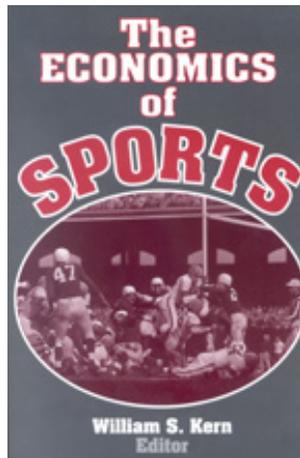


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Market Power in Pro Sports: Problems and Solutions

Rodney D. Fort
Washington State University



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Market Power in Pro Sports

Problems and Solutions

Rodney Fort
Washington State University

Many Americans are completely carried away with sports. During the last baseball strike in 1994, Henry Aaron of the Brookings Institution (yes, there really is an economist with that famous baseball name) tried to put sports into perspective during his testimony before Congress. He pointed out that while the Major League Baseball (MLB) as an industry was just under \$2 billion a year, the envelope industry topped the \$2 billion mark. In a slightly broader view, the cardboard box industry generated well over triple that amount annually. He proceeded to lightly scold the subcommittee for spending its scarce and valuable time on such small potatoes.

Watching this testimony on C-SPAN, I was (very briefly) ashamed. After all, the importance with which I view sports is neatly summarized in one of my favorite Far Side cartoons. Artist Gary Larson shows a group of primordial sea-dwellers just off shore. One of the group holds a bat, and their baseball lies on the beach, just out of reach. The caption reads, "Great Moments in Evolution." The clear implication is that baseball is the reason we waddled out of the ooze in the first place. And here before Congress was an economist of no small renown pointing out that this inflated enthusiasm is over an industry that is dwarfed by only a small share of the paper products industry.

But my shame faded when I remembered that there is no cardboard box page in the daily paper. And it never has been the case that massive public subsidies for cardboard box companies have been on a referendum ballot. Sports really are different than cardboard boxes. Many of us enjoy benefits from sports that are vastly beyond what we spend on them. Whole other media industries thrive on its output, and it can be a consuming passion, this love of sports shared by so many. I think I might mail a copy of that Far Side cartoon to Professor Aaron.

This depth of feeling generates the concern of so many fans over the current state of pro sports. Talk to any sports fan and you will get at least one of the following opinions. Rising ticket prices threaten to slam the door on the average fan. Growing revenue imbalance leaves most teams out of contention before the season even starts. Stratospheric player salaries make it impossible to identify with players and introduces skepticism about whether or not they really lay it on the line every play. And do not even get a fan started about labor-management relations! MLB fans have recently lost their play-offs and a World Series because of them, and National Basketball Association (NBA) fans just lost half a season to labor unrest.

All of these outcomes are for the fans lucky enough to have a team. Many other fans have spent what seems an eternity waiting for an expansion team to arrive in their area. Others have seen their existing team threaten relocation at the drop of a hat. Team owners put all-or-nothing demands on their host cities and balk at every hint of intrusion into the power they wield over their sport. No other industry in the United States has such control over 1) exclusive geographical franchise rights over the entire industry, 2) team movement and location, 3) gate and TV revenue sharing, 4) TV contracts as a joint venture, and 5) entering talent through rookie drafts.

In the midst of all this unrest, you'll find economists nosing around. In our book, *Hardball* (1999), James Quirk and I organize the questions surrounding this fan frustration into a few chapters. Are the media and big TV money to blame? Is it player unions? Owners? Sports leagues? State and local politicians? Or what? As you can probably guess, we point our finger at "or what," which we define as market power.

Almost all economists see the ultimate culprit as market power, which derives from the special legal treatment of leagues. The outcomes are exclusive franchise rights for teams, management of sports leagues as cartels, and a complete stifling of any competing leagues, precisely those indicated by the basic economic theory of market power. In what follows, I will run through this logic and suggest what can be done about these outcomes.

Not much of what I am presenting here is new. Many of the issues were raised during the *Federal Baseball* decision of 1922, MLB's so-called antitrust exemption, enjoying its 75th anniversary this year.

Since that time, nearly all of these issues have been raised repeatedly in Congressional hearings that date back to 1951 and that represent at least 49 years of Congressional scrutiny. The ameliorative device proposed here also is not new. I found it first voiced in Congressional testimony by Ira Horowitz and Roger Noll in 1976. The problem is longstanding and one can only marvel that the current market power structure of sports leagues has withstood this scrutiny for so many years.

