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Economic Issues in the 1998–1999 NBA Lockout and the Problem of Competitive Balance in Professional Sports

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The central problem of any professional team sports league is different from that of a typical industry. On the one hand, the National Basketball Association (NBA), the National Football League (NFL), the National Hockey League (NHL), Major League Baseball (MLB) and Major League Soccer (MLS) are each monopolies. On the other hand, unlike other monopolies, teams within each league compete on the playing field, but cooperate as businesses off the field.¹ Unlike General Motors and Chrysler, the Boston Red Sox would not benefit if competition drove the New York Yankees out of business. In fact, sports leagues need to cooperate in maintaining a certain level of competitive balance among their teams to preserve and enhance fan interest. That is, teams must be sufficiently equal in ability to ensure that the outcome of the games and season are in question.

The problem that professional sports leagues face in the 21st century is how to achieve this competitive balance when some teams represent cities that are eight times larger than the cities of their competitors, some teams play in state-of-the-art facilities and others do not, and some teams are owned by individuals or companies who potentially benefit from significant synergies between the team and their other businesses. While competitive balance is a longstanding problem in professional sports, it has taken on new dimensions since the advent of free agency in 1976, the introduction of the modern sports facility of the 1990s (which can increase team revenues by \$20–\$50 million or more a

year), and the growing penetration of the ranks of team ownership by major media conglomerates.

Five strategies can be employed to address the problem of competitive balance:

- 1) Artificially restrict the growth of player salaries,
- 2) Introduce or increase revenue sharing among the teams with each league,
- 3) Further skew the reverse order draft of amateur players to favor low-revenue or low-rent clubs,²
- 4) Allow freer team movement among cities,³ or
- 5) Compel league divestiture and engender competition.

The NBA lockout of 1998–1999 is an example of the first strategy, but the NBA already had a powerful mechanism to promote competitive balance in their league and the owners tried to eliminate it both in 1995 and in 1998. Thus, as I shall argue, contrary to the basketball owners' rhetoric about their concern for financially weak teams, their lockout was really just a bold attempt to boost profit margins.

BACKGROUND TO THE NBA LOCKOUT

In 1983, when free agency in professional sports was not yet a decade old, NBA Commissioner David Stern convinced NBA players' union director Larry Fleisher that NBA franchises were financially fragile and needed a salary cap to be economically viable. The cap was defined as 53 percent of defined gross revenues (DGR), which included only television, radio, and gate revenues. Both sides, however, agreed that the 53 percent should not be a hard cap and established certain exceptions that would allow teams to spend above the cap limit.

One such exception is called the "Larry Bird exception." This exception allows a team to re-sign one of its own players at any salary, regardless of whether the team has room under its salary cap to do so. For example, if the Chicago Bulls had spent \$28 million on its first 11 players for 1998–1999 and Michael Jordan had changed his mind and

decided to come back, even with the 1998–1999 team salary cap at \$30 million the Bulls could have paid Jordan anything it wanted.⁴ Without the exception, the Bulls could only pay Jordan the salary left under the cap, or \$2 million.

Three characteristics of the Bird exception appealed to owners. First, giving teams an advantage in re-signing their own players meant that the roster would be more stable, and the owners believed that this stability would strengthen fan identification with the team. Second, together with the reverse-order draft (wherein teams at the bottom of the standings have earlier picks in the amateur draft each year), the Bird exception provided a hefty fillip to league competitive balance. Because the original signing team has a substantial advantage in re-signing its own free agents, superstar players signed out of college generally remain with their first team throughout their professional careers. In 1997–1998, 7 of the 11 top-paid players in the NBA still played for their original teams. Thus, if Michael Jordan had originally signed with Milwaukee or Utah instead of Chicago, he probably would have played in those cities throughout his career. The Bird exception, then, is a powerful force preventing the rich teams from accumulating all the best players.

This observation is reinforced by the weak statistical correlation between team salaries and team win percentage in the NBA since the introduction of the salary cap. Using annual data for 1984–1985 through 1997–1998, the coefficient of determination between these two variables is between 0.30 and 0.40 in only 2 of the 14 years, between 0.20 and 0.30 in 5 of the years, between 0.10 and 0.20 in 5 other years, and below 0.10 in 2 of the years.⁵

Third, the Bird exception with the salary cap still provides a break on superstar salaries relative to a more open system of free agency. This is because most teams will not have enough room under their cap to bid effectively for a superstar. The star player, then, generally will not receive competitive bids for his services and will not necessarily end up where his marginal revenue product is the highest. If the Bird exception was the price the owners had to pay to get the union to agree to a cap system, then it was a price well worth paying.

