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A Restructuring of Nonprofit Professional Sports Leagues in North America

Greg Swanson
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Introduction

The major professional sports leagues in North America, the National Football League, the National Basketball Association, Major League Baseball, and the National Hockey League, are all nonprofit organizations. This organizational structure of professional sports is a common oversight of the general public. People think of a professional sports league as a for-profit entity because they are constantly hearing about the large revenues that the league earns each year, but the league itself does not actually keep this revenue. Similar to any other nonprofit organization, the league is subject to the non-distribution constraint. This constraint states that nonprofit organizations are prohibited from distributing their net earnings to individuals who oversee the organization. After accounting for league administration costs, all of the revenue generated by the league is redistributed to the individual teams that make up the league.

Each league is owned and controlled by the individual teams that comprise the league. A league commissioner is assigned to oversee league operations. The duties of the commissioner often include leading collective bargaining negotiations with the players' association, appointing officials for games, and determining game schedules. However, the commissioner is not responsible for making decisions on the extent of the league revenue sharing policy and other cross-subsidization policies, the optimal number of teams for the league, or the location of the teams in the league. When it comes to these matters, the individual team owners come together to vote on these policies with a super majority vote required to pass a decision. This process leads to inefficiencies in the determination of the number and location of franchises, the sale of broadcasting and marketing rights, and the efficient allocation of player talent among teams (Ross and Szymanski, 2003). Under this

system, policies that would increase overall league-wide profits often fail to pass because of the significant influence that the high revenue generating teams hold over the rest of the teams. If a proposed policy increases league-wide revenues but reduces revenues for the top revenue-generating teams, then this policy will not pass because the top revenue-generating teams will not have incentive to adopt the policy. The transactions costs that are generated by the team owners impede efficient outcomes for the league (Ross and Szymanski, 2003).

As an alternative to a nonprofit league organization, Ross and Szymanski (2003) have discussed the feasibility of a for-profit sports league and how this type of league would behave. Their proposal consists of a vertically separate, third party investing group that would own the league and make all of the decisions. This third party investing group would take a share of the league revenue before redistributing it to the teams. This system would allow for one group to make decisions that would maximize revenue for the league as a whole. It would also reduce the high transactions costs associated with a club-run league, allowing the for-profit organization to operate with greater efficiency than the nonprofit club-run league. While Ross and Szymanski's for-profit league makes a case for reducing the inefficiencies that a club-run league produces, it poses the problem of getting teams in the current club-run leagues to agree to the for-profit league organization because of the fact that the teams will lose the revenue that the new league would keep for its investors.

The purpose of this paper is to provide a model of a nonprofit governing body that is vertically separate from the league and how it would be structured and operate. I will explain how a vertically separate, nonprofit league will address the problems that a for-

profit organization would create. This new nonprofit league will be different from the existing nonprofit league in the fact that the governing body of the league will control all of the decisions rather than simply addressing coordination issues. In doing so, the new league will reduce the inefficiencies generated by the current system of a club-run league and maximize league-wide revenue.

Review of Literature

In discussing the efficiency of professional sports leagues, it is necessary to explain the need for a league in the first place. Since the beginning of discussion in the field of sports economics, Neale (1964) identified professional sports leagues as a different animal than any other competitive industry. Professional sports leagues and the teams that comprise them are in the market for producing and selling sporting events (Fort and Quirk, 1995). A professional sports league is made up of many individual teams. Each of these teams relies on the opportunity to compete against another team to produce their output, a game. In this sense, a professional sports league is different than any other competitive industry because it cannot produce its output on an individual basis. For this reason, the league is considered to be the firm, not the individual team (Neale, 1964). These individual teams come together under the league and make joint decisions. It is cheaper for them to function in this manner than if the teams made decisions on a game-to-game basis.