MARKET POWER PROBLEMS IN PRO SPORTS

Before proceeding to the heart of the matter—namely, market power—let us examine the more well-publicized culprits. Many claim that the media and big TV money cause most of the economic problems in sports. But the media are nothing more than a pipeline for advertising revenues, transporting them from advertisers, through broadcasters, and on to sports leagues and teams. There can be little doubt that the game on the field or floor is different because of television; there wouldn't be much point to on-field celebrations or taunting without an audience. But to networks, sports are just another type of programming that reaches particular demographic groups of interest to their advertisers. And, given that leagues can confront a small number of bidders with a chance at the rights to these important properties, it should come as no surprise that the bulk of the proceeds moves to the leagues and their teams. And this happens because leagues are allowed to act jointly in the sale of their TV rights, a practice that surely would be outlawed in any other industry.

Sportswriters are especially fond of making unions one of the major culprits in pro sports. Unions have no doubt changed the face of professional sports by removing nearly all of the mechanisms that owners previously used to restrict the free movement of players between teams. The result is that players now receive salaries much closer to the value of their contribution to team revenues. Some fans might begrudge players their huge salaries, but the money that fans spend on sports will not go away. If players don't get the money, then owners will keep it. In no small way, salaries are large because leagues earn more than the normal rate of return; it is the monopoly profit

earned by leagues that is up for grabs in player-owner negotiations. Because players are free to move between teams without this profit, there wouldn't be much for a union to negotiate except minimum salaries and benefit packages. In summary, unions have not created the fabulous wealth available to athletes; they have just been proficient at moving that wealth from owners to players.

What about the players, themselves? Is their insatiable greed at least partly to blame for rising ticket prices? There is both a contradiction and a fundamental economic misunderstanding behind this view. First, for the interesting contradiction, why do fans think that players are any greedier than anybody else, including themselves? How many fans would be willing to take less than they could possibly make? Second, for the economic misunderstanding, sports salaries simply reflect the value that fans place on player talent. Player salaries are not the cause of high ticket prices or the rise of pay-per-view televised games. Instead, it is the willingness of fans to pay ever more for sports that raises player salaries and encourages owners to seek new avenues of collection like pay-per-view. Players are no more to blame for the high price of sports than movie stars are to blame for the rising price of movie tickets. According to economic theory, it is demand that drives the result. Besides, if players didn't take their share, would anybody reasonably suggest that owners would rebate the balance to fans?

So, it is not the media, or unions, or players who are responsible for market power problems. However, the source of the problem plaguing pro sports comes to light when we examine owners and their behavior together as a sports league. At the most basic economic level, owners possess the rights to a very valuable monopoly. That monopoly is granted by pro sports leagues, in plain view for all to see. Because leagues are allowed to behave like cartels in controlling inputs and outputs, individual teams in these leagues confront no current or future competition from rivals. The result for fans in this setting has been clear since the time of Adam Smith—restricted output, prices greater than marginal cost, and profits greater than the normal rate of return. Thus, it is not the personalities of owners that cause the economic problems in pro sports; it is in fact the leagues, which operate as one of the most successful monopolies in history.

That leaves politicians. Typically, when market power runs wild, we hope for political intervention to protect consumers, but, if any-

thing, politicians have facilitated sports monopolies. First, despite the open invitation by Justice Holmes in his *Federal Baseball* decision, Congress has never intervened to define the antitrust status of MLB. Second, pro sports league mergers have been encouraged by Congress rather than denied. Finally, specific laws enacted by Congress, from local black-out laws to joint venture sale of TV rights, have served to cement the monopoly power of leagues. And it doesn't get any better at the local level. Witness the stadium mess plaguing so many current pro sports team hosts.

So, there you have it. Ticket prices are high because there are no competing teams in the same geographic market to push prices to marginal cost. Competitive balance is lacking because leagues restrict the number of teams in large revenue markets to the advantage of all league members. Salaries are higher than they would be under competition because some of the rents from market power accrue to players in a labor market that is carefully managed by unions. Strikes and lock-outs occur as owners and players lock horns over the division of monopoly profits. Because leagues carefully manage the number of teams, output is restricted and prices rise, and some cities are purposely held open to solidify threats of relocation against current host cities. On the other hand, host cities are confronted with these all-or-nothing propositions because the careful management of alternatives by pro sports leagues has resulted in a lack of substitutes for professional sports teams. All this has occurred because market power has been allowed to dominate in pro sports.

