The New Systems Thinker • Volume 1 • Issue 6 • Article 2 • April 2015

A Systems Look at Professional Sports in the US

Given the tremendous success of the professional sports business, is there something to be learned that could be applied to other industries? Or are there things going on that we might consider to be, well, anti-capitalist? Jenny Zhou's blog, Systems & Us, has a great article to help non-systems thinkers zoom out in their thinking about the professional sports industry. It's called the "Rise of the Sports Cartel," and while reading it, I saw some parallels that were potential insights about effective governance.[1] Zhou lays out a sizable, though not exhaustive, list of concerns about the sports industry as a business in the United States (US). But what lessons can be learned from this darling among industries?

By Kristina Wile, Leverage Networks, Inc.

Systems in Sports

Clearly a beloved part of our culture, professional sports are a staple of entertainment on and off the field. The financial success of professional sports in the US is well known, although much of the focus is at the level of the team and the individual players. Because the professional teams are typically privately owned, audited financial records are not publicly available, so profitability is estimated.

However, according to Forbes annual team valuation data, revenues have been growing over time for the most part, with the NFL (National Football League) leading the pack. Team valuations take into account operating profits and have similarly risen over the past 14 years, with the NFL average team valuation pulling even further ahead of the other leagues. But worth a look is the overall business success of the leagues, especially at the organizations that run the shows, the NFL, the NBA (National Basketball Association), the MLB (Major League Baseball), and NHL (National Hockey League).

Interconnected Markets and Their Systemic Relationships

Several of Zhou's observations are about how the NBA, NFL, and MLB stabilize the markets for major league players in each of their arenas. In a classic free market (the supply and demand structure shown in Figs. 2 and 3), price increases or decreases in response to changes in either demand and supply. And in the business of professional sports as in many businesses, there are two interconnected

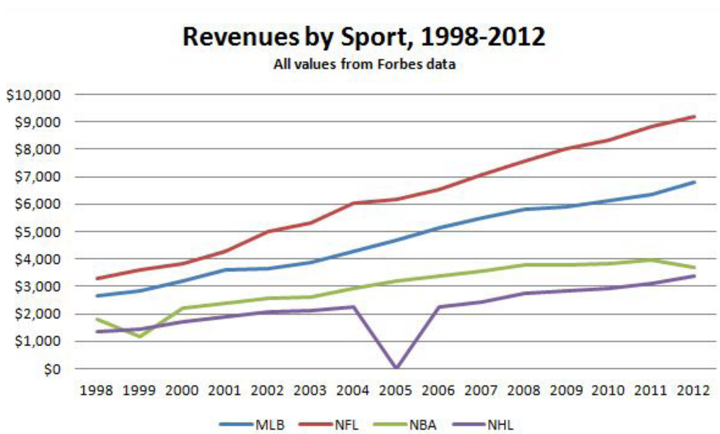

Figure 1. Yearly revenue of sports leagues. [2]

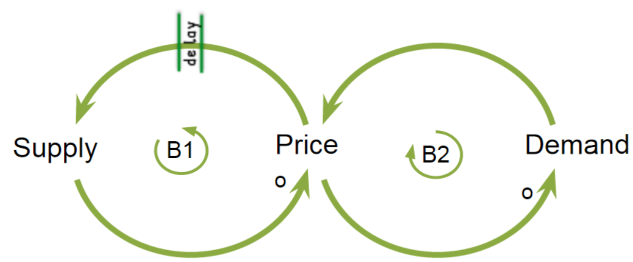

Figure 2. Classic supply and demand structure. Source: Leverage Networks

markets: the labor market (the players) and the entertainment market (tickets, merchandise, and distribution rights).

The leagues dampen the adjustments in both their labor and their product market in a couple of ways. The NFL, MLB, and NBA have established rookie salaries, and the NFL and NBA have established overall salary caps (signing bonuses notwithstanding), which keep players' salaries (the price) from varying too widely. These practices were implemented so the wealthiest teams wouldn't have a lock on the best players year after year, which helps to level the playing field across all the teams.

Essentially, the leagues prevent a *Success to the Successful* situation, where one or two teams would tend to grow in resources and talent, and dominate all others by creating a monopoly on talent. This would be a detriment not only to the other teams, but also to the fans, who would find the games boring. It would also ultimately decrease the overall demand for tickets, cable, merchandise, etc. So the commissioners, elected by the team owners, have stepped in to devise a way to prevent that with these salary leveling measures. And although there are clearly winning and wealthy teams in each league, they are not always at the championships, indicating that the system works pretty well, as it effectively breaks the law of supply and demand for salaries.