In the typical competitive industry, a firm is better off when it faces the least amount of competition, and it will try to attain a situation in which it is the only supplier to the market (Neale, 1964). This is not the ideal situation for a professional sports team. Because the team relies on at least one other team to produce its output, the team does not want to be the only supplier in the market. The team also does not want to compete at a

significantly higher level than their opponents. The team receives income from fans that either purchase tickets to the game or watch the game on television. As Neale (1964) argues, uncertainty about the competition arouses fans' interests. Therefore, professional sports leagues need to sustain a degree of competitive balance in order to survive. If one team is so much better than the other team that fans know what the outcome of the game will be before the game is even played, then the fans will lose interest. It is in the best interests of both teams involved in the game to have a balanced level of competition to pique fans' interests and maximize revenue.

A governing body that organizes the league is necessary to address the issue that is referred to as the coordination problem. This problem exists when two parties need to join together to produce their output. Without a league, a team could contact other teams on an individual basis to schedule a game. When making the arrangements for the game, the teams will have to agree on a time, location, and rules of how the game will be played. Without a consistent set of rules, the transactions costs associated with this process would be high, as each detail would need to be specified. Fans would also not know what to expect from one game to the next as the rules may change. A league solves these problems by creating a schedule for all of the teams, implementing a consistent set of rules, and scheduling officials to enforce the rules during the course of the game. The league creates product homogeneity that enables fans to know what to expect from one game to the next.

In the early era of team competition, many teams would play each other but only after the team leaders would meet first, sometimes for days, to discuss how the competition would occur, who would be eligible to participate, and how any revenues would be split. Often, games between clubs from different towns were scheduled but not played because

teams were waiting for each other at separate locations, rules officials would not have been scheduled properly, or teams would walk off the field for assumed unfair advantages. Most professional leagues have at least some of these similarities in their histories.

According to Dobson and Goddard (2001), the main role of a professional sports league is to implement rules aimed at furthering the collective interest of the teams in achieving joint profit maximization. The league attempts to achieve joint profit maximization through the use of several different tools. These tools include league control of competition rules and schedules, league control over entry and exit of teams from the league, revenue sharing programs, and salary caps. The league uses these tools to try and create a level of competitive balance that will maximize the joint profits for the teams in the league. Because of the club-run structure that currently exists in North American professional sports leagues, the leagues produce fewer franchises, fewer opportunities for broadcasting of their games, an inefficient allocation of player talent among teams, and therefore, a less than efficient amount of profit (Ross and Szymanski, 2003).

There has been a significant amount of investigation into the effects of the policies used by leagues to increase league revenue. According to Vrooman (1995), a salary cap could serve as a collusive attempt to control total player costs, and it would allow the maximization of profits for the league as a whole. Szymanski (2003) claims that a salary cap should improve competitive balance if it is enforced. If small revenue generating teams are not forced to increase their spending on player costs to a level near the cap, then the cap will be useless in terms of creating competitive balance. In regards to the revenue incentives associated with national television contracts, Fort and Quirk (1995) claim, "There are obvious advantages to a league-wide contract as compared to individual

contracts. In the NFL, a shift in 1962 from individual team contracts to a league-wide contract led to a 33 percent increase in TV income.”

Economic Theory

The current club-run league structure of professional sports leagues in North America leads to inefficiencies that prevent the league from maximizing joint profits. As Ross and Szymanski have argued, a vertically separate league that would be altogether separate from the clubs and their owners could behave more efficiently and increase profit for the league as a whole (2003). With the current system, a representative from each team is sent to negotiate with the other team owners on league policies such as revenue sharing programs, expansion or retraction of the league, relocation of teams in the league, and the distribution of talent among the teams. When the representatives are negotiating these league policies, they are trying to implement the policies that will maximize league-wide revenue. The representatives usually do not end up accepting the policies that will maximize overall revenue because of the super majority vote that is required to approve the policy. If the new policy increases joint revenue for the league as a whole, but it does not increase revenue for a majority of the existing teams, then the policy will not be passed. The interests of the minority teams that this policy may help as a result of the added revenue they would receive, for instance, from the addition of a new team, are left behind. This situation is similar to government failure. Frumkin (2002) claims that one of the reasons nonprofits exist is to attend to the minority voice. While the behavior of a professional sports league is not a governmental issue, this situation resembles that of the government appealing to the majority's interests and neglecting the minority's opinions. In the club-run professional sports league, the minority teams' interests take a backseat to the