Make no mistake about it. The value of market power in pro sports is high. When an owner buys a team, the price includes rights that are valuable beyond control of capital and a player roster. The new owner buys a monopoly right to provide the only game in a specific location as a member of the league. This right yields 1) gate, stadium, and local TV revenues; 2) any revenues that can be extracted from players; 3) special tax treatment; 4) a share of league-wide, national TV contract revenues; 5) a share of league earnings from expansion fees; and 6) spill-over benefits to other business enterprises of the team owner. In Los Angeles, the value of these rights recently was revealed at around \$300 million during the sale of the Dodgers in 1998. In Cleveland, it was \$530 million for the Browns in 1998. Abroad, it was nearly a \$1 billion offer for the Manchester United soccer team in 1999.

There isn't any mystery about the remedy: a stiff dose of competition. However, this kind of economic competition is repulsive to owners and league personnel. National Football League (NFL) Commissioner Paul Tagliabue has been quoted as follows (*Sports Illustrated*, September 16, 1996), "Free market economics is the process of driving enterprises out of business. Sports league economics is the process of keeping enterprises in business." Quite aside from inventing a brand new term, *sports league economics*, the self-serving nature of the statement is only barely veiled. Before proceeding to a prescription for what ails pro sports, let us examine just what we would expect from a good stiff dose of competition.

ECONOMICALLY COMPETITIVE SPORTS LEAGUES

As Walter Neale (1964) pointed out long ago, the economics of sports indeed is peculiar. Cooperation is essential for the survival of sports leagues. They must cooperate in order to determine a schedule and a common set of rules and their enforcement. Appeals are essential, so some sort of cooperative central decisions are necessary. And, finally, leagues may need to cooperate to determine championship formats. But no one expects this cooperation to result in a restriction of output and prices exceeding marginal cost. That sort of cooperation is no more justified in pro sports than it is in any other economic endeavor.

Economic competition would tip the economic scales away from owners and players and toward fans and taxpayers. First, think about TV. Competition among leagues would eliminate monopoly profits from national TV contracts. Because a monopoly league can maximize TV revenues by restricting the number of games shown, introducing competition would result in more televised games. This would reduce the value of game broadcasts to advertisers because competition acts to bid away the profits earned from market power. Similarly, local TV revenue would decrease. Local broadcasters would go with the cheapest team of equal quality in their area. And the same argument applies to gate receipts. If fans could find substitute teams of equal quality, they would go with the one that charged least.

The impact of competition on player salaries is more difficult to determine. Players would no longer contribute to an economic activity that earned more than a normal return; therefore, players would be worth less. A further decline in player salaries would be expected from competition. Charles Finley, former owner of the Oakland Athletics, knew this well. He responded to player demands for free agency in the mid 1970s with a hoot. He suggested that MLB embrace this idea whole-heartedly because competition would kill the rising union tide and, along with it, salary arbitration and other artificial mechanisms propping up salaries. If competition removed sports unions from the picture, wages would fall even further. But there would be an important, off-setting factor. If leagues became truly and legally competitive, other restrictions on player earnings would not be expected to survive. For example, a rookie draft would wither away with the introduction of competition; this sort of restriction would not stand up to raiding by rival leagues. Thus, players in a competitive situation would be worth less than they had been under monopoly; and if their ability to organize were dealt a death blow as well, then their salaries might decrease further. But, this decline would be partly offset when other restrictions on earnings withered away under competition.

And while we are on the topic, most labor-management strife would disappear with competition because the major source of strife, monopoly profits, would be gone. Unions might still try raising pay for some players, which, in a competitive environment, would only increase owner costs and reduce overall player employment, but this behavior would be up to the union members themselves. The union focus might shift to pensions and other fringe benefits. And the already contentious issue of income distribution between superstars and journeyman players would increase.