When wages are bracketed at the low end (something like minimum wage) and at the high end (say, like a maximum executive compensation) it keeps the teams competitive with one another. The level of the salaries on the low end makes the industry attractive to new talent. The laws of economics support the idea that higher wages increase the demand for the position. If there were a livable minimum wage, more people would want to work. The limits on salaries at the top end prevent bidding costs from spiraling out of control, costs that would be passed on to the end consumers which would reduce demand. In other industries, the costs associated with extremely high executive salaries are rolled into prices. Salary caps also help to maintain team cohesiveness on sports teams.

Patterns of Market Dominance in Professional Sports

In our economy and in other capitalist markets, we tend to see this *Success to the Successful* dynamic (Fig. 3), where one or two businesses tend to dominate industries, especially in given geographical locations (e.g., automotive, operating systems, air travel), creating entry barriers to other would-be competitors. As single corporate entities grow, they garner more market power and they accumulate more resources, thus allowing them to further control the supply. This makes individual consumers absorb higher prices. Purely competitive markets with economies of scale tend toward oligopoly. Professional sports have acknowledged this problem, at least as far as inter-team competition, and devised a solution.

The leagues also have self-imposed

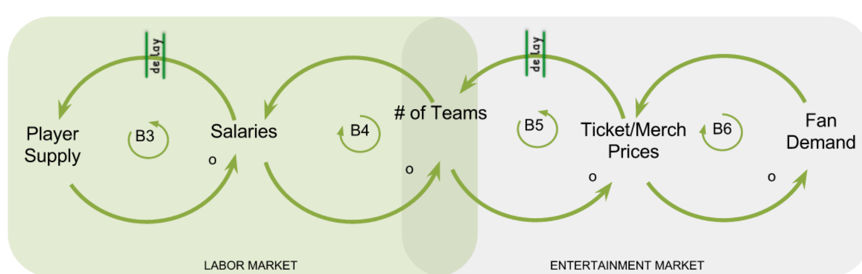

Figure 3. Professional sports: labor and entertainment markets. Source: Leverage Networks

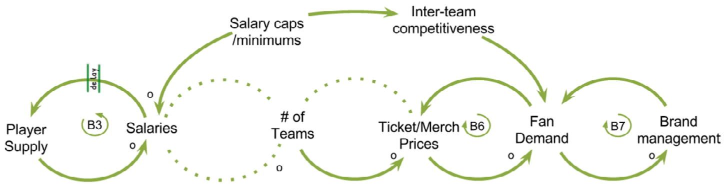

Figure 4. Effects of salary caps and minimums.
Source: Leverage Networks

barriers to entry for new teams. This protects from oversupply of tickets and games, and helps to maintain the high prices, at least to the extent that fans will tolerate it. Expansion teams are only added when the population in a given area expands significantly. Sometimes teams are relocated or renamed, but all adjustments are sanctioned by the leagues. So the supply of the end products is carefully controlled, which again breaks the forces of supply and demand, and allows the leagues to charge higher prices for tickets, merchandise, and distribution rights.

Brand Management Counter Balances Fan Engagement

Another dynamic that Zhou mentions, I would call *brand management*. In instances where specific actors in the league do something incorrigible and cause public outrage (e.g., spouse abuse, child abuse, racist speech, or rape), it is roundly condemned by the organizations. The competent commissioners tend to act quickly, either to oust, suspend, or punish the offending individual. This effectively distances the sport from the damaging behavior, and protects both their brand and their revenue streams. This is a strong balancing loop protecting the quality of their brand, and the resulting demand. Notice that it originates from outside the team structure, from a higher authority that has the good of the entire league in mind.

An interesting parallel can be drawn to those actors whose behaviors have been destructive to the wealth and the health of our economy (e.g., the fraudulent activities of the large investment bankers and traders in 2008). Except in that case, there were virtually no prosecutions of individuals. There was no strong outside force and no commissioner. Some fines were levied against some investment banks, but quickly paid off in the ensuing years, demonstrating that the punishments were light. In some respects, the sports cartels are better managed than our economy.

Cost Shifting and Governmental Parallels

Another dynamic that Zhou writes about has to do with *cost shifting*. The arenas in which all these teams play have been funded by public funds to a large degree over time. The cities that offer these incentives certainly believe it will be a boon to local businesses and will also create local jobs, but ultimately the taxpayers shoulder the burden of these bonds.

