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North American Major Leagues and European Club football – An Institutional Economic comparison

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1. Introduction

The main goal of this paper is to analyze and compare the basic organizational elements of both the North American Major Leagues – the National Football League (NFL), the Major League Baseball (MLB), the National Basketball Association (NBA) and the National Hockey League (NHL) – and the European club football leagues. Generally, leagues are the primary organizing entity in professional team sports. Leagues create value through their sport's inherent and/or developed popularity with fans, through the appeal of its teams and players, as well as via marketing partnerships with broadcasters and sponsors.

Following an institutional economic approach, we conjecture that the specific organizational structures of professional team sports leagues are unlikely to be just the result of historical coincidence. Rather, the adoption of specific structures can be explained as the result of a general attempt to solve certain organizational challenges and increase efficiency in producing an attractive championship race. The concept of efficiency is, of course, not universal but relative to some specific set of economic actors, whose interests are being taken into account, and also to some specific set of available options.¹ An organizational structure is efficient, if no alternative structure improves coordination and motivation among clubs and therefore reduces the “costs of running the system” or transaction costs as Coase (1937) termed them.

On both sides of the Atlantic, the historical process of developing professional team sports leagues in their modern form got started long before the organizational elements came up that represent the point of departure for this paper. Today, the North American Major Leagues have important organizational elements in common with European club football, yet there are also substantial differences. Our theoretical analysis contributes to a better understanding of an otherwise complex story about people, emotions, scandals, coalitions, etc.

In the following we first take a closer look at the specific two-stage-production process as a common characteristic of all professional team sports leagues. Second, we address the organizational challenges of internal league organization. We compare the degree to which clubs vertically integrate in order to jointly produce a championship race in Europe and in North America, respectively. Third, we outline how moral hazard behaviour among clubs can emerge and which institutions help protect clubs from being opportunistically exploited by fellow league clubs in Europe and in North-America, respectively. Fourth, we compare the institutional devices to curb the club's incentive to (over-)invest in playing strength in Europe and North-America. Fifth, we conclude by outlining why North American

¹ See e.g. Meyer, Milgrom and Roberts (1992), pp. 22-25 for a discussion of these issues.

Major League clubs tend to be profitable whereas European professional football clubs tend to be chronically unprofitable.

2. Two-stage-production process

Team sports are characterized by a specific two-stage-production structure.² While in individual sports individual athletes compete against each other to produce a marketable product, team sports require the interaction of various stakeholders – especially players and coaches, but also “suppliers” of a stadia and other infrastructure – to produce a team at a first stage. At the second stage, different teams compete against each other and thereby *co-produce* a marketable product. No team can produce a marketable product in isolation.

At the second stage of production, clubs can co-produce and market two related products. In “simple” team sports production systems, clubs merely co-produce single, isolated games.³ In more complex team sports production systems – as they are common in all modern leagues –, clubs also co-produce a championship race as a marketable product. In this meta-game, each game becomes related to each other and thus meaningful by standardizing the rules in the playing field and the playing programs.

By definition, a championship race is a procedure that ranks the playing strength of all participating clubs. No club should benefit from unfair advantages by breaking the rules that define equal conditions for every performer. One manipulated game may suffice to imperil the outcome of the entire championship race.⁴

The second factor is a league’s monopoly status which emerges “naturally”. A natural monopoly is commonly understood as an industry, in which a single firm can satisfy the market at lower total costs than could be achieved if two or more firms would supply the industry’s product. All entertainment products are characterized by significant set up investment (for example high fixed costs for creating and establishing a championship; hiring players, building teams, organizing games, building adequate infrastructure etc.). But once the “league production” is running, the cost to serve an additional customer is close to zero. Nowadays, with TV sets in every household, the costs to serve an additional customer are exactly zero. In such settings, market share becomes critically important. One league serving the entire market operates with lower costs because it has a clear advantage in amortizing the significant set up investment.

² See Franck (1995) for a detailed discussion.

³ At the beginning of professional team sports in North America, this simple production system was common. So called barnstormers travelled from town to town and played exhibition games against local amateur teams and other barnstormers (Noll, 1991, p. 19). Genuine team owners took over the functions of capitalistic entrepreneurs in the professional sector arranging games and hiring players. Agreements on the specific rules and other conditions, for example, revenue sharing, were made and renewed on a bilateral basis for every single encounter. The product that barnstormers marketed was the single game. There was no meaningful relationship between a sequence of games and no clear ranking of teams since the programs played by different barnstormers differed greatly. After much trial and error and many failures, some team owners eventually succeeded in switching from barnstorming to the production of a championship race.