majority teams' interests. A vertically separate, nonprofit organization that acts in the best interests of all of the teams will address the minority teams' interests and add a new team whenever net marginal revenue exceeds net marginal cost. A club-run league will only add another team to the league if net average revenue exceeds the marginal cost of adding a new team (Ross and Szymanski, 2003).

If the vertically separate organization is for-profit as Ross and Szymanski (2003) propose, it will have a difficult time convincing the teams and their owners to leave their current league and join the new league because of the new league's for-profit status. Although the new organization will increase efficiency and overall revenue for the league, it will also be taking a share of the increased revenue. For this reason, it will be difficult for the teams in the league to trust that the league has the teams' best financial interests in mind. The teams in the league will worry that the for-profit owners of the league will be taking more than their share of the league's revenue. If the vertically separate organization is nonprofit, then the teams will not have to worry about this issue because the league will be forced to redistribute all of the league revenue after adjusting for administration costs.

Minority teams will be relieved that their interests are heard by the non-profit league organization and life-giving revenue sharing will occur for all teams. These minority teams cannot afford any further dilution of their revenues by a for-profit controlling body. In the same manner, the largest teams of the league already have shown that they are uninterested in sharing any additional revenues with minority teams. These teams would not want to share this additional revenue further with the for-profit controlling management of the league.

A new type of vertically separate league that uses a nonprofit organization to oversee the league and make all of the league decisions could be more efficient than the current league and increase joint profits without taking a share of this increase in profits. While this nonprofit organization would be similar to the current league organization, it differs by assuming the role of making the decisions that the club owners currently decide upon. It is recommended that the new nonprofit organization be run by a board of directors that are entirely separated from any of the teams in the league. This board of directors should include individuals who understand the effects that cross-subsidization policies have on professional sports leagues.

Although this board of directors will be looking to maximize overall league revenues, they will also be interested in the long-term health of each individual club. Their interest would not be altruistic since their own compensation would be gauged on overall league success, but the lack of concern that they might have for one team's interest over another team's will alleviate current tensions in club-run non-profit league structures. This freedom could allow for new ways of considering league success.

A vertically separate, nonprofit league's administration would increase opportunities for financial success in a new way. The league's board of directors, consisting of members of the business community and public figures who do not have ties to the individual teams, could improve chances of public funding of the league's infrastructure. Under the club-run structure, individual team owners look for public assistance when building new stadiums and arenas, but the owners continue to run into less than enthusiastic legislative bodies and supporting communities. These local and state governments are concerned that they will be criticized by voters for helping for-profit

organizations. With a nonprofit league, this concern will disappear. The vertically separate, nonprofit league would not be tainted by partial club control through owner committees.

This new form of league leadership, separate from any individual team's interests, could embrace each community where its teams reside. Youth programs in the team's sport as well as Special Olympic support programs could be organized through this new nonprofit structure. Fans already exhibit a connection and a sense of loyalty towards their local professional teams. The professional teams provide a common cause for local communities to support as a joint effort. This sense of community will only be enhanced with the new league structure. The youth programs will capture children at a young age and make them life-long fans of the local team and the league. The league would not be looking for fans. All of the people in the region would be automatic fans because of the increased sense of community ties that the new league would create. The current nonprofit, club-run league does not presently enact this policy because the teams spend too much of their time concerned with ensuring that the league policy that promotes their best interests is enacted. With a vertically separate, nonprofit league, the teams would not have to spend their time worrying about these issues because the league organization would act in the best interests of the entire league.