Both sides agreed that the Bird exception was an ingenious and productive institution for the NBA until the 1995 negotiations, when the owners called for its elimination. In 1995, with average player sal-

aries at \$1.44 million and with Simon Gourdine installed as the players' union (NBPA) director, the owners saw an opportunity to slow down salary growth. Gourdine, oddly enough, had worked as an executive in the NBA's central office between 1970 and 1981, the last seven of those years as deputy commissioner. Gourdine acceded to major concessions proposed by Commissioner Stern, only to provoke a player movement to decertify the union. Eventually, the players accepted a deal that gave the owners a three-year rookie salary scale, as well as new restrictions on free agents, and eliminated a middle-range salary exception. The Bird exception was preserved, albeit somewhat weakened. The decertification drive had badly divided the players, the agents, and the union. When it was all over, the player representatives to the union voted to oust Gourdine in February 1996. Several months later he was replaced by Billy Hunter.

In spite of these changes, league revenues and player salaries grew handsomely in the ensuing three years. With payrolls growing faster, the salary share of basketball-related income (BRI)⁶ rose from 53 percent in 1995–1996, to 55 percent in 1996–1997, to 57 percent in 1997–1998.⁷ This growth, of course, was acceptable to the players, but they were concerned that, with the elimination of a middle-salary exception⁸ in the 1995 agreement, salaries were becoming too stratified. Despite the growth in the average salary to \$2.4 million in 1997–1998,⁹ between 1995–1996 and 1997–1998, the number of players earning the minimum salary almost doubled to 60 and the number earning less than \$1 million grew to 151.

The owners' concerns were different. Individual salaries were hitting unprecedented peaks, and some young stars who had scarcely demonstrated their potential value were receiving long-term, mega-salary contracts. As a consequence, the players' salary share was increasing and the owners saw no end to this growth. Further, the owners knew that a) the union still had some scars from its bitter internal battles in 1995; b) the union had a new director who had no direct experience in collective bargaining; c) growing salary stratification could further undermine union solidarity; and d) strong, ongoing revenue growth allowed the owners to offer the players absolute salary growth even with a decreasing share of the total pie. The owners again saw an opportunity to restrain salary growth and they seized it. On July 1,

1998, the owners imposed a lockout. One of the owners' demands was that the Bird exception be eliminated.

ECONOMIC ISSUES IN THE LOCKOUT

The owners claimed that the league had become unprofitable and that more than half the teams lost money in 1997–1998. However, the players were never given detailed team financial statements for 1997–1998 to allow them to confirm this extravagant claim. But they did receive this information for 1996–1997 and previous years. The union hired Stanford economist Roger Noll to decode the books. Based on Noll's work, the union concluded that no more than four or five teams out of 29 actually lost money in 1996–1997.

To understand the union's suspicion about ownership accounting practices, it is instructive to review some collective bargaining history in the NBA. Following the 1988 collective bargaining agreement (CBA), which defined DGR as revenues derived from, related to or arising out of the performance of players in NBA basketball "games," a dispute arose over what sources of income should be included.¹⁰ Owners divided luxury suite revenue into two parts: the rental payment for the comfort and convenience of the suite and the ticket price for watching the game. The owners claimed that the latter belonged to DGR and the former did not. This and similar issues led the players to bring an arbitration complaint against the owners, which they eventually won in 1992 for a settlement of some \$60 million.

When the 1995 CBA was signed, DGR was changed to BRI and the players accepted a lower share (48.04 percent) in return for a broader definition of revenues applicable to the cap. The 1995 BRI included all basketball income except naming rights, 60 percent of signage and luxury box revenues, certain property income, and part of related-party income.

The 1995 CBA took 11 pages to define BRI, and it was still subject to regular disputation. Suppose you are an owner negotiating an arena lease and are given a choice: pay \$2 million in rent and receive 50 percent of a projected \$4 million in signage income or pay no rent and receive no signage. It might seem that this is a choice between equals,

but since the CBA gives 40 percent of signage income to the players, the owner would do better with the second option of no rent/no signage. Lease agreements offer manifold opportunities for such juggling, especially when the arena and team are owned by the same person or entity.

Related-party transactions are a central component of the finances for most teams. If the owner of the team also owns the arena, the arena management company, the concessionaire rights, a local TV or radio station, Web pages, local real estate, law, or consulting firms that do business with the team, then the owner has tremendous latitude about where to make his or her profits appear. Abe Pollin, for example, owns the new MCI Center in Washington, D.C., where both his NBA and NHL teams, the Washington Wizards and Capitals, play. He can retain arena revenue from naming rights, premium seats, signage, catering, and theme activities in his arena corporation, thereby reducing the revenues earned by his teams by tens of millions of dollars annually. Almost half of all NBA team owners also own their facilities while several others own companies that have management contracts for their arenas.