⁴ See, e.g. Hill (2010) on the collapse of several professional football leagues in Asia due to systematic match-fixing.

Besides the cost side argument, there is another explanation for the emergence of monopolistic leagues. Having several competing leagues in a single market area, each of them producing a champion, does not lead to a consistent ranking of all relevant performers. The more parallel champions there are the less valuable the meta-game becomes. A brief look at the history of team sports shows that the periods of inter-league competition have been rather short and ended in mergers when the contender succeeded in seriously challenging the established league.⁵

The market value increase of the single game, induced by a meaningful meta-game, is difficult to quantify. Yet it is likely to outweigh the significant cost of league organization.⁶

3. Internal league organization

Clubs, which jointly produce a championship race, must decide on their optimal degree of vertical integration. At one end of the continuum – the market solution – each of the legally independent clubs could contract bilaterally with each other club as well as with a private league organisation. At the other end of the continuum – the hierarchical solution – all clubs could give up their legal independence and integrate vertically into one league firm. In this scenario, the clubs would become regional outlets or divisions of the league firm which employs a manager for each club.⁷

As it turns out, the most efficient organizational solution to co-produce a championship race is a hybrid form. More specifically, a structure of cooperative governance in which clubs partially integrate forward to govern league affairs seems to be more efficient than any organizational alternative. Equal representation of all clubs in the “legislative assembly” of the league and majority voting on all questions of league-wide relevance guarantee transparency and prevent one club or a group of influential clubs from dominating. At the same time, all clubs remain legally independent. They thus face stronger incentives to contribute to a fair competition and perform on the pitch than as divisions of a single league firm which might strategically plan outcomes. A legislative assembly will likely sanction any club which jeopardizes the integrity of the championship race.

Another argument why a cooperative form of league governance possesses significant efficiency advantages can be derived from the fact that professional leagues tend to be monopolies. In monopolistic leagues, the clubs’ necessary investments in team development are specific by definition. Incapable of producing neither a single game nor the crucial meta-game in isolation, an individual club has no economically viable exit option from a monopolistic league. Terminating production and selling players is only a poor exit option because the value stemming from the co-specialization of

⁵ In economic theory, monopolies are generally considered to be inefficient. Yet, the interpretation of individual clubs as firms and their collaboration at the league level as a monopoly is misleading. In contrast to firms in other industries, clubs in professional team cannot produce a marketable product in isolation. The joint production of many clubs within a league is necessary from an efficiency perspective and must not be exclusively evaluated from a market power perspective (see Franck, 2003).

⁶ Exhibition games, such as those of the Harlem Globetrotters, are obviously less attractive in the perception of the common viewers than league matches of an NBA club.

⁷ See Franck (1995) for a detailed discussion.

players and other assets and first of all the reputation attached to the established name of the club would be lost. As the specific investments of the single club in team development represent hostages for an economic actor in control of the second level of production, a systematic hold up-risk arises (Williamson, 1975, 1979). Any third party controlling the second level of production (i.e., the championship race), say a centralized league firm or a sports governing body, could extract the economic rent from the clubs' specific investments in team development, for example by demanding higher portions of club revenues. The clubs have literally no alternative but to accept the conditions.

Exit options created by competition are corrective forces that help in other industries where hold-up risks are common. The dilemma of professional team sports leagues is obvious in this context. Creating corrective competition requires the existence of several leagues that operate under the control of different actors. This, however, partly destroys the market value of the product.

Cooperative league governance is an efficient solution for this dilemma because it preserves the league's monopoly status and, at the same time, safeguards the clubs' league-specific investments and reduces hold-up risks (Franck, 2007). In other words, every club is systematically compensated by "voice" for the lack of exit options (Hirschman, 1970). Vertical integration between the two levels of production is the standard governance prescription when specific investments are involved (Klein, Crawford & Alchian 1978; Williamson, 1975, 1979).

If the league were organized as a classical firm both relevant steps of the value chain would come under unified ownership. In such a setting the hold-up-risk loses its relevance because it is the league-owner who invests in the development of his different club-subsidiaries. However, the classical firm as a form of vertical integration between the two steps of the value chain cannot serve as a role model for major league sports. It is in conflict with the requirement of securing the integrity of the championship race.

