion of the luxury goods sector in Europe – for personal luxury goods, Swiss companies account for 16% of European revenues – and are typically considered to be an important element of the European luxury economy.
- **European or global impacts:** European companies account for 70% of global luxury output, but sales within Europe account for only around 40% of global sales. While the focus of this study is primarily on the impact of European policy interventions, in a number of

categories it is important to look beyond the direct impact on European sales:

- For IP issues, a key focus of European policy must be on working to secure improved global IP protection and enforcement;
- For selective distribution, a diminution of current European regulations could have impacts wider than Europe through online sales channels;
- For trade, key decision-makers are likely to lie outside the EU, yet the raising of trade barriers could have a profound impact on the future prospects of the sector. In consequence, a key focus for European policymakers must be on working with our global trading partners to secure reduced trade barriers and free and fair access to key export markets.

For these scenarios, therefore, we believe it is important to look beyond the impact on direct European sales.

The demand curve for luxury goods

Luxury goods display demand characteristics that are very different to typical or mass-market consumer goods. In particular demand for luxury goods appears to be subject to what the economics literature describes as interpersonal effects. In a basic form of this analysis the perceived quality of the product is related to its exclusivity, which in turn depends on the numbers of consumers buying it.

In some elements of the literature, it has been suggested that for these types of products, there may be an upward sloping demand curve – i.e. that demand increases as price increases, and conversely, decreases as price falls.

However, this does not accord with the day-to-day experience of companies operating within the sector, who find that while price may not be as important as in some mass-market segments it is still a critical element in the overall sales offering. More recent specifications of demand for luxury goods suggest that:

- Demand curves may not be upward sloping, but rather may either be peaked or discontinuous – this implies that while for some sections of the demand curve demand increases as price increases this does not hold in general, and that a more traditional relationship also exists;
- Demand curves can take into account quality based on exclusivity but remain downward sloping.

We therefore assume that there is a downward sloping demand for luxury products, albeit that they display significantly higher price inelasticity than other products.

5.1.2 Type of impact

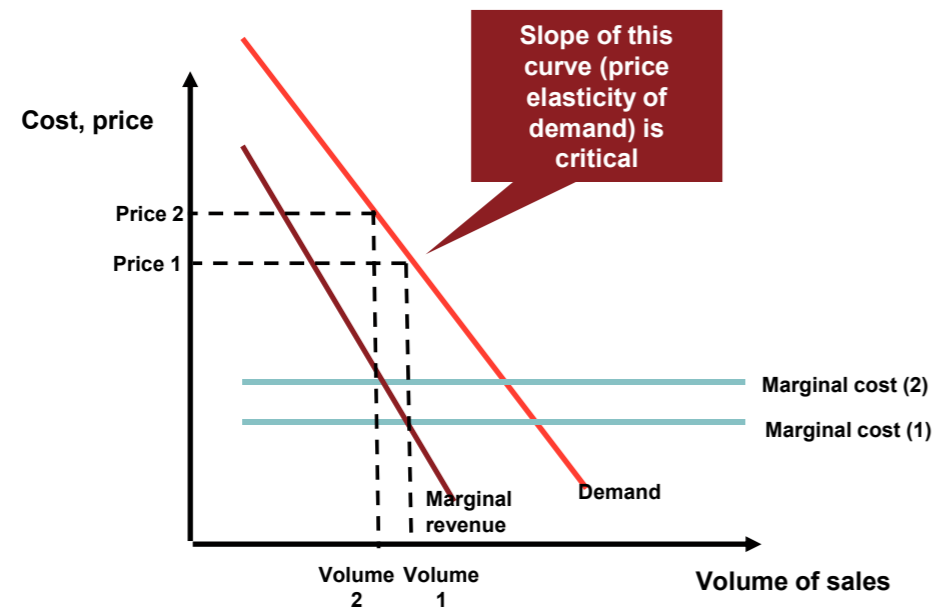
Our analysis is based on an Excel model that has two elements. The first calculates the sales and employment impacts of threats to the drivers. The second models the tax and revenue effects for government as a result of changes in sales and employment. We do not use any indirect multipliers in the modelling, and the results are therefore likely to present a conservative estimate of impact.

The model takes assumptions regarding the impact of each of the threats and translates them into estimates of the effect on industry turnover, and unemployment.