Owners can also pay themselves exorbitant salaries and consulting fees as well as receive extensive perquisites. They can choose to capitalize their franchises through owner loans rather than paid-in capital and take their returns in the form of interest income (which shows up as costs on the team ledgers) rather than profits. Thus, Wayne Huizenga, owner of the Marlins (until February 1999), Dolphins, Panthers, Pro Player Stadium, Sports Channel Florida, and arena management and concessionaire ventures, could rechannel his teams' revenues to his other related businesses, making the 1997 world champion Marlins appear to lose money.¹¹

In leagues where there is a salary cap, such accounting legerdemain comes in handy to reduce player payrolls. Where there is no cap, owners have still preferred to hide profits to reduce revenue-sharing payments or to argue for larger public stadium subsidies, collective bargaining concessions or special treatment under the law.

So, when the NBPA reviewed the teams' pre-1997 financial records, it could not discover a basis for the owners' claims of declining profits. The few teams that lost money in 1996–1997 generally did not have losses in prior years. Moreover, each of these teams would

have a new arena to play in within two years. New arenas usually raise a team's revenues by \$20–\$30 million a year. Moreover, the NBA had signed a new four-year television contract with NBC and Turner that would begin with the 1998–1999 season and increase the average annual payout per team from a guaranteed \$9.5 million to a guaranteed \$22.8 million. Thus, even if four or five teams had true financial difficulties in 1996–1997, it seemed that new arenas and television money would wash away their problems.

The NBPA also wondered why the owners were so alarmed that player salaries had increased to 57 percent of BRI. By comparison, the NFL was using a different, narrower revenue concept and setting its salary cap at 63 percent of defined revenues. But the NFL cap also had loopholes, albeit fewer than the NBA's, and its salaries frequently rose to 70 percent of defined revenues. If the NFL's defined revenue concept were converted to the NBA's BRI, the salary share in the NFL would have hovered around 60 percent in recent years. In Major League Baseball (MLB), the comparable player share was also around 60 percent, excluding the additional 12 percent that the teams spend on their player development systems. (For the NBA, the latter is an expense that is borne almost entirely by college basketball programs.)¹² Furthermore, an NBA team played half the number of games as an MLB team, had half the number of players for whom it has to pay for travel, lodging and meals, has fewer coaches, smaller facilities and less equipment. Therefore, could not NBA teams still be profitable with player shares around 60 percent?

Other facts as well undermine the owners' claim to dwindling profits. The NBA lavishes alluring sums on its coaches and front office personnel. In 1997–1998, Commissioner David Stern reportedly earned \$8 million a year, far in excess of his counterparts in the other sports. The salaries of head coaches and general managers more than tripled between 1994–1995 and 1997–1998. Fourteen head coaches received over \$2.8 million a year, with one coach's salary reaching up to \$8 million. In contrast, the three highest paid coaches in the NFL each earned under \$2.5 million a year, although each had won a Super Bowl. Asked to comment about the astronomical increases in NBA coaches' salaries, David Stern commented to the Web site Sportsline USA: "If the owners spend all that money on coaches, that means they have it. Otherwise, they wouldn't do it."

Consider what would happen to NBA profitability if the players salary share remained at 57 percent. In its December 14, 1998 issue (p. 130), *Forbes* magazine estimated that the average NBA team earned \$6.6 million in profits during 1997–1998.¹³ To be conservative, let us take half of this figure and round down and, thus, assume that the average profits were only \$3 million. The average team, then, would have financial results that looked something like this in 1997–1998:

Team revenues = \$60 million
 Player salaries = \$34 million
 Other costs = \$23 million
 Profit = \$3 million

Now assume, as the NBA did in its projections, that revenues grow at 12 percent annually. For player salaries to retain their 57 percent share, they would also have to grow at 12 percent.

The owners had long argued to the players that they needed artificial constraints on salary growth because they were unable to behave rationally given the pressure they are under from the fans and the media to sign the best players. That is, they need protection from themselves when it comes to player salaries. Granting the owners this dubious premise, it certainly cannot also apply to their other expenses. Costs like plane travel, hotels, arena maintenance, front office personnel, and coaching staff should more or less follow the underlying rate of inflation. Let us generously assume that the “other costs” category will grow at 5 percent annually, approximately two times the current rate of inflation. Now, consider what would happen to profits under this scenario. As the share of player salaries stays the same, the share of other costs falls rapidly and, hence, the share of profits rises. As the share of profits in revenue grows, and revenues grow at 12 percent, absolute profits exhibit explosive growth. By the year 2002–2003, the average team would have these results:

Team revenues = \$105.8 million
 Player salaries = \$59.9 million
 Other costs = \$29.3 million
 Profits = \$16.6 million

That is, profits would grow more than fivefold over the period; the annual growth rate of profits would be 40.8 percent!

Would \$16.6 million represent a fair return for a team owner? On revenues of \$105.8, this is a 15.7 percent return. This is approximately three times the average, pretax rate of return on revenues in the leisure-time industry in the United States between 1990 and 1997 of 5.8 percent.¹⁴ Even if we assumed that in 1997–1998 the average NBA team earned zero profits (instead of \$3 million) and other costs were \$26 million (instead of \$23 million), at the assumed rates of growth, average team profits in 2002–2003 would be \$12.6 million, or 11.9 percent of revenues.