In the Major Leagues, private club owners bear the clubs' financial risks – just like firm owners in any other industry. The league as a cooperative association of club owners is basically a cooperation agreement among the closed circle of club owners, who agree on a catalogue of rules to collectively produce a championship race. Only the club owners are entitled to vote. The club owners establish all the regulations governing their industry through majority voting. This institutional innovation has been realized by the foundation of the Baseball National League in 1876 and has since represented the single most robust element of organization in professional team sports. Other Major Leagues have quickly adopted this transformation.

In contrast to North America, professional European club football is historically rooted in amateur football, organized by member associations and non-profit football governance bodies. Every national football association governs a system of leagues, which is open through promotion and relegation from the amateur level to the top national division of professional football. On top of the national league pyramid the European Football Association UEFA, an association of national associations,

organizes European club competitions like the Champions League and the Europa League for the teams meeting certain qualification criteria.

As a consequence of the liberalization of the European TV market in the 1980s and the rapid growth of the TV market, a paradox situation emerged. The national top leagues, such as the German Bundesliga and the English Premier League, became producers of entertainment content with professional players and coaches. Simultaneously, all national top leagues in European club football were still organized by the national football governing bodies until the 1990s.

These national governing bodies are direct democratic member associations. However, they do not only represent the interests of the professional clubs but also those of all other stakeholder groups, such as the amateur and the youth sector. The “voice” of the professional clubs within the national governing body, representing the sport in its entirety, is heavily diluted. Given their lack of exit options, the professional clubs faced a substantial hold-up risk. In case of conflicting interests, the clubs could hardly control the decisions of the governing body.

To overcome this inefficient “intermediary stage”, more and more European top leagues emancipated from their national governing bodies to increase their organizational independence. They copied organizational developments that had been established by the North American counterparts much earlier.

The first case of clubs’ forward integration into their own league organisation was the English in 1992. The Premier League became is a private company wholly owned by its 20 member clubs who make up the League at any one time. Each member club is entitled to one vote and all rule changes and major commercial contracts require the support of a two thirds vote, or 14 clubs, to be agreed. The English governing body, the Football Association, is a special shareholder of the Premier League. It has the ability to exercise a vote on certain specific issues – such as the nomination of the chairman of the Premier League –, but has no role in the day-to-day running of the Premier League.

In Germany, the 36 professional football clubs of the first two leagues are associated in a self-governed cooperative called Ligaverband. To manage its league operations, the Ligaverband founded a limited liability company, the DFL Deutsche Fussball Liga GmbH. The Ligaverband itself is a member of the national governing body, Deutscher Fussball-Bund (DFB). The new regulatory framework to govern the relationships between the clubs, their cooperative Ligaverband and the DFB were introduced in 2000.

Similar developments towards cooperative forms of league organization, more independent from national governing bodies, also took place in Spain, Italy, France and most of the smaller national football markets in Europe.

4. Moral hazard within leagues and the protection of team effects

Despite its decisive efficiency advantages, cooperative forms of league organization are subject to an inherent measurement problem, which favours the emergence of moral hazard behaviour. The logic of

team production, as proposed by Alchian and Demsetz (1972), implies that the contributions of individual clubs to the integrity and attractiveness of the championship race are only imperfectly measurable.

“With team production it is difficult, solely by observing total output, to either define or determine each individual’s contribution to this output of the co-operating inputs. The output is yielded by a team, by definition, and it is not a sum of separable outputs of each of its members.” (Alchian & Demsetz, 1972, p. 779)

Team production technology will be used if it generates a surplus value compared to the situation of isolated production by each owner of the input factors, and if the surplus is large enough to cover *“the costs of organizing and disciplining the team members”* (Alchian & Demsetz, 1972, p. 779). These costs occur in fact because it is difficult to assess individual team members’ contributions to team output.

The measurement problem inherent in team production favours the emergence of moral hazard behaviour. And it is precisely the application of this specific idea to sports production that allows for the identification of the measurement problem leagues are faced with. Each club with a positive contribution to the integrity and attractiveness of the championship race generates positive externalities for all other clubs. If, for example, one club recruits several additional superstars, all other clubs benefit from more attractive direct encounters, *ceteris paribus*. Thus, a club fully incurs the costs and opportunity costs of its positive contributions, yet the induced benefits are partly socialized among all clubs. Clubs can free-ride on other clubs’ positive contributions. Likewise, if shirking in specific areas of the co-production of a championship race is difficult to detect, individual member clubs privatize the benefits of reducing their effort in those areas. At the same time, the subsequent reduction in the attractiveness of the championship race is socialized among all clubs.

