

Baseball 2000 is history. It was not a bad year in the aggregate, but try telling that to fans in Montreal, Minneapolis, Milwaukee or a dozen other cities not beginning with the letter “M,” that couldn’t begin to contemplate signing Alex Rodriguez (for \$252 million over 10 years) or Manny Ramirez (for \$160 million over eight years). Baseball commissioner Bud Selig says the game’s economic system is broken and needs immediate repair. Here is some of the evidence he adduces.

Dividing Major League Baseball teams into quartiles according to their total payrolls reveals some dismaying realities about the five seasons following the 1994 television agreement and players’ strike:

- No team in the bottom two quartiles won any of the 158 playoff games.
 - Every World Series champion was from the top quartile, and no club below the first quartile won a single World Series game.
- The only club outside the first quartile to reach the World Series was the San Diego Padres (in 1998). The Padres lost in four straight games to the New York Yankees.

This pattern was broken in 2000 – but only a bit. Of the eight playoff teams, three came from below the top-10 in team payroll: the San Francisco Giants (\$54 million payroll), the Chicago White Sox (\$37 million) and the Oakland Athletics (\$32 million).

None of the three teams, however, made it beyond the first round Division Series. By contrast, the first and fifth payroll teams made it to the World Series, and, once again, the top payroll team won. Of the 48 playoff spots during the six-year stretch from 1995 through 2000, only three went to clubs in the bottom half of team payrolls, and these teams won only three out of 189 postseason games.

Of course, there has always been some degree of competitive imbalance in baseball, and as long as one team has something other than a 50 percent chance to win a game there always will be. Viewed as a business, baseball or any other sport would rather have teams from bigger cities win more frequently than teams from smaller cities. Big-city teams raise national television ratings for postseason games.

BASEBALL

But you can only take this logic so far. If teams from small or medium markets have but miniscule chances to play in the postseason, let alone to win the World Series, local fans would lose interest.

Increasingly, baseball seems to be in this predicament. Despite the unveiling of several

use the standard deviation of winning percentages as our gauge, there was a gradual, increase in baseball's competitive balance between 1903 and the 1980s. The improvement was most striking after the introduction of the reverse-order amateur draft in 1965.

Free agency gave competitive balance a further boost after 1976. Once players became

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new stadiums and successful assaults on the single-season home run record, baseball's attendance per team has leveled off, and television ratings for both in-season and postseason games have dropped. Outside of New York, there was near apathy about the vaunted subway series this past fall.

Some say the past five years represent nothing more than the ascension of another Yankee dynasty. The last period of Yankee dominance in the 1950s and early 1960s, however, was not a time that baseball should seek to emulate. Between 1950 and 1965, average attendance at games grew by less than 3 percent, even though real ticket prices remained virtually flat, and real disposable incomes in the United States grew by 74 percent. Moreover, four and five decades ago baseball stood alone on the pedestal of popular team sports. Today, it is challenged by the NBA and the NFL, as well as by the growing list of new professional sports and entertainment options.

Competitive balance in baseball improved from 1965 through the 1980s. In fact, if we

free to join new teams, it became more difficult to hold a winning team together. The era of team dynasties seemed to be gone forever, and Major League Baseball's 1990 economic study committee found only a slight correlation between city size and team performance.

Then came the 1990s. At first, the news was good. Baseball signed a new national television contract with CBS and ESPN for 1990-93, which together with growing central licensing, the rise of cable superstations, and Copyright Royalty Tribunal revenue, meant that each team received \$19 million a year. In 1990, this amounted to almost 40 percent of average team revenue.

But baseball's new national television contract in 1994 cut payments by over 60 percent. Exacerbating matters, big-market teams were getting rich on unshared local media revenue – the Yankees were earning \$40 million a year – and the era of stadiums designed for revenue was ushered in by Baltimore's Camden Yards in 1992. With centrally distributed monies down sharply, teams with big markets or new stadiums stuffed with skyboxes found themselves with a growing advantage.

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lion in 1989, by 1999 it had reached \$164 million. That latter year, the Yankees earned \$176 million in local revenue, while the Montreal Expos managed just \$12 million.

To this volatile mixture, add new franchise owners who controlled international com-

for 2001-02), he had in mind a new sports channel built around the Yankees.