We consider that policy shocks can have three impacts on the sector:

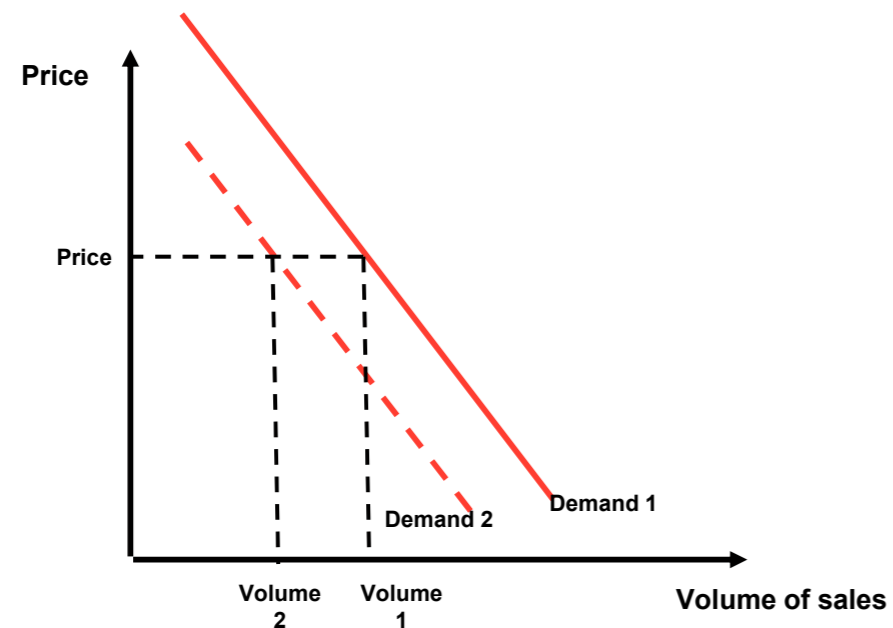
- **Direct sales impact:** for example, in the case of IP infringements, infringing products may directly displace genuine sales;
- **Direct cost impacts:** policies may result in an increase in the cost base of the sector (for example, tariffs may result in an implicit increase in the costs of European exports). The impact of this type of cost effect is set out in the first Figure below.
- **Indirect sales impact:** some policy impacts may result in shifting the demand curve for luxury products, with consequent negative impacts on sales and employment. This is illustrated in the second Figure below. Types of policy that could have this impact include IP infringements which reduce consumer demand for a product (for example by undermining the perceived quality or exclusivity of the product).

Figure 7. Stylised diagram of impact of cost increases



Source: Frontier Economics

Figure 8. Stylised diagram of impact of demand shifts



Source: Frontier Economics

5.1.3 Data used in the analysis

We have drawn on a wide range of data in carrying out the analysis. Key data sources have included:

- Data on market size and output;
- Company level data on turnover, employment, margins and exports;
- Analyst reports;
- Academic analysis of price and income elasticities and the impact of vertical restraints; and
- Eurostat and national statistics office data on taxes, exports, tariffs, wages.

5.2 Threat scenarios and impact analysis

Based on the methodology described above, this section sets out the potential policy threats to the pillars of the business model, and the scenario analysis which seeks to estimate the potential impact on the sector and the wider economy.

In all, we consider the following scenarios:

- An increase in the rate of IP infringement;
- A weakening of the selective distribution regulations, and of brands' control over distribution and retail;
- An impact on the aura driver that led to a significant cost increase;
- An impact on the aura driver that led to reduced demand; and
- An increase in tariff or non-tariff trade barriers.

For each scenario, we describe:

- The potential threat to the sector;
- Evidence in relation to the potential magnitude of the problem; and
- The modelling results of the direct sectoral impacts and wider economic impacts.

5.2.1 IP infringement

With respect to the IP driver, the key issue of concern relates to a significant further increase in IP infringement as a result either of policy decisions that fail to protect IP, or too little enforcement activity by national governments. It is widely accepted that IP infringements, and in particular counterfeiting, have increased substantially over the last decade, and are likely to continue to increase.

A driver of this growth has been the growth and expansion of internet access. While the growth of e-commerce has brought substantial economic benefits, one substantial dis-benefit has been the extent to which it has eased the sale of IPR infringing products. This was most recently recognised in the European Commission's annual report on IPR enforcement which found that the rise in IPR infringing cases:

“is an all-time high and there certainly seems to be a link to increased sales via the internet. The internet is a virtual market place offering all kinds of goods, many of which are genuine. By simply clicking on the order button, consumers have their goods delivered to the front door. However, the growth in on-line sales has opened up a new method of distribution for all kinds of IPR infringing goods. Such goods may be of poor quality or even dangerous but are a challenge for customs to identify and intercept, and the administrative burden when one or two items are found in a package is disproportionate.”