Cooperatively organized clubs, however, can protect themselves from internal moral hazard risks. By means of their voting right in the legislative assembly, member clubs can effectively sanction any club which jeopardizes the attractiveness of the championship race. Besides their voting rights, member clubs ideally also perceive themselves as part of one social group. Within the rather small group of member clubs, opportunistic behaviour is readily detectable and can be sanctioned by means of social marginalization. A shared sense of sportsmanship, common goals and interests in bargaining with different stakeholder groups, such as governing bodies and broadcasters, and the close collaboration over many years tends to promote what Draheim (1952) called *Genossenschaftsgeist*, that is, a shared cooperative spirit. The instruments, voice and a shared cooperative spirit, are likely to mitigate internal moral hazard behaviour and also safeguard the surplus of team production.

Alchian and Demsetz (1972) argue that the most efficient approach for handling moral hazard problems is monitoring. Gains from specialization are at the core of the approach: Team members do not have to engage in complex mutual control activities. Rather a specialized monitor focuses on his narrow task of controlling the contributions of all members. Obviously, the monitor needs to be

independent and have the power to sanction effectively. Over time, a reinforcing self-selection mechanism may kick in: the more successfully shirking is detected, the less league clubs with a propensity for positive contributions fear being opportunistically exploited by other league clubs. The former are systematically attracted, whereas the latter are either disciplined or excluded from competition.

4.1. The protection of team effects in the Major Leagues

In the Major Leagues, member clubs protect the surplus of an attractive championship race by means of voting rights. The club owners' right to vote on the club composition of the respective closed league with a fixed number of member clubs is especially important. League entry based on sporting merit is not possible. Each league can expel a club that violates league rules, plays in a substandard facility, or poses a threat to the league reputation in any other way. The relocation of a club as well as league expansions (i.e., additional clubs) and contractions (i.e., expulsion of clubs that do not want to withdraw and that have not violated any league rules) also require league approval. By controlling the club composition of the league, member clubs can efficiently handle internal moral hazard problems. The high degree of stability in club composition across all Major Leagues is likely to favor a shared cooperative spirit which further curbs opportunism.

In line with Alchian and Demsetz' (1972) monitoring approach, the assignment of an independent commissioner in all Major Leagues is to be seen as an institutionalized monitor.⁸ While the club owners collectively represent the legislative power to make the rules, the commissioner represents the executive power to enforce these rules. Markham and Teplitz (1981, p. 36) state, "...*the office of the commissioner's main function is to maintain the integrity of the sport*". The commissioner is elected by the club owners to safeguard the league reputation by checking the "supply" of integrity by the individual member clubs. As the club owners can also dismiss the commissioners by a vote, the commissioner faces strong incentives to conscientiously exercise his role as the "constitutional safeguard".

4.2. The protection of team effects in European club football

In contrast to the closed Major Leagues, European club football has had open leagues since creating a lower professional league in England in 1882. Based on sporting merit, the best clubs from a lower league are promoted to the next higher league, while the weakest clubs are relegated to the next lower league. Thus, the voting rights with which Major League clubs control the league composition, do not

⁸ The commissioner is no "full monitor" in the sense of Alchian and Demsetz (1972) because he is no residual claimant. A "full monitor" has the sole remaining claim on the generated team surplus, positive or negative, that is, after the deduction of all other stakeholders' contracted claims. Accordingly, the "full monitor" is incentivized to choose an efficient level of monitoring. In team sports, however, the commissioner cannot be a "full monitor" because this would make him the owner of the league. A commissioner's league ownership would be in conflict with the requirement of securing the integrity of the championship race. Thus, the commissioner's specific monitoring responsibilities in all Major Leagues are narrowly defined and functionally delineated.

exist in European club football. As a consequence, no club can prevent the entry of another club in the same league. Whereas Major Leagues tend to strategically allocate their clubs and protect the exclusivity of each club's local market, a European football club such as Real Madrid simply cannot drive its rival Atletico out of Madrid to become the only professional club in the city.

The clubs' lack of control over the league composition suggests that moral hazard behaviour with leagues is more likely than in the closed Major Leagues, *ceteris paribus*. Only clubs in an open league system face the uncontrollable risk that new entrants devalue the reputation of the league and thereby devalue of the incumbents' specific investments.

