Competitive Conditions in Pro Sports Leagues

by Glen Hodgson and Mario Lefebvre | May 2011

Sports fans eagerly give their hearts to their favourite teams. But pro sports leagues are full of perennial winners—and losers. Sometimes, winning or losing can be determined by underlying competitive conditions that are not always equal. In this fourth briefing, we analyze the concept of a level playing field as it applies to the various leagues.

The competitive conditions that exist within a pro sports league can be crucial to the success of individual franchises and to the long-term health of the league as a whole. When looking at a given league, we want to know whether it pays more than just lip service to creating the conditions for a level playing field—competitively and financially—among its franchises. Specifically:

- Does the league limit the salaries of players, relative to expected revenue?
- Are revenues shared among the franchises? If so, from what sources, and to what degree?
- Do all teams have equal access to existing and new talent?
- Does the league compensate teams when changes in conditions beyond their control (such as changes in the exchange rate) make them less competitive?
- Moreover, is there a relationship between competitive balance and league profitability?

The answers to these questions will help determine whether a given league has found the right mix of business and on-the-field competitive conditions, and whether a level playing field has truly been established among its franchises.

Salary Cap and Player Salaries

Most professional sports leagues today have some form of a salary cap. In an age of player free agency, a salary cap helps to ensure that franchises can be operated profitably. The cap does this by constraining the ability of players and their agents to bid up player salaries beyond a certain level, and by preventing the richer teams from gaining a competitive advantage by using their wealth to lure talent away from the not-so-rich teams. The salary cap limits total player salary expenses (usually to a percentage of revenues) and allows teams that are well managed and well positioned in their market to operate profitably.

In terms of simple economics, a salary cap is usually implemented in response to unequal financial and market power across the league's franchises. Economic theory suggests that if all franchises were equal in economic and competitive strength, and all were driven by the desire to maximize profits, then a salary cap would not be necessary. All teams would have a comparable ability to attract and retain talent, and no one would have an incentive to offer a significantly larger contract than anyone else to a specific player. In the real business world of pro sports, however, such equality does not exist—the financial and business circumstances of franchises vary greatly. Salary caps are therefore created to level the playing field among franchises in terms of player costs.

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Salary caps in the various sports leagues are a source of recurring tension between owners and players because they constrain the capacity of players and their agents to maximize salaries through open-market negotiations. The periodic negotiations that take place on the salary cap regime in the various pro sports leagues have produced systems best described as complex and convoluted.

Take the salary cap system currently in place in the NHL, for example. Before each season, the NHL establishes the level of the salary cap, as well as a salary floor, to be applied to all teams. These maximum and minimum levels are based on a percentage of league revenues, as defined by the current Collective Bargaining Agreement negotiated by the league and its players. Under the cap system, a team's total player payroll for the season cannot exceed the maximum or drop below the minimum at any point during the season. The cap is set as a function of revenues. For

the 2010–11 NHL season, the cap was established at $59.4 million, or 57 per cent of all revenues from the previous season. The salary floor is set at $16 million below the salary cap. For 2010–11, that worked out to $43.4 million. (These are the basic rules. In fact, the NHL salary cap system is highly complex and will be looked at in more detail in a later briefing.)

Major League Baseball still does not have a hard salary cap. (The NBA has a hard cap system, but with many quirky exceptions that allow teams to exceed the cap.) Instead of a hard cap, MLB has a “luxury tax” that is paid when the player payroll exceeds a pre-negotiated amount—$178 million in 2011. This amount is far beyond the revenue-generating capacity of nearly every team in MLB. Such a high level reflects both the negotiating skills of the players association and the high level of influence possessed by a few powerful franchises, led by the New York Yankees. (This aspect will also be examined in greater detail in a future briefing in this series.)

Revenue Sharing

If a league wants to create a more level playing field among its franchises, one of the fundamental steps it can take is to implement a system in which a significant portion of league-wide revenues are shared among its teams. The relationship between revenue sharing and competitiveness within the league is simple: the more that revenue is shared among the teams, the more the playing field is levelled—financially and competitively. In fact, leagues were created in the first place to foster fair competition among teams by imposing a uniform set of rules—so revenue sharing is aligned philosophically with the concept of a sports league.

