Sports

Where have you gone Joe DiMaggio

Perfect Competition?

- Professional Sports Poses a Few Interesting Problems
  - Are the Teams in the League a Single Entity, or Are They Competitors, or Some Combination?
  - What Is the Relation of Professional Sports to the Rest of the Entertainment Industries?
  - What Is the Source of the Value Creation in Professional Sports?
- Use Baseball As the Paradigm

Single Entity?

- Clearly There Are Aspects of Both
- One Way to Think About It Is to Look at the Incentives of Any Owner to Field the Best Possible Team
  - And Consider How the Motives of a Single Owner Interact With Those of Other Owners
- A Specific Example Is Brought About by the Advent of Free-agency in Major League Baseball
First of All, I'd Like to Talk to You About Starting Salaries in the Major Leagues

Are Teams of Equal Quality?
- No
- Actual Winning Percentages Are More Disperse Than They Would Be If Teams Were of Equal Quality
  - Either Lifetime or Season-by-season
- But There Is a Clear Aversion to Having Teams Be Too Bad or Too Good for Too Long
  - Reserve Clause
  - Revenue Sharing
  - Salary Caps

Owner Arguments for Restrictions on Salaries
- Same Arguments for Reserve Clause or Salary Caps
- Need to Maintain Competitive Balance
- Affect on Ticket Prices
So What Is the Effect of Free Agency on Competition?

- No Detectable Effect on Competitive Balance in Baseball
  - Standard Deviation of W/L % Is the Same

Is this a surprise?

- We Need an Economic Theory of Salaries

First Consider Two Teams
Now Look at Marginal Revenue

$\text{$/ W/L %}$

- $MR(A)$
- $MR(B)$

Now What Happens in Competition

- The Competitive Equilibrium Must Be One in Which Price Is Equated to Marginal Revenue for Each Team
  - both teams face same marginal cost of a victory
  - old $MR=MC$

- Graph Shows This, Note That for Team A the W/L % Goes up As We Move to the Right, While for Team B the W/L % Goes up As We Move to the Left

Equilibrium With Competitive Mkt

- $MR(A)$
- $MR(B)$

- $C^*$

- Cost per W/L %

- W/L % (A) .6
- W/L % (B) .4
What About Revenue Sharing?

Revenue Sharing Has No Effect on W/L %
- As Long As Teams Take Into Account the Effect of an Added Victory on Not Only Their Home, but Also Their Road Income, Revenue Sharing Will Not Increase Competitive Balance
- But, Since a Given Victory Is Now Worth Less to a Team (As Long As the Revenue Sharing % Is Less Than .5), Salaries Will Fall
- Revenue Sharing Doesn't Lead to Balance, It Leads to Lower Player Wages As Long As Teams Remain Viable
- It Will Transfer Wealth From Big-city Clubs to Small-city Clubs

You Are Either Going to Play on a Baseball Team or Get a Salary Cap
Reserve Clause

Initial Allocation W/L = .5

Effect of Reserve Clause
- Initial 50-50 Allocation Is Not an Equilibrium Because MR(A) [Big Market] Is Higher Than MR(B) Small Market
- If Cash Sales Are Possible, Will Move to Competitive Allocation by Player Sales
- Relative Wealth of Teams Will Be Affected
- Players Get No Benefit

Conclusion
- Neither Revenue Sharing, nor the Reserve Clause, Can Be Expected to Maintain Competitive Balance
- They Can Be Expected to Increase Owner’s Wealth
But We Have to Protect the Poor Fan?

- Owner's argue that high salaries must lead to high ticket prices so they are harmful to fans.
- But that hard to believe because it is inconsistent with profit maximization by owners.
  - Once the Mets sign Piazza his salary is fixed, but fixed costs don't affect prices. Remember your economics, firms equate marginal revenue with marginal cost.
  - True as long as the Mets stay in business.

So, Will All the Best Players End up on the Yankees?

- I hope not!
- Two views:
  - Even without free agency, as long as cash sales of players are permitted the best players will all go to the teams with the biggest payoff to winning.
  - It does affect who gets the money - the owners or the players.
- Others, George Daly for example, argue that owners will not let this happen because fans like competition.

Important Caveat

- This assumes owners are value maximizing and won't overpay to win.
- There are numerous examples where this appears to miss something.
So What Is the Effect of Free Agency?