Perhaps the most dramatic impacts of competition would occur in expansion and relocation. Under competition, all financially viable locations would have a team from one league or another. This would probably increase the number of teams in megalopolis markets and fans in these locations would enjoy more professional sports; but there would be a downside for other fans. Because gate and TV revenues would be lower, current marginal locations might become unprofitable. As always, with changes in market structure, there would be distribu-

tional consequences. Here, the trade-off would appear to be between the fans of marginal teams in a few cities and fans in larger areas.

State and local taxpayers also would feel the impact of competition on expansion and relocation. Because all viable locations would have a team, team owners would not be able to make threats about leaving their current host cities. In fact, the tables would take a dramatic turn: teams actually would compete for financially viable locations. If one team pushed its host too far, another team would be waiting in the wings for a lower subsidy. Competition should reduce subsidies to teams and possibly even put a market rental rate on existing and future publicly owned stadiums.

So, in a competitive economic environment, there would be more teams in big cities and a team in all economically viable locations. Cities would provide much lower subsidies, if any, in the form of extravagant stadiums and sweetheart stadium deals. The stadium mess would be alleviated. There would be more games on television, lower revenue to teams from television contracts, and lower ticket prices. Player salaries could either fall or rise, depending on the relative impacts of a few obvious labor market factors. Team profits would fall and franchise values along with them. In effect, power would be shifted from players and owners to fans and taxpayers. Some fans would enjoy more sports, while others would lose their team if it was just hanging on in the first place.

But economic competition has its limits, which must be considered when prescribing a remedy to the problem of market power in pro sports. First, there have been competitive leagues in the past, but the tendency has always been back toward a single, monopoly league. Economic competition has not been self-sustaining in pro sports, historically. Owners in rival leagues would ultimately see the value in reforming another monopoly; therefore, something more than just setting the wheels of competition in motion would be required to create change.

Another nuance to pro sports leagues also dictates caution in the prescription for market power. Existing leagues have already established their reputations and created a strong sense of fan identification. These teams suffered low or negative profits during their early years of growth and have paid public relations expenditures since that time. The returns on such an investment are the monopoly profits earned by

these sports teams under their current league structures, and these returns have been earned for quite some time. A rival league planning to compete with existing leagues would have to make the same kind of investment, in addition to competing for talent to demonstrate that they really were an enduring, big-league alternative. This effort would be required in order to encourage fans and the media to commit their loyalties to their new league. But, if competition were enforced from the very outset for the new rival, the league would not be able to recover these costs. So, competition would not sustain itself, and it must be sustained externally in a very careful manner in order to nurture a rival.

In addition to the economic circumstances described so far, politics also impede economic competition in pro sports. As even the most casual student of government and the sports business knows, choices by elected officials often facilitate, rather than ameliorate, market power. Congress has failed to respond to the MLB antitrust court decision of 1922. In 1962, it exempted league-wide TV contracts in all sports from antitrust laws. Congress exempted the American Football League (AFL)–NFL merger from antitrust laws in 1966 and brought pressure to bear on the NBA to merge with the American Basketball Association (ABA) in the mid 1970s. Congress also has allowed other leagues to exercise veto power over the location of their teams. Now, leagues put teams where they want them and carefully control the most lucrative markets. Thus, despite repeated investigation, Congressional action has consistently enhanced monopoly power in sports, and state and local government outcomes have given us the stadium mess confronting so many current and prospective host cities.

CREATING ECONOMICALLY COMPETITIVE SPORTS LEAGUES

In summary, competition stands a better than decent chance of eliminating the ills in pro sports. But competition will not be self-sustaining, and in sustaining competition, one must exercise caution. Generating fan loyalty and staying power would be an expensive proposition for any new, competing league. Some long-term return would be required to make such an investment pay. An assurance of return

would mean that special antitrust accommodations would be required because overzealous enforcement of competition would kill that return and the hope for competitive leagues. Finally, there is no reason to expect that federal, state, or local politicians would embrace a more economically competitive setting for pro sports. Politicians pursue reelection. Currently, that pursuit appears to favor the current market power status of leagues and we should not expect any change until politically potent opposition appears. A few voices crying in the wilderness is not enough.