It is, of course, theoretically possible that even with such strong average profits, the distribution of profits might be so unequal as to leave a handful of teams in financial difficulty. However, with the new arenas projected for the bottom teams and the nearly two-and-a-half fold increase in the national television contract, which is divided equally among all teams, it is likely that even the financial bottom dwellers would have acceptable rates of return.

If some teams had true financial problems, then the players' association believed that they should have been addressed through additional revenue sharing among the owners rather than through new artificial restraints on salaries. Unlike the NFL or MLB, the NBA does not share any local revenues. The NFL teams share net gate revenue 60/40 percent between the home and visiting team.¹⁵ They also share permanent seat license and club seat revenue under certain circumstances. Baseball introduced a new revenue sharing system in 1996 wherein the top revenue team would be transferring approximately \$18 million to the bottom team in 1999. Finally, it is important to recall that a significant part of the return from owning a sports team may not show up in the profit and loss statement. Apart from their ability to manipulate related-party transactions, owners reap substantial tax sheltering benefits from player amortization schemes. They also benefit from capital gains, psychic income, ability to aid their other businesses, political access, and perquisites.

It is the total economic return that buyers consider when they contemplate owning a sports team. The definitive measure of this total economic return is the franchise value, which is determined in the marketplace. The value only rises when the economic return to ownership

rises. And here the numbers speak loudly and clearly: expansion fees for an NBA franchise were \$32.5 million in 1988 and \$125 million in 1994. In November 1998, the New Jersey Nets sold for \$150 million. The Nets were ranked by Forbes as the fourteenth most valuable NBA team out of twenty-nine in 1998, or, basically, in the middle of the pack.¹⁶ Based on these figures, NBA franchises have increased in value nearly fivefold over the last ten years. This would not have happened if there were not a substantial and growing economic return to ownership.

ASSESSING THE NEW COLLECTIVE BARGAINING AGREEMENT

Some sportswriters, player agents, and even the guru of sports union leaders, Marvin Miller, have questioned the efficacy of union leadership during the recent NBA lockout. While the final 1998–1999 CBA makes some significant concessions from the players' perspective, the deal also contains some important gains for the union. Moreover, both the structure of the deal and the union's accrued experience from the process augur well for the next confrontation in 2005–2006. The critics are right when they argue that Billy Hunter and Patrick Ewing, the union president, may have made some mistakes. They are wrong if they believe that Hunter and Ewing did not do a superlative job under the circumstances.

The two significant concessions made by the union were accepting a near hard cap at 55 percent of defined revenues during years four through six of the agreement¹⁷ and accepting a limit on individual player salaries. Marvin Miller critiqued the deal, asserting that the role of unions is to set minimum not maximum wages. Fair enough, but Miller leaves out the following facts: a) the NBA has had a salary cap, albeit porous, since 1983; b) the union was coming off a near devastating bargaining process in 1995 which sharply divided the players and resulted in greater salary stratification; c) the NBA players had no prior experience with work stoppages; d) the economic conditions of the 1990s are far different than those that prevailed in baseball when

Miller's players' union cut its teeth; and e) the NBA owners conducted a very controlled, deliberate, and sophisticated lockout.

Under the new deal, the salary cap remains at 48.04 percent of defined revenues, and it remains subject to various exceptions. These exceptions will allow team payrolls to go up to 55 percent of defined revenues without any additional restraint. If aggregate payrolls go above this percentage, however, the players will reimburse the owners dollar for dollar of any overage up to 60.5 percent of revenues. If payrolls go above this latter level, then the owners whose teams' payrolls exceed the 60.5 percent threshold will pay a 100 percent tax on every dollar of salary above this level. Thus, there are strong constraints built into the system to keep player compensation expenses at 55 percent of defined revenues in net terms, but there is certainly some wiggle room. The point here is that the current deal has evolved out of the existing salary cap institution. It was not created out of thin air.

What is new, even to basketball, is the acceptance of an absolute limit on individual salaries. For 1999, the limits are \$9 million for players with less than 7 years of service, \$11 million for players with between 7 and 9 years, and \$14 million for players with 10 or more years. These limits will rise in step with NBA revenues and no existing player will be forced to take a cut thanks to a grandfathering provision that allows any salary to grow by 5 percent over its previous level. Further, these limits apply to the first year of a contract, but contracts for Bird free agents can extend for seven years and grow at 12 percent of the base salary per year. If these limits had been in place during the last CBA, only three players would have been affected directly. The potential problem here is not whether Patrick Ewing makes \$20 million or \$14 million (Ewing forfeited \$8 million of his 1998–1999 salary from the lockout), it is that historically the star players were the salary trailblazers for the entire league.