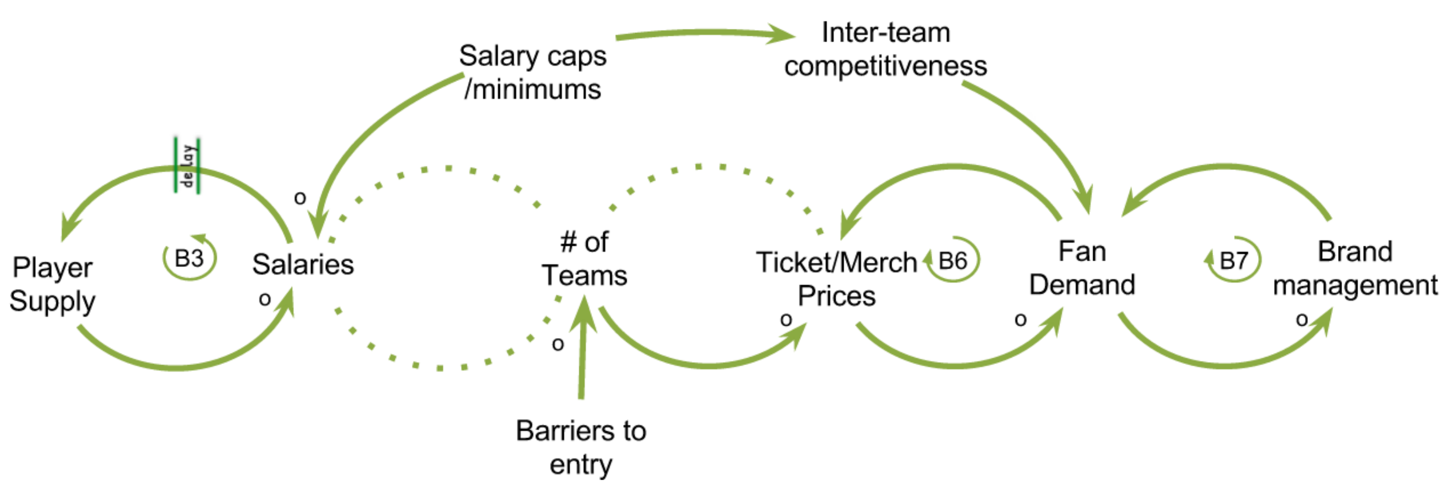

Figure 5. Managing salary costs while building demand separately. Source: Leverage Networks

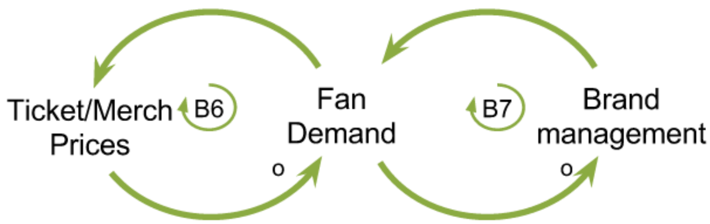

Figure 6. The dynamics of fan engagement and brand management. Source: Leverage Networks

The logic is similar to that for government doing basic research, the foundation for innovation and growth of new spin off business. It is also similar, in that not all of these construction projects will pan out. Teams may not choose a city even if it makes this type of investment. Likewise, the innovation returns can be uncertain when investing in basic research. The sports leagues do an effective job of selling the benefits to local governing bodies. Surely the governing bodies at the national level can see how well placed investments are necessary to attract innovation and new business, and in the short term provide jobs. It's the same model, and the same dynamics.

And yet another cost shifting example, the television rights to distribute these games to the public are sold to networks at a much higher price than all the other content providers. So cable subscribers who have ESPN included in their bundle pay a higher rate than they would without it. Again, all cable customers bear that cost, not just sports fans.

This could be similar to the idea of public funding of campaigns, which would also bundle the costs to all Americans to distribute the marketing messages of citizens running for office. This approach could even the playing field for candidates from all walks of life.

Sports Industry Impacts Laws of Free Market

The business of professional sports has modified the laws of free markets in many important ways. And several of the market controls they employ are quite effective. They are clear in their purpose, to ensure a steady labor supply but manage its costs, and to protect and grow the demand for their entertainment products. I think there is an opportunity to learn from this industry that effectively has increased the value of their sports economy steadily, and to design similar management techniques to boost the effectiveness of our national economy.

Sources

1. Zhou, Jenny. "The American Professional Sports Cartel." Systems and Us. June 9, 2014. http://systemsandus.com/2014/06/09/the-american-professional-sports-cartel/

2. Lindholm, Scott. "Major League Team Revenues." Scott Lindholm, Davenport IA (blog). August 16, 2013. http://beyondthescorecard.blogspot.com/2013/08/major-league-team-revenues.html

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