



Is revenue sharing the best way to keep major league baseball competitive?

BY ERNIE SICILIANO

The Baltimore Orioles spent just over \$95 million in payroll for the 2007 season. Their American League Eastern Division rivals, the Boston Red Sox, spent over \$143 million.

So, most observers were not surprised when the Red Sox finished the season 27 games ahead of the Orioles. The Red Sox seemed to have simply bought better players.

The issue of inequality in baseball has attracted a wave of attention, much like the issue of income inequality in American politics. In baseball, the concern is that higher-revenue teams will continue to monopolize all the talent, resulting in a situation where only the same few teams are competitive year after year.

Andrew Zimbalist, a sports economist at Smith College, has discovered that, since 1995, a team's payroll has indeed had a growing influence on a team's success on the field at a time when revenue distribution has become further skewed. As he notes, in 1989 the gap between the highest-revenue and lowest-revenue teams was \$30 million. By 1999 it had ballooned to \$163 million.

Television contracts have something to do with the revenue disparity. For example, the New York Yankees own 37 percent of the YES Network, which broadcasts their games. Last year, revenues at YES were \$340.5 million. "When the Yankees win, there are more people in the New York media market who can spend more money," Zimbalist says. Indeed, over a quarter of all official baseball merchandise sold is Yankees gear.

What this means for the game of baseball — and how to remedy this situation — is something that sports economists see differently than the head honchos of major league baseball.

Is Equality a Good Thing for the Game of Baseball?

If the outcome of a season is essentially predicted by payroll, fans might quickly lose interest in watching the games. That's the worry of Major League Baseball (MLB) executives. A July 2000 report issued by a panel headed by baseball commissioner Bud Selig; former Federal Reserve Bank Chairman Paul Volcker; economist and current Yale University President Richard Levin; and columnist George Will, concluded that "the prosperity of some clubs is having perverse effects that pose a threat to the game's long-term vitality."

Many economists who study the game seem to agree that a sporting league's vitality is dependent on at least a minimal level of competitive balance. But they differ in how much is necessary to spur fan interest.

"Uncertainty at some level is necessary for a sports league," Zimbalist said. "You want to have a situation where fans in as many markets have a chance to compete."

However, to expect all 30 major league baseball teams to have a real chance may not be realistic or profitable for the league, says economist Raymond Sauer of Clemson University who blogs at TheSportsEconomist.com. He calls the barometer of competitive balance "overrated" in terms of explaining a

league's financial success. For example, the English Premier League — the top soccer league in England — generated profits for the 2007-2008 season that were double the previous season. But the 20-team EPL is dominated by just four teams: Manchester United, Chelsea, Arsenal, and Blackburn Rovers. These "Big Four" are the only teams in the Premier League's history to have won a league championship.

In the United States, parity advocates frequently cite the National Football League as one that has drawn fans by offering a high degree of competitive balance. By most conventional metrics, NFL teams are more competitive with each other and football is more popular than any other American sport. The NFL typically generates more revenue than major league baseball. The MLB's commission report specifically cited the NFL as a successful model.

One way the NFL has accomplished competitive balance is by maintaining a strict revenue-sharing policy that has managed to eliminate the disparities created by differing market sizes. The league signs its television contracts as a league and distributes the revenue equally to all teams. The MLB, on the other hand, allows teams to set up their contracts individually. This means that large market teams, like the Yankees, are able to exploit their growing television market without sharing all the revenue they generate.

Sharing the Wealth

The 1997 collective bargaining agreement was baseball's first attempt at

revenue sharing. The agreement mandated that all teams pool a certain percentage (currently 31 percent) of local revenues, including television money. The pool then gets divided among all teams, but the largest chunk — about 48 percent — is given to the smallest-market teams. A team with a large television deal like the Yankees would share their revenue with a less profitable team like the Kansas City Royals. Ideally, the Royals would then be able to spend as much money on payroll as the Yankees.

But economists are skeptical that revenue sharing produces such a scenario. “It doesn’t equalize spending,” Sauer says of revenue sharing. “It depresses spending.”

When a team’s management signs a player, they estimate his salary based on how much additional revenue the team expects to gain from him. For example, a player signed to a \$5 million contract is expected to bring in \$5 million worth of revenue in terms of television ratings, higher attendance, and merchandise sales.

But if that revenue is shared across all 30 teams, individual owners do not receive all \$5 million of the generated revenue. Consequently, teams are less inclined to spend on talent. This might create competitive balance, but only if the high-payroll teams reduced spending. However, because revenue sharing affects the behavior of all 30 teams, every team reduces spending. In other words, the rich teams spend less but so do the poor teams and the gap in payroll remains the same.

Empirical studies specifically on baseball’s most recent revenue-sharing provisions have found little connection between increased revenue sharing and enhanced competitiveness in the league. In 2006, University of Georgia economist Joel Maxcy found that the most talented players were

more likely to sign with the richest quarter of baseball teams. His findings suggest that progressive revenue sharing does create an incentive for low-revenue teams to divest their talent.

Maxcy’s findings bring to light a classic case of moral hazard. What incentive do low-revenue teams have to spend money on talent when they could lose every game and still collect a healthy check from the league’s high-revenue teams?

“It’s almost like a scam,” says California State University Bakersfield economist Dave Berri. “If you go buy a team in Kansas City and get money from revenue sharing ... you can just keep the money.”

Anecdotally, there are instances of this disincentive mechanism at work. The most flagrant example occurred in 2006, when the Florida Marlins cut their payroll from \$60 million to \$15 million, despite receiving \$30 million in revenue-sharing money.

A Better Solution: The “Luxury Tax”

One thing that Sauer and other economists agree would work better is a luxury tax on a team’s payroll. Such a tax would be progressive in that it affects only rich teams that spend wildly. It only affects big market teams, Sauer says. “That’s going to cause [revenue] allocation away from big teams.”

Many economists think this system is preferable because it addresses the real problem that the MLB is trying to address — hefty payrolls that sap competition — instead of focusing on the revenue generated by any specific team. In addition, a luxury tax would not influence the spending habits of the poorer teams the way revenue sharing does. Thus, payrolls

should become more equal over time.

The luxury tax first entered the baseball’s union agreements in 1996. The agreement has recently been amended so that the teams which repeatedly spend more than a certain threshold are subject to progressively higher tax rates. For example, in 2007, a team that passed the \$148 million payroll threshold for the first time was taxed at only 22.5 percent, while those who passed it a third time, like the Red Sox and Yankees, paid 40 percent.

In fact, the Red Sox and Yankees seem content to continually spend gobs of money and pay the luxury tax. For them, the tax is merely an impediment to spend more, not a ban. The more those two teams spend, the more revenue baseball collects.

For Sauer, that’s the ideal situation. “That’s where you want to put your tax burden,” he says.

This proposal doesn’t solve the moral hazard problem of lower-revenue teams sitting on their revenue-sharing money, however. To remedy that, Sauer says baseball should rely on something else favored by economists: competition.

With any form of revenue sharing, he says, “you take away from teams that are in demand and give it to teams that aren’t producing, [and] they just sit on the money,” he says. He prefers the idea of sending underperforming teams down to the minor leagues at the end of every season, and calling up the best minor league teams to replace them the next season.

“Every other country in the world does that,” Sauer said. For example, in the EPL of soccer, the bottom four teams get “relegated” to a lesser division if they finish the season with a poor record. Perhaps that’s just the sort of competition that baseball needs too. **RF**

READINGS

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Zimbalist, Andrew. *May the Best Team Win*. Washington, D.C.: Brookings Institution Press, 2003.