- Strong Evidence That Player Salaries Are Higher
  - Except in Years When Owners Collude
- No Evidence of Any Effect on Competition

Why Couldn’t the Players and the Owners Cut a Deal in 1994?

- I.E., Why Was I, a Loyal White Sox Fan, Unable to See the Sox in the Series?
  - Jerry Reinsdorf
- In Order to Understand the Bargaining Game You Have to Look at the Underlying Economics of Bargaining Power

Need to Get Some Idea of How Value Is Created in Baseball

<table>
<thead>
<tr>
<th>Substitutes: Football, Basketball, Other Entertainment, New Player League, Radio</th>
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<tbody>
<tr>
<td>Players, Stadium Owners</td>
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<tr>
<td>Team Owners</td>
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<tr>
<td>Fans, TV Stations</td>
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<tr>
<th>Complements: Other Fans, Little League, Souveniers</th>
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| Willingness to Pay | Willingness to Sell |
WTP, WTS

- These Are Simply the Old Economic Notion of the Opportunity Cost
- The Willingness to Pay for a Fan or a TV Station Depends on Her (or Its) Next Best Alternatives
- Willingness to Sell for an Owner or a Player Depends on Their Next Best Alternatives
  - Clipping Coupons
  - Retirement
  - Soccer
  - Broadcasting

Prior to Strike Baseball Creates Value

- Prices Going up 10% Per Year and Fans Still Pay
- Big TV Contracts
- But Some Signs of Trouble
- Still WTP Looks Strong

- $1.8 Billion Dollar Industry With Only 700 People
  - Plus a Lot of O’Malleys
- Why?

What Is Going on?

Up to the time of the strike, baseball created value

- Fan & TV WTP
- Value Created
- Potential for Owners to Make Profits
- Player’s Opportunity Costs: coaching, etc.
What Is Going on?
It looks like owners have been setting prices near WTP

- Fun & TV WTP
- Price

Value captured by owners depends on how much they pay players
- Salaries
- Player’s Opportunity Costs: coaching, etc.

Problem: Can’t Separate Value Provided by Current Owners From Value Provided by Players
- Players and Owners Already Have Made Big Commitments to the Game
  - Players Train for Years
  - Owners Invest in Training Facilities, Stadiums
- The Commitments Preserve Value Creation Relative to Alternatives
- If Either Refuses to Participate Other Is Left Holding the Bag

What Does Free Agency Do?
- Changes the Nature of the Bargaining Between Owners and Players
- Clearly Owners Will Be Getting Less of the Value
  - Free Agency Forces Owners to Compete With Each Other
  - Players Have Always Been Competing With Each Other
- Free Agency Exacerbates Small Vs. Large Market Problems
Alternatives

- Vertical Integration
- Build New Stadiums
- Find Different Owners

Vertical Integration

- Similar to Problems in Other Areas
- Let Players Own the Clubs
- But This Turns Out Not to Work
  - Problems With Personnel Decisions

Build New Stadiums

- Luxury Boxes Are an Untaxed (by Revenue Sharing) Source of Income
- Can Get the Municipality to Finance It
- Box Income Not Tightly Tied to Quality of the Team
  - Require Multi-year Deal
Find New Owners

 Owners Who Only Bring Money to the Table Will Not Make Money
   – Lots of People With Money Want to Own a Ballclub. Too Much Competition

 Need Owners With Special Skill
   – Give Me a Break

 Owners Who Bring Something Unique to the Table
   – Entertainment Companies

Owners

 1950’s Owners Either Started or Inherited Clubs or Made Money in an Unrelated Business

 Now We Have a Number of Teams Owned by Entertainment Companies
   – Dodgers, Cubs, Braves, Angels

 Why?

Vertical Integration

 Sports Is Important Content

 Why Will Murdoch Pay More Than Anyone Else for the Dodgers?
   – JSkyb
   – Will This Affect the Team on the Field?

 For News Corp, and Somewhat for Disney, Sports Is Central
Murdoch and Sports
- Premier League (UK Football)
- Use of Local Sports Team Loyalty
- Different Strategy From Disney Re Sports Network
- Key Point Is That Value of Sports Depends on Decisions Made There
  - This Is Just Like Other Places Where Vertical Integration Makes Sense

New Stadiums
- These Virtually Never Generate Public Benefits That Exceed Public Costs
- Benefits Flow Entirely to Owners