The luxury sector is particularly prone to IP infringement as counterfeiters have typically targeted the high-end luxury goods sector.

It is important to note that there are a number of different IP infringements of concern to the sector:

- **Counterfeit products:** the most commonly understood form of IP infringement relates to fake products that are passed off as the genuine article. With respect to this type of product it is important to note that:
 - The quality of fakes has improved dramatically over the last decade, and a key problem for the industry now is not cheap knock-offs that are obviously fakes, but high quality fake products that results in consumers unknowingly buying counterfeit products. This results in a direct sales displacement effect.
 - Counterfeits can be found in a wide range of luxury markets, and not just in the traditional personal luxury goods market. For example, a growing counterfeit market relates to the luxury car segment.
 - In addition to the direct displacement effects counterfeiting can also have a brand-damaging effect which results in lost sales. This can either arise where the counterfeiting of a particular brand becomes ubiquitous such that the exclusivity and aura associated with the brand is diminished, or because the prevalence of fakes of a particular product can undermine consumer confidence that they are purchasing a genuine product.
- **Look-a-likes:** a second issue for the sector is the production of products that are not seeking to pass themselves off as the original, but which are very similar in terms of look. There have been a number of legal cases recently

involving high street retailers and luxury brands over this type of infringement.

- **Grey-market products:** The final category of infringement relates to the sale of infringing grey-market products. These are genuine products, but which are sold in markets other than those for which they were intended for sale.

Magnitude of the problem

Given that IP infringements are illicit activities there are limited official statistics which quantify the scale and impact of the problem. However, the evidence suggests that:

- Counterfeiting has increased substantially over the last decade: A recent report for Bascap by Frontier Economics found that since 2005 counterfeiting and piracy has been growing at around 20% per year. The European Commission's most recent report identified a continuing upward trend in the number of seizures of infringing products. The Table below sets out data on cases and postal seizures for 2009 and 2010 from the EU's most recent report. This shows that between 2009 and 2010 the number of cases almost doubled whilst the number of postal seizures more than trebled.

Table 4. EU data on IP infringing cases and postal seizures

	2009	2010
IP infringing cases	43,572	79,112
Postal seizures	15,000	48,000

Source: European Commission

- Counterfeiting is a particular challenge for the luxury goods sector.
- Counterfeiting has a significant negative impact on luxury brands in the form of brand damage and displaced sales. A study in the UK found that only 17% of consumers are confident that they can tell the difference between a counterfeit and a genuine item, while 31% of purchasers bought a fake item believing it was a genuine product.¹⁰

¹⁰ Ledbury Research, “Counterfeiting Luxury: Exposing the Myths”

Measuring the impact of an increase in IP infringement

To measure the impact of an increase in the rate of IP infringement, we have considered two scenarios¹¹:

- A five percentage point increase in the rate of IP infringement; and
- A 15 percentage point increase in the rate of IP infringement.

The key findings from the scenario analysis are set out in the Table below. This shows that a substantial increase in the rate of counterfeiting would have a very significant impact on the sector in terms of output loss and employment, with almost 100,000 jobs lost in the lower growth scenario¹². European governments would lose between €14 and €26 billion per year in terms of lower taxes and higher welfare spending. This is based on reduced VAT, corporation taxes, export taxes and personal income taxes and increased welfare payments for those who lose their jobs.

Table 5. Estimates of impact of an increase in IP infringements

Scenario	Output loss	Employment loss	Tax and welfare impact
Scenario 1: 5% increase	€43 billion	98,000	€14 billion
Scenario 2: 15% increase	€79 billion	180,000	€26 billion

5.2.2 Selective distribution

The second policy impact we consider relates to selective distribution, and to factors more generally that restrict brands' ability to exert control over the distribution and retail of their products and services.

¹¹ We note that the following assumptions have been used in developing these scenarios – 70% of consumers knowingly purchase fakes, of which only 40% would have purchased the genuine product. 95% of unknowing purchasers are assumed to purchase the genuine product (this figure is less than 100% as there may still be a price differential between the fake and the genuine article – look-a-likes are often sold at the promotional price point for genuine products). We also assume a reduction in output associated with the negative brand impact of the increase in infringing products.