The easiest revenue sources to share are those that are earned by the league as a whole—such as fees from national broadcasting and related media, collective merchandising, all-star games or similar league-wide events, or revenues related to special events, such as the NHL’s participation in the Olympics. Fees from league expansion are another significant potential source of shared revenue (and, over the years, have created a bias in favour of expansion).

Convincing successful teams that they should share revenues from such things as sales of tickets, food and drink, team merchandise, and local broadcast rights is much more difficult. Teams can argue that their own-source revenue is the result of their own marketing and sales efforts in their home market—and they should not have to share it with teams that have not done as good a job at boosting revenue. But the counter-argument is that if there was no opponent on the field to face these successful franchises, there would be no fans to buy the tickets, food and drink, and merchandise. Therefore, there is a basic logic to sharing at least some of these revenues among all franchises. In fact, implicit revenue sharing also occurs when the more popular teams with wide fan bases (such as the Red Sox, Maple Leafs, or Lakers) visit an opponent and attract additional fans to the game.

A league’s approach to revenue sharing says a great deal about the underlying business philosophy of the league. The NFL leads the way in terms of advancing the collective business interests of the league. Other leagues have adopted the opposite philosophy—every man for himself and minimal sharing of revenues. In those leagues, revenue sharing only becomes an interesting idea when financial weakness in some franchises begins to threaten the local revenues or franchise values of the financially strong teams.

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The NFL has set the standard when it comes to revenue sharing. For decades, the NFL and its franchises have shared more than 80 per cent of league and club revenues—a great example of putting the collective interest ahead of the individual team interest (although some maverick owners, such as Jerry Jones in Dallas and Al Davis in Oakland, have shown they are only too happy to seize opportunities to make more money outside of the league-sharing formula). Television broadcast revenues for the NFL are currently worth over $20 billion annually and are shared evenly among all franchises, as are merchandising revenues. To ensure that it has an attractive product for TV, the NFL has placed considerable weight on establishing a competitive balance on the field, and most analysts agree that the NFL is the leader in that regard. Not surprisingly, the NFL is the most prosperous pro sports league in

North America, with over half the franchises valued by Forbes at $1 billion or more. In this case, there appears to be a relationship between the league's competitive conditions and the financial results.

The on-again, off-again, on-again NFL player lockout, which began in March 2011, is an indication of the stakes involved in sharing the massive revenues of the league. But it also signals the risks to the NFL's revenue-generating capacity if common sense in labour relations does not eventually prevail.

The NHL's revenue-sharing system is based on a different business philosophy. The NHL has a TV revenue pool that has just increased (with a recent new deal with NBC and Versus) to about $340 million annually, shared among its 30 franchises, or about $11.3 million per team. But individual teams are free to develop their own independent TV deals for games not covered in the national/regional TV packages. So if the NHL decided to extend its revenue sharing, the money would first have to be pulled out of the individual teams' pockets—a key difference from the NFL's collective approach. Since the money would be coming directly from their own coffers, owners of the more successful NHL franchises have a good reason to share only as much revenue as is necessary to keep the weakest franchises from collapsing and thereby depressing the value of the surviving franchises.

Access to Player Talent

Common, or comparable, access to player talent across the league is another way of creating a more level playing field among franchises.

The market for player talent has come a long way from the early days of pro sports when the competition for talent was little more than a free-for-all. Decades ago, depending on the sport, a team could gain a competitive advantage on the field or rink by creating a competitive advantage in spotting talent. A team could:

- develop a deep knowledge of its local market (as the Montréal Canadiens did, which led to their historical dominance in the francophone Quebec talent pool);
- search out talent in distant markets (as some baseball teams did in Latin America); or
- use a cozy relationship with feeder teams to protect and groom certain players (such as we still see in the soccer world with its academy system).