For all but its political limitations, one plan would work. Suppose an existing league were simply broken up into competing leagues. The foundation is there already. The American and National leagues in baseball would be economically competitive if they were not under unified, cartel management by MLB. Indeed, prior to 1901, the two were, by and large, economic competitors! Essentially the same thing is true of the NFL. The American Football Conference (AFC) and the National Football Conference (NFC), with only a few cross-over teams, are precisely the most recent version of the AFL and the earlier NFL prior to the merger in 1969. The same would be true of the NBA and the National Hockey League (NHL). A breakup could restore much of the same competition that existed prior to their mergers with the ABA and the World Hockey Association (WHA), respectively. Therefore, a breakup of existing leagues could potentially create competing leagues.

But, again, one would not expect this situation to last on its own. Enforcement of these breakups under existing antitrust laws would be required for competition to flourish. If leagues tried to regroup and merge, antitrust enforcement should preclude their forming new cartels. Perhaps the most important element of a breakup/antitrust enforcement approach is that it would allow the resulting, competing leagues to retain the fan loyalty and media ties that they had cultivated over the years. The new leagues already are “major” in every sense of the word. And they wouldn’t lose the fan identification that they have cultivated over the years. Interestingly though, one would expect that expenditures aimed at maintaining this loyalty would fall over time. The reason? The return on such investments would be falling under a competitive structure.

Of course, any movement away from monopoly would affect the welfare of leagues, players, fans, and taxpayers. Owners and players could be characterized as losers because their welfare will fall. Overall, fans would be winners because they would enjoy sports at lower prices, and taxpayers would win because subsidies would be reduced. However, some fans at locations with marginal teams might lose because competition would drive marginal teams out of business or to other locations.

One of the usual questions posed at this point is “What would be the quality of competition on the field with increased economic competition?” A long-standing “invariance principle,” attributable to Simon Rottenberg (1956), suggests that quality will stay at its current level. After all, all of the earnings over and above the competitive rate were pure economic rents. Because the changes projected here would occur league-wide, players and coaches would face diminished opportunities wherever they turned in their sport. And their nonsport alternative would not have gotten any better. Would players play for less and coaches coach for less, rather than leave their sport? Almost certainly. Although the level of competition, while probably still unbalanced across a given league, would not be expected to decline.

Perhaps the minor leagues (baseball, basketball, and hockey) and college football, which operate at the same time and often in the same vicinity as major league teams, might prove instructive on the quality issue. Because economic competition would yield a different number and mix of teams of major league caliber, with more of them located in the largest cities, perhaps there would be a more continuous quality gradient between the current minor leagues and college conferences and the major leagues. Among the minor leagues and college teams, size and drawing power are similar to the determinants that would drive a competitive pro league structure.

But the nagging question is just how in the world will this ever happen. This idea of breaking up the major leagues dates back to Congressional testimony in 1976 by Ira Horowitz and Roger Noll, and still there has been no political action. This inaction is cause for pessimism among those interested in fixing the problems of market power confronting sports fans. However, market power and its consequences in pro sports must be good for politicians because it has been the norm for almost 100 years.

The environmental movement offers instructive lessons in changing the political status quo. When a problem becomes important enough to voters, they become politically mobilized. It is an expensive and laborious process. Those bent on such change must successfully accomplish an overwhelming educational mission. They must also overcome the high costs and free-riding behavior associated with organizing a politically potent group. After all of that, they face the dog-eat-dog world of advocate politics. Small wonder that market power has ruled in pro sports given the obstacles to bringing it down.

But maybe the times are changing. On the Internet, many fan advocate and alternative ownership arrangement pages have begun to appear; and the Internet dramatically reduces the costs of forming organizations. Further, while Major League Baseball appears to be rebounding from the strike of 1994, it could well be an illusory return driven mostly by the “Mark and Sammy Home Run Show.” Dramatic revenue dispersion remains a source of tension between owners, and any additional interruption of play could bring down the wrath of fans. This wrath, however, might be a prerequisite to forming a politically potent interest group aimed at eliminating the market power in pro sports. Perhaps this organization might begin with the NBA, which is in turmoil. Their fans just lost half a season and are getting a weak imitation of the usual level of NBA play. If NBA fan interest groups rise to change the current local reelection margin, they may remedy the problem. For that is surely the only real solution. I hope I have made it clear that the culprit is market power. The rest is up to the fans, who, after all, are the source of nearly all of the profit in the first place.

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William S. Kern
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W.E. Upjohn Institute for Employment Research

300 S. Westnedge Avenue

Kalamazoo, Michigan 49007-4686

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