Results

The new nonprofit league will work to establish and maintain a level of competitive balance that will maximize league revenues. In order to achieve this level of competitive balance, the league will implement several different tools. These tools will include a salary cap, national television revenue sharing, and the decisions concerning when to expand the league or relocate a team already in the league.

The new league will implement a salary cap in an effort to control total player costs and achieve competitive balance. By placing a limit on the amount that a team is able to pay its players, the league will effectively control the maximum amount players can earn. The salary cap will keep labor costs low, allowing the league to maximize profits for the individual teams. The cap will likely face opposition from players who will feel like the league has taken advantage of them. An agreement between the league and the players to redistribute a share of the league's revenue to the players in exchange for the salary cap could serve as a remedy to this problem. This would be similar to the current agreement between the NBA and its players¹. A level of competitive balance will be achieved through the enforcement of the salary cap because teams will be forced to spend approximately the same amount on talent as other teams in the league. In order for this policy to be effective, the league will need to make sure that costs of a team's player salaries are close to the salary cap. If a team tries to minimize its costs by hiring low levels of talent at a cheap price, then the competitive balance implications of the salary cap will be undermined.

The league will have a league-wide national television contract as opposed to individual contracts. The collective bargaining power of the teams will produce a more lucrative contract than if the teams were to bargain with television channels on an individual basis. The league will distribute the revenue from the contract equally in an effort to maintain competitive balance. The larger market teams that contribute more viewers to the audience than the smaller market teams will be subsidizing the weak teams.

The league will decide when a new team will be added to the league and when a team needs to be relocated. If the marginal revenue from adding a team to the league

¹ In 1980, the NBA and its players agreed to a plan that shared a fixed percentage of league revenues with players in exchange for a salary cap (Fort and Quirk, 1995).

exceeds the marginal costs of adding the team, then the league will decide to add the team. If a team is struggling financially in its current location, then the league will decide to relocate this team to a new location rather than adding another team to the league. The league will not guarantee geographic exclusivity. If the league decides it could increase league-wide revenue by adding a team to an area where a team already exists, then the league will add another team. This additional team may decrease revenue for the existing team in that area as a result of decreased demand, but if overall revenue increases because of the additional demand created by the new team, the league will add the new team. The team that currently exists in this area will be compensated for its loss in demand.

The league will need to continually evaluating fans' response to the level of competitive balance. With too much competitive balance, fans may lose interest, as all the teams in the league will be mediocre. To address this issue, the league will offer a financial prize incentive based on the standing of the teams at the end of the season with the champions receiving the largest share.

Conclusion

The most difficult part of implementing the vertically separate, nonprofit professional sports league will be to convince the teams in the current league to leave and join the new league. The low revenue generating teams will be the most likely candidates to join the new league because their interests will be addressed in the new league. All of the teams, regardless of revenue generating potential, may be hesitant to join the new league because they will lose the power to make decisions concerning league policies.

Regardless of whether the new league decides to entrust a single benevolent dictator or a collective board of directors with the responsibility of making league decisions, there will be a fear of potential corruption. Teams may fear that other teams will privately agree to provide the league's decision maker with financial compensation if they choose policies that are in the best interests of several individual teams rather than the league's best interests. This fear of corruption is no different than the fear that exists with any other nonprofit organization. Because nonprofits are run by humans, the possibility of corruption and the advancement of personal gains will always exist. A system of checks and balances will need to be investigated and implemented to ease these fears.

Another concern with the new league will be the dilution of the league's talent pool. As the new nonprofit league decides to add more teams to the league, the league will experience diminishing quality returns because the quality of talent declines as less skilled players are drawn into the league. The league will have to keep this in mind while estimating the marginal benefit of adding an additional team to the league. While the league will want to add another team if it increases overall league revenue, it will have to consider the decline in fan interest that may occur from the decrease in the talent level.

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