¹² Normally, in a full employment economy one would assume that workers who lose their jobs would find alternative employment relatively quickly. However, given the current levels of unemployment in Europe, it is reasonable to assume that at least in the short- to medium-term there would be a significant permanent unemployment impact.

Examples of such policy impacts could include:

- At a European level, changes to the Vertical Restraints Block Exemption (VRBE), or a re-interpretation of the guidelines to place stricter limits on the types of selective distribution arrangements brands can put in place; and
- At a national level, this could cover any other legislation that may negatively impact a producer's ability to retain control of distribution (e.g. legislation on unfair commercial practises in B2B or specific e-commerce legislation).

Evidence of impact

Given that we are considering a hypothetical change to the current arrangements it is difficult to be precise as to the potential impacts that one might expect to observe. However, it is important to note that:

- At the time of the VRBE revision, submissions were provided by a significant number of luxury brands which indicated the central role and importance of selective distribution to their business model;
- The Court and the European Commission have both recognised the importance of selective distribution, and the current VRBE allows for the types of selective arrangements necessary to protect the value of luxury brands; and
- A review of the empirical academic evidence also suggests that vertical restraints such as selective distribution result in benefits for both manufacturers and consumers. Work by Lafontaine and Slade¹³ examined a range of empirical studies looking at the effects of vertical restraints, and concluded that *“the empirical evidence concerning the effects of vertical restraints on consumer wellbeing is surprisingly consistent. Specifically, it appears that when manufacturers choose to impose such restraints, not only do they make themselves better off, but they also typically allow consumers to benefit from higher quality products and better service provision. In contrast, when restraints and contract limitations are imposed on manufacturers via government intervention, often in response to dealer pressure due to perceptions of uneven bargaining power between manufacturers and dealers, the effect is typically to reduce consumer wellbeing as prices increase and service levels fall”*.

¹³ Lafontaine, F. and Slade, M.E. (2008b) ‘Contracting between Firms: Evidence’ in *Handbook of Organizational Economics*, R. Gibbons and J. Roberts (eds.) Princeton University Press, forthcoming.

Measuring the impact of reduced ability to control distribution and retail

It is difficult to model this potential policy threat precisely, as the likely level of impact would depend on the precise policy change and the extent to which brands' ability to control distribution was restricted. However, in the event that there was a significant diminution of control it is not unreasonable to assume a decline in output over time in the order of 20%. This is on the basis that:

- There would be a substantial decline in sales in Europe which make up one third of all sales for European brands; and
- There would be a significant increase in online sales, as brand control over this sales channel is diminished, which would result in a loss of sales in other markets.

The impact of such a scenario is set out in the Table below.

Table 6. Estimates of impact of reduced control of distribution and retail

Scenario	Output loss	Employment loss	Tax and welfare impact
Reduced control over distribution leads to a 20% decline in output	€84 billion	190,000	€27 billion

5.2.3 Aura, Craftsmanship and Creativity

We next consider the effect of policies that would impact negatively on the aura of luxury associated with high-end products and services, or that would reduce the supply and availability of skilled and creative labour¹⁴. To do so we:

- First consider the types of policy and policy issue that are likely to be relevant to each of the elements of the aura pillar; and
- Second consider the transmission mechanism by which a shock to any element of the aura pillar could result in negative effects on output employment and tax revenues.

¹⁴ Note, we treat these two pillars together as the impact in terms of sector and wider impacts is likely to be similar.

Relevant policy issues for aura

Below we set out each of the elements of aura, and the types of policy issue that may affect it:

- **The cultural and artistic dimension and the craftsmanship of the product** – the sector requires access to a workforce with the necessary creativity and skills to deliver to the exacting standards that consumers demand. In recent years the sector has found it increasingly difficult to secure and maintain the necessary skilled resources. This is driven in part by education and skills policies placing less emphasis on encouraging careers in manufacturing and craftsmanship, and less policy focus being placed on partnerships with industry and apprenticeships relative to more academic career paths.
- **The excellence of materials used** – the manufacture of luxury goods requires the highest quality materials. In consequence, the ability of the upstream supply chain to deliver inputs of the necessary quality is vital to maintaining the aura of luxury goods. Policies which are supportive of the upstream input industries are of direct relevance to the luxury sector.
- **Product presentation and communication** – there is a wide range of policies that can impact on the presentation and communication of luxury products that have a direct bearing on maintaining aura. Examples include issues relating to product labelling and country of origin labelling.
- **The way products are offered to consumers and the way the customer relationship is maintained both in terms of the sales experience and the after-sales service** – we have discussed in relation to selective distribution the importance of luxury brands being able to maintain control over distribution and retail and the key policies that can impact on it.