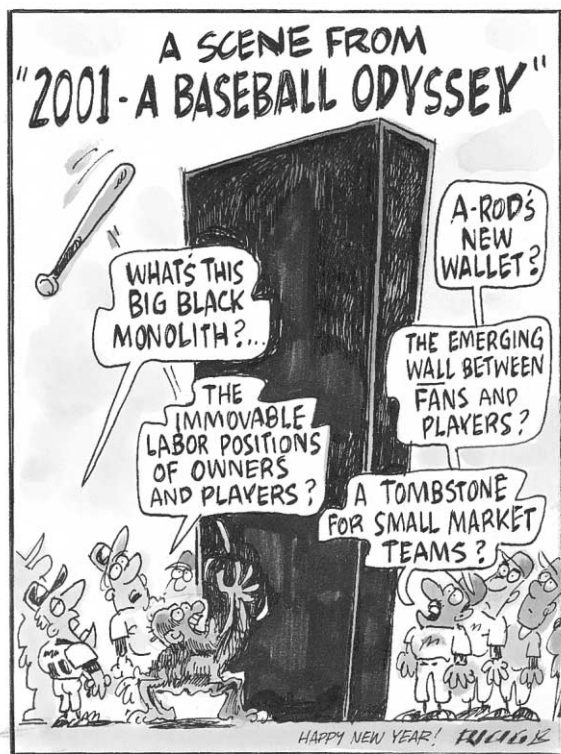
Further, consider the impact of baseball's expansion by four teams in the 1990s. While adding excitement to the game, it makes the star players stand out more – which in turn makes it easier to buy a winning team.

This takes a bit of explaining. Let's start with the evidence. There have been just 16 perfect games pitched in 98 years of modern baseball history, but two of those were in the last three years. Sixty home runs stood as a single-season record for 34 years; 61 homers stood for 37 more. Then two players hit 66 and 70, respectively, in one year.

Note, too, that almost all of baseball's personal achievement records were set in a narrow span of years. Rogers Hornsby batted .424 in 1924, Hack Wilson knocked in 190 runs in 1930, Earl Webb whacked 67 doubles in 1931, Babe Ruth scored 177 runs in 1921, and Dutch Leonard had a 1.01 ERA in 1914. Many people believe that the players then were simply better. A more plausible explanation is that baseball stats are the product of competing forces, and that records are

determined by the relative degree of talent compression.

The distribution of baseball skills follows the familiar bell-shaped curve. The larger the number selected to play major league baseball, the greater will be the difference between the best and the worst players. If the population grows and the number of teams does not, the proportion of the population playing the game professionally falls and the distribution of talent becomes more compressed. This is what happened between 1903 and 1960, with the population growing from 80 million to



munications networks or were attempting to build regional sports channels. These owners value their ballplayers not only by what they produce on the field, but also by what they produce for their networks. When Rupert Murdoch signed 33-year-old Kevin Brown to a seven-year deal worth an average of \$15 million annually for his Los Angeles Dodgers, he was thinking about the News Corp.'s emerging influence in Asia via satellite television. When George Steinbrenner opened the New York Yankees' vault for David Cone (\$12 million in 2000) and Roger Clemens (\$30 million

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BASEBALL

181 million and the number of teams remaining constant at 16.

Moreover, in the late 1940s baseball began to accept black players and recruit Latin and other international players in greater numbers, enlarging the pool of potential players and increasing the compression. The difference in skills between the best and worst players narrowed, and it became more difficult for the best players to stand out.

It thus makes little sense to argue that Ruth hit more home runs per season than Harmon Killebrew because he was stronger or had superior baseball skills. More likely, Ruth played during a time when talent was more dispersed, so he faced weaker pitchers. Similarly, Walter Johnson (ERA of 1.09 in 1913) faced weaker hitters than did Sandy Koufax, Ron Guidry or Roger Clemens.

The ratio of the U.S. population to the number of major league players rose from 250,000 to 1 in 1903 to 452,500 to 1 in 1960; thereafter it fell gradually to 360,000 to 1 in 1998, after MLB's second expansion by two teams in the nineties. Thus, by 1998 talent dilution had almost reached the level of 1930.