The owners stand to reap some handsome profits from these limitations. If net salaries remain at 55 percent of defined revenue,¹⁸ then under the assumptions in the new profit model, an average owner's profits would grow to \$18.7 million in 2002–2003 on revenues of \$105.8 million. Because of the wiggle room in the system, however, it is likely that some owners will go through the 60.5 percent trigger and raise the overall net player share somewhat above 55 percent.

One problem that basketball has had for many years and that was exacerbated by the 1995 CBA is that the cap system, without sufficient exceptions for mid-range players, generated a sharp class system among the players. Rather than pulling up all salaries, the superstars were forcing the salaries of most other players downward by occupying increasing amounts of cap room. This created not only a problem of equity but also a problem for union solidarity that did not go unnoticed by the owners.

The new CBA scores appreciable gains for the players in recreating a middle-range salary scale. For instance, a new “middle class” exception was added at \$1.75 million for 1999, rising to the league average salary in 2003. Teams can sign one player per year to one six-year contract under this exception, even if the team has reached its 48 percent cap. Thus, by year six of the deal, some teams may have 6 of its 12 players paid the league average salary. The union also scored significant gains in minimum salaries, which now range from \$287,500 to \$1 million, depending on years of service, and substantial improvements in player retirement benefits.

Price regulation always creates strange outcomes. In the case of the NBA cap, we are already seeing that some excellent (but not superstar quality) players have had their salaries shoot up to the maximum. That is, instead of having, say, a Patrick Ewing at \$18 million and a Latrell Sprewell at \$10 million, we might find them both at \$14 million. And other players whose salaries are effectively constrained by the maximum may find that the owners will give them a seven-year deal at the maximum, instead of what, absent the new limits, might have been a five-year deal at a few million more per year. This possibility will be especially beneficial to older veterans. In other words, the owners will find a way to pay the players.

It is apparent that in the short run, a majority of players will either gain from or be unaffected by this new CBA. The 55 percent threshold is essentially the 57 percent the players attained in 1998 without Michael Jordan’s salary. This is the key to understanding the union’s dilemma and the eventual outcome.

In the early and mid 1970s, when Marvin Miller fashioned the impressive solidarity and militance among baseball players, the minimum salary in baseball was \$16,000 (in 1975) and the average salary was \$44,676 (in 1975). An average baseball player who sat out a

whole season in 1975 would then lose less than one-fiftieth of what an average NBA player in 1998–1999 would lose. Moreover, the potential gains in 1975 for the baseball players were astronomical if they could move from the reserve system to a system of free agency.

Union director Billy Hunter did not have these advantages in 1998. Nor did he have the advantage of a union with any history of struggle and sacrifice. In their book *Money Players*, Armen Keteyian, Harvey Araton, and Martin Dardis said this about the state of union politics in 1994: [Charlie] Grantham (then union director) knew his players were not about to strike or tolerate being locked out. Worse still, Hunter inherited a union that was bitterly divided over a failed decertification vote in 1995 and highly unequal salary distributions.

The absence of a history of collective bargaining struggle is not just the absence of an abstract notion of solidarity. Collective bargaining involves establishing practices of cohesion and strategic communication. Hunter faced strong criticism for being both too authoritarian and too democratic. On the owners' side, democracy was not an issue. Commissioner David Stern called the shots and spoke for the 29 owners. Hunter needed to lead, but he could not get too far out in front of his 400 players.

In October 1998, Hunter called a meeting for all union members in Las Vegas. The issues and positions were exhaustively debated in small and large groups. The meetings were open only to players and union staff, but it was clear within days that David Stern knew what was discussed and decided upon in Las Vegas. Indeed, individuals from the Commissioner's office have suggested that they had informants all along and knew about every move the union made.

Hunter was also accused of being David Falk's puppet and, sometimes, Arn Tellum's. Large parts of the media uncritically regurgitated these claims. Yet anyone involved in the process, who spent time in the union office or knew the deep integrity of Billy Hunter, knew that these charges were utter nonsense. To be sure, the willingness of the union staff initially to discuss and then accept limits on high-end salaries ran diametrically counter to the interests of the big-time agents.

On the other hand, Hunter developed a wonderful rapport with the players and his staff. He fashioned a strong unity out of division, and he held the players together for several months of the lockout—itsself a Herculean feat. While the final settlement terms were not everything

the union wanted, they were a very long way from the owners' original demands and even from the owners' position when they supposedly made their last offer in late December. What is remarkable about both the process and the outcome is that under the circumstances Billy Hunter and the union accomplished as much as they did.

In the future, the union will have this negotiating experience under its belt and player salaries will be more compressed because of the mid-range exemptions. Both changes augur well for union solidarity and strength. Most important, the vast majority of NBA players are pleased with the present deal and, therefore, with their union experience.