The above provides an indication of the breadth of policies that can directly or indirectly impact on the ability of luxury brands to maintain the aura of luxury for their products and services that is such an essential element of their business model and product appeal.

Policy shocks and transmission mechanisms

A supportive policy environment is essential to brands' efforts to maintaining and developing the luxury aura of their products. Below we set out for each key element the transmission mechanism by which a negative policy shock could undermine the aura pillar and negatively impact on the sector:

- **The cultural and artistic dimension and the craftsmanship of the product** – Policies that reduce the availability of skilled labour are likely to have multiple impacts on the sector. Of greatest concern is that luxury brands would not be able to maintain the quality of their manufacturing, with the result that the quality of European luxury products diminishes. This would result in falling demand for luxury products generally, and make European products more susceptible to competing luxury products from other luxury markets, a particularly worrying concern, as Europe's reputation in these sectors has been built up over centuries and once lost could take a very long time to regain, if ever.

Alternatively, European brands would have to invest more heavily in wages to attract skills and workers to the sector, or to go outside of Europe to attract the type of worker that is required. European brands would also have to invest even further in training and development of the workforce than they do today. The concern in this regard is that the type of general skills training required has elements of a public good, and so is unlikely to be optimally provided by the market operating alone. Despite the demand inelasticity of luxury goods, a significant increase in the cost base of the sector, passed on to consumers in the form of higher prices, would have a chilling effect on consumer demand, and would see the competitive position of European luxury goods weaken vis-à-vis luxury producers located outside the EU.

- **The excellence of materials used** – European industries produce key inputs that are of a substantially higher quality than can be found in other regions. If the supply of such products were to be undermined in any way it is not obvious that the European luxury sector would be able to source appropriate quality inputs from elsewhere (and to the extent that such inputs exist, their supply may already be locked-in to non-European manufacturers). This means that it would be difficult for European manufacturers to maintain the quality of their products, resulting in a reduction in the quality and hence consumer demand for European luxury products. Again, it is important to note that such an impact could have a long-lasting effect. A key insight from behavioural economics is the importance of reputation, and the difficulty brands have in restoring reputation, once lost. There are numerous examples of luxury brands where a diminution in product quality for a short period of time led to a long period of subsequent decline.
- **Product presentation and communication** – Key issues with respect to presentation and communication relate to the ability of the sector to maintain its reputation for quality and to present and package products in a way that maximises their appeal to consumers. Undermining the

former is likely to have a direct impact on demand for European luxury goods, and may weaken the competitive position of European luxury goods vis-à-vis luxury producers elsewhere if the perceived quality differential between European luxury products and luxury products produced elsewhere is reduced.

Limiting the freedom of brand manufacturers with respect to packaging and labelling may reduce the ability of the sector to differentiate its products from the mass-market segment, and therefore undermine the price premium that can be maintained between luxury and mass-market. Such impacts will also reduce consumer welfare, as regulatory intervention is limiting the ability of the market to provide a product for which there is clear consumer demand. More importantly, given that this type of regulation is typically aimed at the mass-market and not the luxury sector, there will be no off-setting consumer benefits.

- **The way products are offered to consumers and the way the customer relationship is maintained both in terms of the sales experience and the after-sales service** – we discuss the relevant transmission mechanisms for these elements of aura in the section above on selective distribution.

Modelling policy impacts on aura

We have demonstrated above the complex transmission mechanisms by which policies which undermine the key elements of aura can negatively impact on the sector. Modelling these types of transmission mechanism is difficult, as it will depend critically on the sector under consideration and the particular type of policy impact.

However, it is important to illustrate the potential impact that such policies can have given the critical importance of aura to the luxury business model. To do so, we have made two simplifying assumptions.

First, we have assumed that negative policy shocks to the aura driver will either:

- Impact on the cost base of the industry: or
- Impact directly on the brand, leading to a direct sales reduction.