So, today, the McGwires and Sosas can more easily excel. To the point here, when the better players can more reliably outperform the others, it becomes easier to buy a winning team. It is one thing for the Yankees to generate \$176 million in local revenue while the Expos generate \$12 million. If the teams spend their very different talent budgets inef-

ficiently, the Yankees may squander their revenue advantage. But in a world in which the best players are more easily identified, management ineptitude is less likely to offset purchasing power disparities.

In 1995, the payroll of teams in the top quartile was 2.6 times that of the bottom



quartile. But by 2000 the top quartile was spending 3.5 times as much on payroll as the bottom quartile. And by no coincidence, correlation between team payrolls and team won/loss percentages was statistically significant at a 99 percent probability level in every year between 1995 and 2000 (and in no year between 1985 and 1994).

This does not mean that rich teams are guaranteed to finish first, or that an occasion-

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al impoverished team cannot win its division. It does, however, mean that the probabilities have shifted sharply against low-end teams, undermining fan interest.

WHAT IS TO BE DONE?

Last year, Major League Baseball's team owners nominally gave commissioner Bud Selig

willing to share his local television money, what would Selig do about the Players Association? Revenue sharing among franchises is subject to collective bargaining – and with good reason. The more revenue that gets shared, the lower the payoff to having a successful team, and the less a player is worth to an individual owner. That helps to explain

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the authority to do whatever was necessary to ensure competitive balance. The problem is that competitive balance can't be achieved without finessing the interests of the rich teams' owners, who do not want to part with their revenue advantage, and the Players Association, which resists change that does not clearly serve the players.

If we take MLB's press releases at face value, George Steinbrenner, Rupert Murdoch and Peter Angelos, owners of the high payroll Yankees, Dodgers and Baltimore Orioles respectively, would sit idly by if Selig decides that all local media money must be distributed equally among the clubs. Maybe so, but I would bet that before that happens, John Rocker will win the Nobel Peace Prize.

More likely, Steinbrenner, who has already sued baseball once on antitrust grounds so he could pursue his sponsorship deal with Adidas, would take MLB to court, claiming that his property was being confiscated. Selig must also know that any initiative to redistribute the game's riches would smack of conflict of interest; as an owner of a small-city team, the Milwaukee Brewers, he has a major stake in spreading the wealth.

Furthermore, even if Steinbrenner were

why the National Football League has higher revenue and higher franchise values, but pays a third less than baseball.

While the players accepted the revenue sharing that was added in the 1996 collective bargaining agreement (in 2000, \$155 million went from the top teams to bottom teams), it is likely that they will want concessions in exchange for further redistributions. They should also want a say in how the revenue sharing is managed. If the formula were built around teams' *actual* revenues, each franchise would have less incentive to pay a player his full value, because some of that value would be shared with other teams. If, however, the sharing were out of *potential* revenues (based on the size of the local market and stadium conditions), teams would have a greater incentive to win and pay players what economists call their "marginal revenue product."

The owners also declared last year that teams would pool their separate Internet businesses. Once MLB's contract with SportsLine.com ends after the 2001 season, baseball's central office will be able to make deals with national advertisers and sponsors for its newly controlled Web site. It is possible, but hardly inevitable, that this will generate more

BASEBALL

revenue than 30 separate Web sites.

But how much money will there be? Today, the most successful team Web sites gross around \$1 million each. But if more companies advertise on Internet sites, won't there be less demand for advertising at the ballpark and on television? Similarly, if more goods

accounting principles, I can turn a \$4 million profit into a \$2 million loss, and I can get every national accounting firm to agree with me."

Nor is profitability (or lack thereof) adjusted for the high levels of waste in baseball's management. Last year Jerry Colangelo, managing general partner of the Arizona Diamondbacks, told the *Arizona Republic* that

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sell on the Internet sites, won't fewer goods be sold via other channels?

THE BLUE RIBBON PANEL RECOMMENDATIONS

The Report of the Independent Members of the Commissioner's Blue Ribbon Panel Report on Baseball Economics, issued last July, offers insights into how MLB plans to cope. Indeed, with members including Richard Levin, the president of Yale, George Mitchell, the former Senate Majority Leader, Paul Volcker, the former chairman of the Federal Reserve, and George Will, the newspaper columnist, it is hard to see how the report could be ignored.