The first salary results from the new CBA are already in, and so far it looks good for the players. They have increased their share in defined revenues to approximately 59 percent (on a nonprorated basis), even without Michael Jordan's salary, which took up about 2 percentage points. The average player salary jumped to \$2.8 million in 1998–1999. Moreover, the players clearly have resurrected the middle-salary range. On a nonprorated basis, the median player salary rose by more than 20 percent from \$1.4 million to \$1.7 million. In 1998–1999, 13 players signed for the mid-level exception and 20 veteran players signed for the new veteran minimum salary of \$1 million. All told, in 1998–1999 there were 120 players with salaries between \$1 million and \$2 million, compared with only 74 in the category in 1997–1998. Further, the number of players with salaries below \$1 million fell from 151 in 1997–1998 to 101 in 1999, and the number below \$500,000 fell from 85 in 1997–1998 to 40 in 1999.¹⁹ Of course, the more problematic years four through six of the new CBA (when the escrow tax kicks in for player shares above 55 percent) are yet to come, but most players cared more about the first three years and getting back to work.²⁰

THE NBA DEAL AND THE Y2K PROBLEM

Not surprisingly, the NBA's new salary constraints and strong profit expectations caught the attention of baseball and hockey owners. For instance, Carl Pohlad, owner of the Minnesota Twins, praised the

salary control aspects of the NBA deal and asserted: "We've got to have some deal like the NBA's if we are to survive."²¹

Can we expect to find NBA-type changes in 2002 and 2003 when the new MLB and NHL deals are negotiated? More generally, how does the NBA deal fit into the changing landscape of professional sports?

It is by now a cliché to note that the ownership of professional team sports is changing. By one estimate, in early 1998, 66 public corporations had direct or indirect ownership interests in sports teams: 31 in MLB, 30 in the NHL, and 20 in the NBA. A large share of these public companies are in the media business. Media-business-owned teams often have a different objective than other teams; namely, the team itself is not necessarily viewed as a profit center, but rather as "software" or programming to promote the larger media empire. For example, when FOX decided to pay the 33-year-old Kevin Brown \$105 million over seven years beginning with the 1999 season, part of the expected payoff was that Brown's stature would help promote the FOX network in the United States and abroad. CBS' gargantuan contract with the NFL is buying football along with its ratings as well as exposure and status for its other programming. In the fall of 1998, CBS led the networks in prime time ratings. It is the first time CBS has topped the charts this deep in the season since 1993, which was the last time CBS had the NFL.²²

Fifteen million dollars a year for a 40-year-old pitcher seven years into the future is a lot of money and probably would not make sense viewed from the perspective of a single baseball team. However, Rupert Murdoch thinks Brown is worth at least \$105 million to his News Corporation, and he likely is right; but it is questionable whether Brown would have been worth this much to the Los Angeles Dodgers baseball team alone.

In early 1998, the 30 owners of MLB teams were debating whether to allow Murdoch and his News Corporation to buy the Dodgers. After their reported unanimous vote to allow the purchase, I asked one owner if the baseball community didn't have some serious reservations about this sale. His reply was, "We didn't have a choice." He was referring to the fact that the FOX regional sports network already had local contracts to televise 24 of baseball's 30 teams. But there was another element as well. FOX was about to offer \$310 million for the Dodgers, by

far the highest purchase price for a team in baseball's history. Baseball's owners were happy to have Murdoch push up the value of their teams, but now when Murdoch also breaks the salary scale, the owners cry that he is upsetting competitive balance.

The media-company-as-team-owner phenomenon is just the latest irritant to the competitive balance mixture in professional team sports. Owners have long argued that teams from larger cities had an advantage over those from smaller cities; and, especially in the 1990s, teams with new facilities generating tens of millions of dollars in additional revenues were seen as having a competitive edge over teams playing in older facilities. That is, a team from a large city or with a new facility or owned by a media conglomerate would be able and willing to outbid other teams to procure top player talent.

In theory, this argument always made some economic sense. In practice, however, the advantaged teams were not dominating their leagues (save in baseball during the pre-free agency, predraft era). Indeed, some even argued that it would have been in the leagues' best financial interests if the big city teams did dominate because having those teams in the playoffs would raise aggregate fan interest along with television ratings.

Beginning in the mid 1990s, however, the big-city/new-facility/media-owned teams in baseball began to monopolize the postseason landscape. During the 1998–1999 offseason, many of the other teams publicly gave up and waived a white handkerchief before the season began. Owners such as Carl Pohlad, whose net worth is \$1.3 billion according to *Forbes*, decided that maintaining a payroll in the \$25–\$45 million range would not allow them to win their divisions. Therefore, their profit-maximizing strategy is to minimize their payrolls to \$10–\$15 million. Pohlad now follows the ignominious example of his fellow owner Wayne Huizenga. Each attempted to punish his fans for not supporting the team in the building of a new stadium with public funds.²³

While the revenue disparity between the richest and poorest baseball team was around \$30 million in 1989, by 1998 it was close to \$120 million. To this volatility, add the presence of new franchise owners who also own international communications networks and who value their ballplayers not only by what they do on the field but what they do for their networks. Further, baseball's expansion by four teams in the

1990s, while adding excitement to the game, diluted the talent pool and made the star players stand out more and, thereby, made it easier to buy a winning team.