Given that we are not considering a specific policy threat in this area, we have made plausible assumptions about the magnitude of impact one might expect. In the case of a cost increase, we have modelled this impact in terms of output loss,

employment loss and impact on taxes and welfare. We consider the impact of a 10% and 20% increase in the cost base of the sector¹⁵.

For policies that impact directly on brand, we have assumed a direct output reduction and estimated the impact on employment, taxes and welfare expenditure. In making assumptions regarding the direct output fall, we have chosen 5% and 10% reductions, which would appear to be a plausible (and if anything conservative) scenario for output decline in the event that any of the drivers of aura were to be undermined as a result of negative policy shocks.

These impacts are set out in the Table below.

Table 7. Estimates of impact of a negative policy shock to the aura driver

Scenario	Output loss	Employment loss	Tax and welfare impact
Scenario 1: 10% increase in the cost base	€12 billion	27,000	€4 billion
Scenario 2: 20% increase in the cost base	€24 billion	54,000	€8 billion
Scenario 3: 5% decline in demand	€21 billion	48,000	€7 billion
Scenario 4: 10% decline in demand	€42 billion	95,000	€14 billion

5.2.4 Trade barriers

The final policy impact we consider relates to trade barriers. As we have set out already in this report, the future prospects and growth of the luxury sector are heavily dependent on continued free and fair access to key export markets in Asia and the BRIC economies.

¹⁵ We assume significant, but not complete pass through of the cost increase, and we assume a price elasticity of demand of 0.3 to reflect the price inelasticity of demand for luxury products. We note that there are no specific price elasticity estimates for luxury goods. However, we have taken estimates for mass-market products in similar product categories and scaled them back to reflect the likely greater inelasticity of demand for products in the luxury segment.

The EU and the G20 economies have all publicly committed to continuing to reduce trade barriers and promote free trade. For example, at the 2008 Washington Summit, the leaders of the G20 committed to refrain from raising new barriers to trade and investment. However, recent evidence suggests that the reality may be somewhat different¹⁶:

- In November 2010, the Peterson Institute for International Economics found that every single G20 government has implemented protectionist trade measures since 2008. Countries applied discriminatory measures worth US\$1.6 trillion, or 10% of all world trade, in 2008 alone. The study also noted that G20 governments are accumulating an arsenal of protectionist measures, many of which are already in the pipeline for implementation.
- In May 2011, a report by WTO-OECD-UNCTAD revealed that G20 governments implemented more new trade-restrictive measures over the previous six months than in any other previously reported period.
- In October 2011, the European Commission's report on Trade Restrictive Measures found that G20 governments implemented 424 restrictive measures since October 2008. In the past 12 months alone, 131 new restrictions have been introduced; only 40 have been removed.

Against this background, it is clear that policy movements in this area can have a potentially significant impact on the future performance of European luxury brands.

Measuring the impact

To illustrate the potential impact of protectionism on the sector, we consider the impact of increasing tariff and non-tariff barriers. To be conservative, we do so by assuming only that trade barriers are raised in a sub-set of export markets, as it may be unlikely that trade barriers would be raised in all markets simultaneously. We therefore consider the impact of an increase in tariffs in a hypothetical export market or markets representing 10% of Europe's exports.

In particular, we have considered the impact of:

- A 20% increase in price tariffs; and
- An increase in non-price tariffs that reduce European imports by 10%.

The results of this analysis are set out in the table below.

¹⁶ Examples, are taken from the recently published ICC Open Markets Index 2011

Table 8. Estimates of impact of increasing trade barriers

Scenario	Output loss	Employment loss	Tax and welfare impact
Scenario 1: 20% increase in tariffs	€2 billion	5,000	€0.7 billion
Scenario 2: 10% decline in imports associated with non-price tariff increases	€3.4 billion	7,600	€1 billion

5.3 Discussion of findings and conclusions

This chapter has sought to estimate the likely magnitude of impacts associated with threats to the key pillars that underpin the luxury goods business model. The results are summarised in the Table below. While the analysis is necessarily high level, as we are considering the spectrum of potential threats to the sector, it serves to illustrate:

- The range of policy threats that face the sector;
- The vulnerability of the sector to adverse policy actions at a European and global level; and
- The consequent impacts for the wider economy and tax authorities given the size and importance of the European luxury sector.

What appears clear from the analysis is that the key risks to the sector relate to the protection of investment in industrial property and continuing to ensure that regulatory and competition policy does not restrict the ability of the sector to control the distribution and retail of products and services, given the vital role that this plays in the overall value and image of the luxury good.