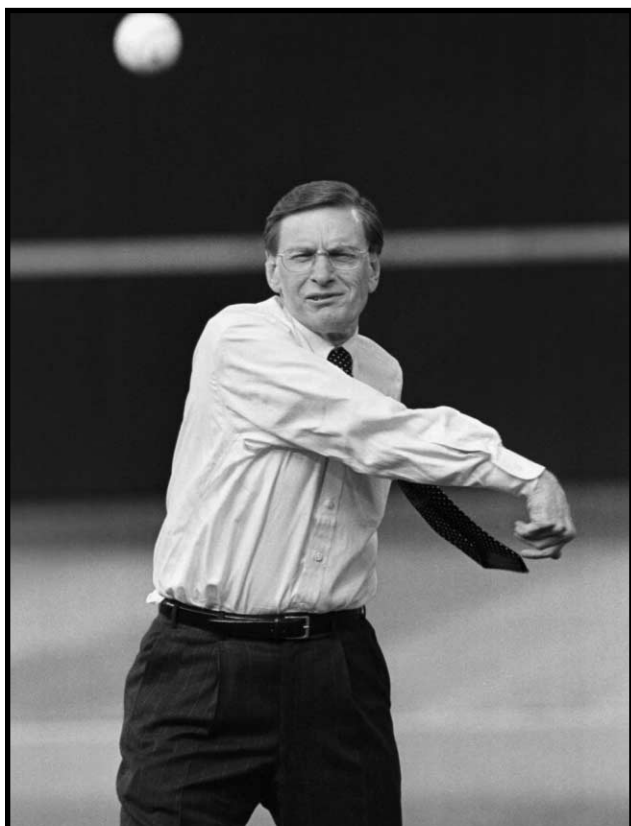
Forbes staff writers Michael Ozanian and Kurt Badenhausen denounced their effort as a "charade" in *The Wall Street Journal* because its authors uncritically accepted MLB's claim that only three teams made money between 1995 and 1999. To be sure, this claim is not credible. Baseball accounting provides all sorts of ways to hide profitability, as MLB's current president, Paul Beeston, instructed us several years ago: "Under generally accepted

he could cut front office expenses by \$10 million without affecting the team's operation or the product. If the quality of the team could be maintained with \$10 million less, why was this money being spent in the first place?

Back to Ozanian and Badenhausen. They refute MLB's profitability figures with their own estimates of MLB franchise values, which reveal substantial appreciation over the last two decades. Franchise values, they reason, would not have risen if the industry were not profitable.

They are half right. First, their data show appreciation over a longer time span than the period considered by the report. Second, franchise values properly reflect *expected future profits*, not current profits. Third, there are multiple ways an owner can receive a return on investment in a baseball team besides cash flow. These include synergies that make ancillary businesses more profitable, greater ability to shape interest group legislation, enjoyment of the power and prerequisites of ownership, tax shelters, and so on. The value of a franchise will reflect all these sources of investment return, not just profits.

That said, it is likely some teams in MLB do have financial difficulty, while many do not. The Blue Ribbon Report unquestionably loses some credibility by uncritically regurgitating owners' claims of financial woes. Similarly, the Report loses credibility when it



asserts that higher player salaries lead directly to higher ticket prices rather than reduced franchise profits.

But the bulk of the 87-page Report offers solid evidence of baseball's growing competitive imbalance, and interesting ideas on what to do about it. First, the authors say, MLB should levy a 40 to 50 percent tax on a club's net local revenue, then put the money into a central pool and distribute 1/30th of the pool to each club. The 1999 revenue-sharing plan,

by contrast, had each club (excluding the expansion teams) contribute roughly 17 percent of its net local revenue to such a pool. Three-quarters of the distributions from the pool were then made equally to 28 clubs, with the remaining quarter going only to teams at the bottom. In 1999, the Yankees contributed a net amount of \$18 million, while the three bottom clubs received a net \$23 million, \$20 million and \$15 million respectively.

In the Blue Ribbon Panel's plan, the Yankees' contribution would rise to approximately \$21 million (using 1999 figures and assuming (a) the tax is set at 50 percent, (b) Yankee stadium expenses are \$20 million, and (c) total MLB stadium expenses are \$500 million). That is, the Blue Ribbon plan would only increase the net Bronx Bombers' contribution by some \$3 million – not much for Steinbrenner to squawk about.