The organizational solution to protect the surplus of an attractive championship race is not the institution of a single commissioner but a hierarchy of different monitoring institutions which reflects the hierarchical structure of European club football.

At the national level, clubs require a license from the league's cooperative association (e.g. the Ligaverband in the German Bundesliga) to compete in the national championship race. The licensing procedures ensures that member clubs meet a clearly defined set of financial, legal, personnel, administrative and infrastructure-related criteria. A club must not "buy" sportive success by underperforming in any these other areas, for example by using dangerous infrastructure, not paying salaries, transfers, taxes and social security, fixing games, violating rules for the protection of minors, violating medical rules, etc. Such behaviours would harm the integrity and smooth running of the competitions. The licensing requirements vary significantly across the 53 national association members of UEFA, the European football governing body.

At the European level, all clubs qualified for the continental competitions, Champions League and Europa League, require an additional license. Compared to the various national leagues UEFA went even further and created the *Club Financial Control Body* (CFCB) in 2003/04. Its task is to enforce the club licensing. Like a commissioner in the Major Leagues, the CFCB is independent from the league organization (in this case UEFA).

Article 6 of the Procedural Rules governing the CFCB states:

"The members of the CFCB are independent. They are bound exclusively by the UEFA Statutes, rules and regulations and the law".

Accordingly, decisions taken by the CFCB cannot be changed or modified by UEFA. They can only be appealed by the clubs at the Court of Arbitration for Sport (CAS) in Lausanne, Switzerland. There is thus strong supervision of the clubs playing in European competitions.

At the global level, there is an additional level of monitoring. FIFA, the international football governing body, sets and enforces the rules which are relevant on a global scale. The Regulations on the Status and Transfer of Players, for example, must be followed by all clubs worldwide.

Article 1, section 1 is clear about this:

“These regulations lay down global and binding rules concerning the status of players, their eligibility to participate in organized football, and their transfer between clubs belonging to different associations.”

The key difference to the North American Major Leagues is thus that the European clubs do not operate under the supervision of one specialized monitor but under a fragmented system of supervision.

5. Clubs’ incentives to invest in playing strength

Due to their rank-ordered contest structure, leagues are zero-sum games by definition. One club’s ascent in rank inevitably implies the descent in rank of all overtaken clubs, *ceteris paribus*. If, say, one club ascends to a higher rank in the league by developing and hiring additional playing skills, that club will take a larger share of the league revenues, *ceteris paribus*. Yet that club has no incentive to internalize the negative externality of the overtaken clubs’ revenue losses. As this logic equally applies to all clubs, all clubs tend to develop and hire playing skills beyond the point where marginal investment costs equal marginal investment returns. Alchian and Demsetz (1972) label this phenomenon in professional team sports hyperinvestment. Each club has the illusion that an additional investment will increase its chance of winning the contest. If all clubs invest more, however, the individual winning probabilities do not change. In a similar vein, Akerlof (1976) describes contests with fixed prizes as rat races in which many participants, the rats, compete for a fixed prize, the cheese. The faster each rat is running, the higher are its chances of winning the cheese and the more calories it will burn, that is the more it will invest. Because only the fastest rats will win the cheese, all other rats will not be able to recuperate their investments (calories).⁹

Thus, there is an inherent tendency to overspend on playing strength in all forms of league competition. Interestingly, and in contrast to striking similarities in how professional team sports leagues on both sides of the Atlantic vertically integrate and how they handle internal moral hazard risks, North American Major Leagues and European football leagues they differ substantially with regard to other organizational characteristics which, in turn, are related to overspending behaviour.

5.1. Clubs’ incentives to invest in playing strength in the Major Leagues

Since the foundation of the Major Leagues, clubs are genuine firms with genuine owners. It seems natural to assume that these residual claimants, that is, economic actors with the right to extract profits, are motivated to earn money with their clubs.¹⁰ In fact, club owners attempt to control the inherent tendency to overspend and protect their clubs’ profitability by means of different

⁹ See, for a formal analysis of structural factors which aggravate the problem of overinvestment in team sports leagues.

¹⁰ In reality things can be much more complicated, of course. If an owner benefits from positive spillovers to other businesses, for example, it may be rational to lose money with the club. An additional dollar invested in a new player may generate less than an additional dollar in revenues for the club, but the investment might nevertheless be profitable for the owner. The media exposure generated with the club, for example, may be a cost effective advertising means for the owner’s other businesses.

interventions. The common interventions on the product market side in all Major Leagues are revenue sharing arrangements and exclusive territorial rights. Salary caps and the draft systems are common player market interventions on the supply market side.

