The economics of sport economics essay

The salaries professional players earn in the world of sports today has been an increasing interest in the economics of sports, particularly to economists. Moreover, it is an important issue as to how and why sports stars earn huge salaries to the general public. Why something with little value towards society gain more revenues compared to something we invest more into such as education and health care. For this essay, I will be explaining the structure of the sports labour market and the economics behind sports stars whilst justifying their salaries.

It is important to understand the labour market for athletes before grasping on the economics of sports. The athletes are equivalent to the products in a labour market as people are paying to see them perform in sporting events so essentially they observing part of the product process. The sports industries are basically selling their athletes to the spectators. I will start explaining the structure of the sport labour market by looking at the perfect competitive market.

In a perfect competitive market, marginal productivity relies on the profit maximisation. On the assumption that firms maximise profits when the last labour employed adds as much to the firm's revenue than to its cost. It is where marginal revenue product of labour (MRP) equals to the marginal cost of labour (MC). So when the last labour hired raised more revenue than costs, then the firm would increase profits by hiring another unit of labour until the revenue generate equals to the costs. Whereas if the opposite were to occur in the last unit of labour generated more costs than revenue, then the firm would reduce labour in order to stay profitable.

We would also assume that the output (ie talent) is subject to diminishing returns. As labour increases, the marginal revenue may initially rise but eventually decrease as they are adding more labour to their fixed capital. In sports terms, fixed capital include things such as arenas/ stadiums and team transportations, in which no matter how many tickets are sold, it will not affect the fixed capital. Not unless a new stadium or other fixed goods are required in the long run. The eventual decline of marginal revenue is called the law of diminishing returns. Therefore, it is ideal to increase labour up to the point where MRP equals to MC.

There are 2 factors in a perfect competitive market that determines the player's increasing salaries. The first factor is the increase in marginal product which means the more the player improve and contribute to the team, the higher the salary he/she will receive in their next contract. The second factor is dependent on the demand for the sport. According to Santo and Mildner (2010), there is a tendency for athletes to be paid under MRP.

http://www. humankinetics. com/excerpts/excerpts/wage-determination-in-professional-sports

Graph?

In reality, the world of professional sports is more complex and athletes are not perfectly competitive. and there are several factors that were not taken into account. First of all, there is a level of uncertainty when it comes to the player's quality, unlike in the PC model where everything is assumed to be known. Also in certain areas, especially in the US, sports teams are associated to being a monopoly due to player mobility restrictions.

One reason why perfect competition does not represent the sport labour market accurately is because of monopsony. A monopsony is where ' one firm bids up the price of labour', it is where there is only one buyer in the market. A factor market where there are a few buyers is referred to a ' monopsonistic market'. Bidding up the price of labour is usually more prominent when hiring star players. That is, hiring a player with average quality may not be as effective and profitable towards the team as opposed to a star player with greater quality of talent, who will be able to contribute more, enabling the team to increase their chances of winning one more game. A sports labour market is characterised by a monopoly in the product market and a monopsony in the labour market. In sense that in general, the team's product market will be performing for local spectators whereas in the labour market, the team would have to pay the adequate amount to encourage a new player to relocate to the team.

The sports labour market also has characteristics of a bilateral monopoly. This is where a single seller is faced with a single buyer. In a bilateral monopoly, players' salaries as determined by club owners and players unions (p6 monopoly, monopsony, vertical collusion), in other words the club owners bargaining power. ' the players alternative earnings.. represent the minimum salary a club owner skilled in bargaining would off the player '(pascal and rapping 1972, pg 50 economics of professional team sports.). Wages are set high enough to convince the player to join whilst low enough to convince the team to sign rather than give up on that player's services.

As widely known, sports superstars generate an increasingly large amount in salaries over the years. This was more prominent from 1970s to 1990s where

player cartels had been involved with manipulating salaries. Players' salaries averaged from an increase of 1631% to 3175% (Adams and Brock, 1997). Below is a table sourced by Staudohar (1996), showing evidence of the increase in salaries in three major sport leagues.

The increase in salary was a consequence of controlling the sport industry due to vertical collusion. This is where one party forms an agreement with another party in which both would benefit from; in this case, vertical collusion occurred between the bilateral monopolies in which player cartels benefitted from (Adam and Brock, 1997).

However there were other ways in which sport owners, players and leagues attempted to gain some control of the industry and their salaries by introducing competitive restrictions in the sport labour market. For instance, the reserve clause was first introduced in 1879 by the National League. This was a way to avoid monopsonistic competition for players from other baseball leagues, which bids up the players' salary. Players were bound to their contract unless with permission from the owner, they are not to leave the team. This inevitably cause the salaries to fall and gain greater monopsony power over the players (Kahn, 2000, p76). During the reserve clause period which lasted until 1976, Rockerbie (2009) further explained its relevance towards the player's marginal product in that due to the restricted movement of the player, owners were able to pay less than the marginal revenue product whilst they would gain huge surpluses.

Free agency which was introduced in baseball and it is another feature replacing the reserve clause that restricts competition in the labour market.

Free agency is where players with at least 6 years' experience in the league are allowed to negotiate their services to the buyers in hopes of gaining the better deal. Due to free agency, the salary distribution of players has widened in the sport labour market (Rockerbie, 2009, p168). This decreased later due to imposing a luxury tax on the top paid sports players. During this period, it was possible for players to ' earn more than the marginal revenue product rule since they are free to sell their services to the highest bidder', (Rockerbie, 2009, p165). As a result, the player would receive large surpluses from the owner.

With free agency in place and the abolition of the reserve clause, not only has the salary distribution widened but also questions whether there is a competitive balance between the large and small clubs.

The introductions of these restrictions are done so to establish competitive balance amongst the teams in the leagues. However according to Rottenberg 1956, whether there are restrictions imposed on player's mobility or not, it would make no difference in talent distribution of the league as illustrated/reflected in the Coase theorem.

Here is diagram illustrating the Coase theorem. The vertical axis shows costs per talent and the horizontal axis shows the number represents the marginal revenue of a large club and for a smaller club. The diagram shows that where the marginal revenue of a large team meets the small team at the equilibrium point is where both clubs will be at profit maximisation level under free agency (Ford and Quirk, 1995). Therefore showing which shows the equilibrium salary level.

So how else can we justify the huge salaries of professional athletes? Rottenberg (1995) has mentioned several examples showing marginal revenue product justifying the athlete's high salaries. An example includes a salary of over $15 million for Michael Jordan's final season in the NBA, in which majority of the games he played in were at full capacity. This pay system is based on the marginal product rule. On the other hand, player's salaries can be based on the rank-order tournament where the money earned is pre-determined by the rank the player is positioned in the tournament. It is more significant in sports such as golf and tennis. With the likes of the world's top golfer, Tiger Woods who as of 2009, earned $110 million in the year alone. Despite the money he made, the tournament alone did not contribute to the total £110 million (Forbes. com, 2009). Similarly with Roger Federer who is currently the highest earning tennis player in the world making $54. 3 million this year. However, like Tiger, he earned £9. 3 million prize money from tournaments and the rest from endorsements (Forbes. com, 2012).