While cost impacts may be less important than in other sectors, their effects are still substantial, and there is a constant need to ensure that regulations aimed primarily at the mass-market do not undermine the aura of luxury that is such an essential feature of the luxury business model. Finally, given the proportion of products and services that are exported, and the importance of export markets to the continued growth and health of the sector, it is vital that European policy continues to honour its commitments to free trade and to push other countries to take a similarly progressive approach to trade policy.

Table 9. Summary of impact analysis

Pillar	Scenario	Output loss	Employment loss	Tax and welfare impact
IP	Impact of a 5% increase in IP infringement	€43 billion	98,000	€14 billion
	Impact of a 15% increase in IP infringement	€79 billion	180,000	€26 billion
Selective distribution	Reduced control over distribution leads to a 20% decline in output	€84 billion	190,000	€27 billion
Aura and Access to Craftsmanship and creativity	10% increase in the cost base	€12 billion	27,000	€4 billion
	20% increase in the cost base	€24 billion	54,000	€8 billion
	5% decline in demand as a result of reduced aura	€21 billion	48,000	€7 billion
	10% decline in demand as a result of reduced aura	€42 billion	95,000	€14 billion
Trade barriers	20% increase in price tariffs	€2 billion	5,000	€0.7 billion
	10% decline in imports as a result of non-price tariff increases	€3.4 billion	7,600	€1 billion

6 Conclusions

Europe is a global leader in the development and manufacture of luxury products and services. The biggest luxury brands are European, and European luxury products, which are deeply rooted in European heritage and culture, are exported across the world, and act as ambassadors for European manufacturing, showcasing Europe's world class innovation, craftsmanship and manufacturing quality.

Our analysis suggests that the European luxury sector is a significant contributor to the European economy in terms of output, employment, exports, tax receipts and wider spillovers. The sector also has strong growth potential given the forecast growth in luxury markets in Asia and in the BRIC economies. Medium-term forecasts suggest the sector will continue to grow at between 7% and 9% per annum, a level of growth significantly in advance of the wider European economy. If this level of growth is realised, the sector will contribute between €790 and €930 billion to the European economy in 2020, and will employ between 1.8 and 2.2 million people directly.

While the luxury sector is made up of a diverse range of products and services, our review of the sector suggests that the pillars that underpin the luxury business model are common across the segments.

The key pillars that underpin the European luxury business model are:

- Aura – it is well recognised that luxury products and services encapsulate more than the physical characteristics of the product. Maintaining the aura of luxury is a key driver of consumer behaviour, differentiates luxury products from mass-market sales and is essential to the ongoing success of the sector;
- Craftsmanship and creative people – quality and craftsmanship are at the heart of the luxury proposition. Access to an appropriately skilled and trained workforce is essential for the continued success of the sector;
- Substantial investment in industrial property – the luxury sector invests heavily in IP in terms of brand development but also in relation to design and innovation;
- Selective distribution – critical to the success of the sector is maintaining control of the distribution and retail of products to ensure that the product's brand and image are not damaged by inappropriate distribution and retail; and
- Developing new markets – the European luxury sector is a significant exporter, and prospects for the future growth of the sector are

predicated on maintaining fair and free access to high-growth developing markets.

The above points demonstrate the unique pillars that underpin the luxury business model and differentiate the luxury segment from the mass-market. They also demonstrate that, far more so than the mass-market, the key pillars of the business model are vulnerable to negative policy impacts.

To demonstrate the importance of achieving the correct policy environment, Frontier has developed a scenario model to assess the impact on the sector if policies were to be implemented which undermine the pillars of the business model.

What appears clear from this analysis is that the key risks to the sector relate to the protection of investment in industrial property and continuing to ensure that regulatory and competition policy does not restrict the ability of the sector to control the distribution and retail of products and services, given the vital role that this plays in the overall value and image of the luxury good.

While cost impacts may be less important than in other sectors, their effects are still substantial, and there is a constant need to ensure that regulations aimed primarily at the mass-market do not undermine the aura of luxury that is such an essential feature of the luxury business model.

Finally, given the proportion of products and services that are exported, and the importance of export markets to the continued growth and health of the sector, it is vital that European policy continues to honour its commitments to free trade and to push other countries to take a similarly progressive approach to trade policy.

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