Baseball tried to address these inequalities in the last collective bargaining agreement. However, it is now clear that the agreement's plan to share revenue among the teams (wherein in 1999 the top team with revenues around \$200 million would transfer approximately \$18 million to the bottom team with revenues around \$40 million) and the luxury payroll tax (wherein the top five payroll teams in 1999 would pay a 34 percent tax on that portion of team salaries above approximately \$76 million) did not go nearly far enough toward leveling the imbalances.

Consider these statistics. In 1998, of the 8 teams that made the playoffs, all were among the top 12 teams in payroll. Further, of these top 12 teams, all had winning percentages above 0.500, save the Baltimore Orioles who finished at 0.488. Of the bottom 18 teams in payroll, only 2 teams finished above 0.500. Of the bottom ten teams in payroll, none finished above 0.475. Put differently, in 1998 no team made the playoffs without spending at least \$47 million on payroll, and no team spending less than \$38 million had a winning record.

Some of these results, no doubt, are from poor management or owner machinations. But others have to do with the underlying institutions and incentives of ownership in Major League Baseball.

With varying degrees of success, the NFL, the NHL, and the NBA have avoided the pitfall of advantaged-team domination. The NFL formula is simple: extensive revenue sharing among the owners, reverse order draft, unbalanced schedule, prohibition against corporate ownership, and a fungible salary cap set at 63 percent of league-defined gross revenues. The NHL formula entails curtailing unrestricted free agency until a player reaches 31 years of age, limitations on player sales, and a reverse order draft. The NBA, as we have seen, albeit dominated in recent years by the big-city Chicago Bulls, owes the strength of many of its small-city teams, such as the Utah Jazz, to the Larry Bird exception to its salary cap.

If and when competitive balance problems manifest themselves in other sports, as they appear to be doing now in baseball, affected leagues would do well to study the NFL example of revenue sharing. By dividing equally all revenue from the national television contract

(an average of \$2.2 billion a year over the next eight years) and national licensing, splitting the net gate 60/40, as well as sharing other revenue sources, the NFL has attained unprecedented balance. Though arguably the NFL's system should be modified because the league offers owners little or no profit incentive to win.

The NBA response to revenue inequality among its teams has been to attempt to lower the player share in league revenue and to turn the soft cap into a hard cap. That is, the NBA has made the players bear the burden of revenue inequality among the owners. Baseball owners attempted a similar solution in 1994–1995. In both cases the outcome was predictable—a lengthy work stoppage. At the very least, the burden of dealing with inequalities needs to be shared. Players should accept some additional restraints, but owners need to do additional revenue sharing. Further, to guard against free riding, teams should be required to meet certain payroll standards (e.g., 80 percent of average league payroll) to qualify as a beneficiary of revenue sharing.

In January 1999, MLB Commissioner Bud Selig, seemingly inspired by the new NBA and the lofty contract for Kevin Brown, formed a committee to study the issue of competitive balance in baseball. Selig appointed several luminaries to the committee, including former Federal Reserve head Paul Volcker and former U.S. Senator George Mitchell, along with several owners. Although some technical questions exist within the issue of competitive balance, the more important and less tractable problems are political. Without union representatives, Selig's committee risks generating solutions that appeal to only one side.

In 1994, the baseball owners, after studying competitive balance, convinced themselves that a salary cap was needed, but they never convinced the players. The result was a strike and no World Series that year. Even if baseball owners eventually decide that the solution is more revenue sharing among themselves rather than new artificial constraints on salaries, the nature of the sharing is something that the union must ratify.

Of course, it is far from simple to convince advantaged owners to increase revenue sharing by voluntarily taxing themselves. These owners would argue that they paid more for their advantaged franchise and that additional taxation amounts to a form of asset confiscation. However, unbalanced competition and work stoppages will also lower the

value of their asset—and possibly by more than additional revenue sharing.

It is a stretch to think that the new NBA deal is easily transferable to baseball or hockey, which have never operated with a salary cap. Indeed, both the NFL and NBA caps were around in 1994–1995 during the last negotiations in hockey and baseball.²⁴ The MLB and NHL owners were emboldened, but so were the players.

If owners and players are unable to resolve the problem of competitive balance on their own, then it will be up to Washington politicians to awaken from their long-standing sports slumber. The natural economic solution for professional sports is competition. With two leagues in each sport, monopoly teams in big cities will soon find another team from the competing league in their territory. The artificial shortage of teams will evaporate and deserving cities will no longer have to compete against each other through public subsidies to get teams. This will erode the competitive imbalance problems from new facilities and larger cities.