The real impact would come indirectly, through the incentive effect of this local revenue tax. Assuming the tax was set at 50 percent, each increment to a team's net local revenue would be reduced by 48.3 percent. This is because half would be taken away by the tax and 1.67 percent would be returned by the equal distribution from the pool to each club. Now, suppose Steinbrenner were contemplating signing Johnny Damon and estimated that, with Damon in the Yankee outfield, the team would generate an additional \$16 million in annual local revenue. Without the local revenue tax, Steinbrenner should be willing to

BASEBALL

offer Damon any salary up to \$16 million. With the tax, he should be willing to offer only \$8.27 million [$\$16 \text{ million} \times (1 - 0.483)$].

Thus, the redistributive impact of revenue sharing is likely to be considerably weaker than its negative impact on salaries. Perhaps this explains why the panelists did not recommend a salary cap – and it would certainly explain why the Players Association would trash this method of revenue sharing.

The panel's second recommendation – for an additional 50 percent tax on team payrolls above a fixed \$84 million threshold – would create a further impediment to the upward drift of salaries. What is most notable here is not the \$84 million threshold, which is close to the threshold of the luxury tax on team payrolls in 1999. Rather, it is the suggestion that the threshold be fixed, even as MLB's revenue continues to grow.

The third recommendation is also problematic. The Commissioner would be able to use any increase in central fund distributions above \$13 million per club to make unequal distributions to assist low-revenue clubs. Since the new television contracts with ESPN (2000-05) and Fox (2001-06) are projected to raise the average annual payout per team to \$19.1 million (from \$11.6 million), this recommendation would put a very significant sum at the discretion of Commissioner Selig and, therefore, may be resisted by high-revenue clubs. An interesting feature of this recommendation is the panel's suggestion that only clubs meeting a \$40 million minimum payroll would be entitled to receive extra distributions from the Commissioner. This would throw a bone to the Players Association and minimize the ability of clubs to free ride on high-revenue franchises.

The report also recommends changes in baseball's draft. The reverse-order draft for

amateurs was introduced in 1965. Almost overnight the (old) Yankee dynasty was ended and baseball entered an era of unprecedented balance that lasted until the mid-1990s.

Yet while the selection of amateur players through the draft was initially an important leveler, the effect diminished – perhaps even reversed – in the 1990s. To see why, start with the fact that revenue disparities exploded in this period, and these inequalities were reflected in vastly different player development budgets. In 1999, the Yankees spent over \$20 million on player development, while the Oakland Athletics invested less than \$6 million. This means that the Yankees, who are willing to pay far larger signing bonuses, have greater success in signing foreign players as free agents.

Only U.S. residents and Puerto Ricans (and foreigners enrolled at U.S. universities) are subject to the reverse-order draft. All other foreign ballplayers come to the U.S. as free agents. And after the collapse of the former Soviet trade bloc and the ensuing meltdown of the Cuban economy, the supply of ball playing Cubans began to expand. More or less simultaneously, free agency rules in Japanese baseball and government conscription regulations in Korea were liberalized, increasing the pool of Asian candidates.

As the foreign free agent market developed, agents staged foreign player workouts for prospectively interested teams. At first, these workouts were attended by scouts from most teams. But as the signing bonuses grew, the number of teams represented diminished.

As the signing bonuses for foreign free agents increased, U.S. amateurs also demanded higher bonuses. Rather than lose draft picks, low-revenue teams began to skip over the top prospects. The high-revenue teams, though lower in the drafting order, started to get better domestic, as well as foreign, talent.

Thus, changes signing new talent, which had promoted competitive balance, seem to be aggravating imbalance today.

The Blue Ribbon Panel sensibly recommends that baseball's amateur draft be made worldwide. The Players Association is likely to resist, however, arguing that the draft, which exploits young American ballplayers by mak-

would then have an initial choice between two teams, but could not re-enter the draft a year later and be selected by different teams, as is the case today. Such a rule should improve the chances that low-revenue teams could actually sign the players they draft.

The Blue Ribbon Panel report also recommends allocating "a disproportionate number

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ing it impossible for them to auction their services, should not be extended to exploit foreign players as well. Instead, the Players Association may seek a modification in the draft process in exchange for internationalizing the draft. They might, for example, demand that two teams be allowed to draft each player, creating some competitive pressure in determining the player's signing bonus.