In today's player talent market, the playing field is much more level. The first step in bringing some order and fairness to the market for player talent was to introduce a common selection process, or "entry draft," for young talent. This practice emerged during the 1950s and 1960s, depending on the sports league. The entry draft system sets common rules under which teams can acquire young players. These rules generally include a minimum age at which a player can be drafted, and can also include such conditions as past experience and the geographical region in which a team has precedence. The draft system prevents teams from hoarding new talent. And by having the weakest teams pick first and the strongest last (based on the team standings in the preceding season), the entry draft gives the weaker teams preferential access to the expected best new talent—thereby making the league more competitive.

The next significant step in expanding access to player talent was the gradual introduction of free agency for existing players. Baseball was a trendsetter here. Names like Curt Flood, Andy Messersmith, and Dave McNally immediately come to mind as pioneers in the fight against the "reserve clause"[1] and champions of free-agent status once an existing contract with a specific team had expired.

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To a great extent, all the major pro sports leagues have now adopted the same operating model—a common, reverse-order draft and free agency for players who have reached a certain level of seniority or who meet other conditions. The specific details of the entry draft and free agency vary considerably among the pro sports leagues and are inevitably at the centre of the players associations' contract negotiations with the leagues. As we've already noted, MLB does not have a hard salary cap. And the lack of a cap means that the richest teams are free to outbid

the others in the battle to sign the top free agents—which undermines the role of free agency in levelling the MLB playing field.

Globalization has also become a factor of growing importance for the professional team sports that have international appeal and a corresponding international talent pool. Soccer is the most globalized team sport. Team rosters in many leagues, including North America's MLS, are made up of players from around the world. In recent years, some top teams in the top English soccer league (the "Premiership") have fielded full squads of eleven with not a single English player on the pitch. North American pro sports leagues are not immune to the forces of globalization. They have quickly internationalized their talent base. Baseball was first, followed by hockey and basketball. The globalization of talent is a circular, or symbiotic, process. As the various team sports have grown in global popularity, more and more talented players have begun to emerge in many new regions. The North American pro sports leagues have responded by searching for and hiring these talented athletes from outside North America—which, in turn, helps to further fuel the global popularity of the sport.

Changes in Competitive Conditions

Changes in the specific competitive conditions within a league can also play a major role in the success or failure of franchises. As discussed in earlier briefings in this series, changes in the exchange rate can be particularly important for franchises in leagues that operate in more than one country.

Another factor that can influence the competitive conditions is the relative tax burden imposed in the various markets. If a team is located in a market where the personal income tax rate is higher than elsewhere in the league, or where there are any special or local taxes applied to high-income professional athletes, that team will be relatively less attractive to free agents. Higher rates of taxation can also reduce the purchasing power of individual consumers and limit their ability to buy tickets. The same logic applies to business taxation affecting the franchise. A relatively higher rate of business taxation would constrain the profitability—and therefore the competitiveness—of an individual franchise, as would a reduced ability for client businesses to write off the costs of such expenses as corporate boxes. Conversely, tax advantages can also be created to encourage free agents to consider a specific market, or to provide an incentive for individuals or businesses to support pro sports through ticket purchases, corporate box rentals, and advertising.

Conclusion

Most sports fans believe that creating a level playing field among the franchises in a given league is a noble and worthy goal. After all, who could object to the idea of giving every team a fair chance—based only on effort, teamwork, leadership, and management skill—to win the championship every year? Isn't that the raison d'être for sports?

But in practice, a level playing field among the franchises in a given league can be elusive. Pro sport leagues have made some advances in establishing a level playing field, but these advances are often selective and reflect the league's underlying business model and the balance of power within the league.

The "level playing field" concept is applied by most leagues—at least to some degree—when it comes to access to player talent. The results include such things as an entry draft, free agency, and the creation of a salary cap. But the concept is much less likely to be applied to the same degree when it comes to revenue sharing.

How far a league goes in implementing a level playing field among its franchises often says a great deal about the distribution of economic power within that league. And sports fans who eagerly hand over their money—and their hearts—to their favourite team should keep in mind the fact that the underlying competitive conditions are not always equal.

A more in-depth look at these concepts and how they apply to specific pro leagues will be the subject of a future briefing in this series. Once again, stay tuned.