The public policy solution is straightforward: pass legislation that will break each league up into competing business entities.

Notes

1. In reality, teams in these leagues both cooperate and compete as businesses, but it is their cooperation in certain areas that distinguishes them from other businesses.
2. For instance, in a league with 30 teams, the first 15 picks could be given to the bottom 15 clubs in reverse order to finish in the previous season. The next 15 picks could go to the 15 clubs with the lowest revenue or rent (potential revenue from site). The third 15 picks could go to the top 15 clubs in reverse order of their finish, etc. “Rent” refers to potential revenue given the characteristics of the city and site. Internationalizing the draft along with our rule changes would also benefit competitive balance.
3. Although this strategy has been employed in all leagues (though not in baseball since 1972), the NFL experience shows it can be problematic. In particular, it can create political problems in the abandoned city and eventually force the league to add an expansion team in order to restore a team to the city. Should this occur, the league loses some control over its output and, hence, some of its monopoly power.
4. Actually, under the new agreement Jordan’s salary could not increase by more than 5 percent. Because his salary last year was \$33 million, the Bulls could have paid Jordan \$34.65 million in 1998–1999 (prorated for the number of games played in the shortened season).

5. The correlation is even weaker when team salary was lagged a year and when MSA population was controlled. Quirk and Fort (1999) present rank correlation statistics that show this relationship is stronger in the NBA than the other leagues in the 1990s. It is likely that this tighter correlation in the NBA can be explained entirely by the Bulls' exceptional success and high payroll due to the presence of Michael Jordan.
6. See definition in text, p. 97.
7. Data from the NBPA.
8. The middle-salary exception allows for a team to pay a player a mid-range salary even if it puts the team over the top.
9. The average salary in 1997–1998 is sometimes represented as \$2.6 million. The \$2.6 million figure includes only full-time roster players. The \$2.4 million includes all players under contract.
10. The author served as a consultant to NBPA during 1998–1999.
11. See my elaboration of this point in “A Miami Fish Story,” *The New York Times Magazine*, October 18, 1998.
12. Since it does not have a minor league system, the NBA's player development expenses principally consist of scouting and come to no more than 1 or 2 percent of the average team's expenses. On the economics of college basketball, see Zimbalist (1999).
13. This estimate was performed by Michael Ozanian, who had done similar estimates for all the major sports leagues for several years for *Financial World* before joining the staff at *Forbes*.
14. *Corporation Sourcebook of Statistics of Income*, 1990–1997; also in *Business Week*, various issues.
15. The actual system in football is to share the gate 60/40 after the home team has deducted 15 percent of the gross gate for theoretical stadium costs. Thus, the actual distribution of the gross is roughly 66/34.
16. Michael Ozanian, “Selective Accounting,” *Forbes*, December 14, 1998, p. 127.
17. Year seven of the deal is at the owners' option. If they exercise the option, the 55 percent threshold rises to 57 percent in the seventh year.
18. The agreement actually calls for the introduction of a new revenue concept, Core Basketball Revenues or CBR. CBR will consist of gate receipts, all broadcasting revenue, luxury suite receipts, NBA properties revenue and certain other revenue to be determined. CBR will come into effect in the 1999–2000 season, and the BRI percentages will all be converted to a CBR basis.
19. For 1998–1999 the maximum player salary only affected two veteran players, Rik Smits in the senior category and Jayson Williams in the middle category (7–9 years of service). Ten players in the junior category, however, were affected with an average salary of around \$12 million in the group over the lives of their contracts. These players were Shareef Abdur-Rahim, Ray Allen, Kobe Bryant, Zydrunas Ilgauskus, Allen Iverson, Stephon Marbury, Antonio McDyess, Arvydas Sabonis, Damon Stoudamire, and Antoine Walker.
20. Data are preliminary from National Basketball Players' Association.

21. Quoted in the *Sports Business Daily*, February 11, 1999.
22. I do not mean to suggest that the only cause of CBS' rating rise was its NFL contract, only that it helped. To be sure, it could not have hurt CBS when the Seinfeld show went off NBC after the 1997–1998 season.
23. A kind of reverse strategy was employed by the Seattle Mariners in 1997 and the San Diego Padres in 1998. In order to arouse public support for new stadiums, these teams fielded championship teams, only to dismantle them after their referenda for publicly funded new facilities had passed.
24. To be sure, it is likely that the NFL constraints on the salaries of franchise players are more severe than the \$14 million cap (in 1998–1999) on veteran free agents in the NBA. Each NFL team can designate a franchise player. The services of this player can be automatically retained by the team if the player is offered compensation at the average of the top five paid players at his position in the NFL or 120 percent of the player' previous salary, whichever is greater.

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