Why does the players' union get to bargain over baseball's draft rules? The union won an arbitration ruling back in 1992 that made the draft a subject of mandatory bargaining on the grounds that free agent signings are compensated by transfers of draft picks.

Since the owners originally sought the system of free agent compensation both as a way to lower demand for free agents and to support greater balance on the field, it is possible they could now seek to remove the compensation rules. Without such rules, draft procedures would no longer be a mandatory bargaining subject.

Alternatively, the owners may seek a reciprocal concession from the players. In return for letting two teams draft one player, they may ask that the drafting teams be given permanent signing rights. The drafted player

of picks to chronically uncompetitive clubs." This idea seems fine as long as the extra draft picks are not a reward for free riding. That is, there should be a string attached, requiring teams to spend some minimum on payroll in order to qualify for extra picks.

All told, these changes in baseball's drafting system would likely be constructive. They would promote balance without engendering conflict among the owners over additional revenue sharing, and hopefully, without stirring opposition from the Players Association because of new artificial salary restrictions.

Of course, reforming the draft alone would at best have only a short-run impact on competitive balance, since highly valued, arbitration-eligible players would likely be traded away to high-revenue teams. Economists will recognize this effect from the well-known Coase invariance theorem: whatever the initial allocation, players would eventually migrate to the teams where their marginal revenue product is highest. So to remain effective over time, any reforms baseball adopts in the name of competitive balance will have to sustain both the financial means and incentives for clubs to compete on a more equal footing.

BASEBALL

The last major recommendation of the panel is that MLB “utilize strategic franchise relocations to address the competitive issues facing the game.” In plainer English, MLB should allow teams in cities that won’t build new ballparks with public funds to move to cities that will. Thus, the Montreal Expos might move to Northern Virginia and play in a new stadium with a larger, more enthusiastic market. Not only would the Expos be more likely to become a competitive team, the franchise would generate two to four times as much revenue and eliminate the need for subsidies from the high-income clubs.

Although MLB has allowed teams to *threaten* to move in order to elicit public subsidies, MLB has not permitted a team to move since 1972. That policy seems ripe for revision. Yet how would MLB decide when a market is dormant, and thus a candidate to be abandoned? Most baseball markets are made, not born. Fans respond to competitive teams and charismatic players. Ineffective ownership can ruin a strong market. Should fans in such a city be penalized for the owner’s ineptitude?

Remember that MLB is a legal monopoly. It is largely this condition that gives franchises the leverage to extract public stadium subsidies that make wealthy owners and players even wealthier. From the public’s perspective, the solution to the subsidy extortion problem is straightforward: break up the monopoly. More specifically, make MLB divest into two competing business entities while allowing the two entities to collaborate on rule-setting and postseason competition.

With two separate businesses, it would be inconceivable that Washington, the nation’s seventh largest media market, would be without a franchise for 28 years. Just as McDonald’s and Burger King race to be the first to open a new restaurant at any promising street

corner, each of the two leagues would try to exploit a potential market. Worthy host cities would not have to go begging for teams. Moreover, cities like New York might find themselves with a third or even a fourth team, and the relative revenue advantage of the Yankees would diminish.

The problem with this plan is political. Such a divestiture policy has about as much chance being implemented as Ralph Nader had of being elected president. So we must look for second-best solutions, and the Panel’s proposal points in a useful direction.

Along with the legal issue of violating the property rights of high-revenue teams and the economic issue of diminishing player value, revenue sharing raises a key question of ownership incentives. If sharing is done out of actual revenues, then the incentive to build a winner is blunted. Owners on the lower half of MLB’s economic ladder might well opt to minimize payrolls and ride the revenue transfers to profitability.

Indeed, several teams have already pursued such a strategy. Ironically, MLB’s 1996 revenue-sharing plan may have exacerbated rather than ameliorated competitive inequality on the playing field.

It is worth noting, too, that other factors will tend to level the competition in coming years. The inequality engendered by new stadiums will recede as the novelty effect on revenue begins to wear off and Pittsburgh, Cincinnati, Milwaukee, San Diego and other teams begin to benefit from new facilities. Also, the increase in shared national media revenue by some \$6 million per year per team should provide a modest equalizing effect.

For these and other reasons, it is necessary for baseball to proceed with much care in introducing additional revenue sharing. It is possible that errant reform will produce more harm than good. **M**