The profitability of all Major Leagues demonstrates the effectiveness of these interventions. Table 1 shows the aggregate operating results¹¹ and the aggregate revenues of all clubs in their respective Major League in the 2013/14 season. Evidently, club owners successfully manage not only to curb the inherent overinvestment problem and but beyond that to capture an attractive margin.

Table 1: Aggregate operating results and revenues of the Major Leagues in the 2013/14 season

	Aggregate operating results	Aggregate revenues
NFL	\$1.4 bn	\$6.6 bn
NBA	\$588 mn	\$4.7 bn
NHL	\$374 mn	\$3.0 bn
MLB	\$240 mn	\$5.9 bn

Source: Forbes (2014)

5.1.1. Extensive revenue sharing arrangements

Revenue sharing arrangements among the member clubs according to principles of financial solidarity apply to all revenue streams (i.e., gate, broadcasting, sponsoring and merchandise revenues). The specific distribution rules are highly complex and vary from Major League to Major League (see, SportingNews.com, 2014). Yet the lion share of the revenues is consistently distributed among all member clubs on a per capita basis, not according to sporting merit. As “stronger” clubs cross-subsidize “weaker” clubs, the rank dependent revenue differentials decrease. Weaker financial incentives to ascend in rank, in turn, curb the incentive to overspend.

Broadcasting rights are consistently the major source of revenue. The pooling and centralized marketing of national broadcasting rights put leagues into the powerful position of a sole supplier when dealing with broadcasting companies.¹²

The NFL has the most extensive revenue sharing arrangements of the four Major Leagues. More than 60 percent of the total league revenues are distributed equally among the 32 clubs (SportingNews.com

¹¹ Operating results refer to losses/profits after wages and all operating costs but before transfer activity, financing and investment/divestment.

¹² Centralized marketing of broadcasting rights as a collusive device of the clubs to exploit their market power raises antitrust concerns. Yet, as no single club can produce a marketable product in isolation, the league itself is to be seen as the relevant firm rather than as a cartel (see, e.g. Franck 2003).

2014). Accordingly, it is hardly surprising that the NFL is also the most competitively balanced Major League (see, Sanderson & Siegfried, 2003).

5.1.2. Territorial exclusivity

Exclusive territorial rights, which protect each member club from local competition within a well-defined home territory (i.e., usually an entire metropolitan area) are explicitly excluded from revenue sharing arrangements. No club can stage or even broadcast within another club's home territory without first obtaining permission.¹³ This collusive non-competition agreement allows all clubs to extract monopoly rents on a local scale. Clubs with more attractive home territories have a more revenue potential than clubs with less attractive home territories and so, if well managed, are likely to dominate.

5.1.3. Player market regulations

Salary caps and the draft are two regulatory devices of the player market which can be seen as the "last stages" in a long history of interventions. A salary cap is a limit on the amount of money that a team can spend on player salaries. The limit exists as a per-player limit or a total limit for the team's roster, or both. All Major Leagues have implemented some variant of salary caps, both to keep overall costs low, and to ensure parity between clubs so that wealthy clubs cannot entrench dominance by signing many more top players than their rivals.

The draft is a procedure to allocate certain players to clubs. Clubs take turns selecting from a pool of eligible players. When a club selects a player, the club receives exclusive rights to sign that player to a contract, and no other club in the league may sign the player. The most common type of draft is the entry draft, which is used to allocate players who have recently become eligible to play in a league. Depending on the sport, the players may come from college, high school or junior teams or clubs in other countries. An entry draft prevents expensive bidding wars for young talent and ensures that no one team can sign contracts with all of the best young players and make the league uncompetitive. To curb the clubs' incentives to invest in playing talent and to encourage competitive balance, clubs that performed poorly in the previous season usually get to choose first in the postseason draft, sometimes with a "lottery" factor to discourage teams from purposely losing (i.e., inverse-order-picking).

Both salary caps and the draft effectively curb the clubs' incentives to overinvest in playing talent. Simultaneously, both are restrictive devices which reduce the players' mobility and thus weaken their bargaining position. There are two key arguments to justify these anti-competitive interventions. First, they allegedly improve competitive balance and increase the attractiveness of the competition. Thus, their benefits are expected to offset the anti-competitive intervention. Second, both measures are the

¹³ In a few cases, approval to allow local competition has been given, but only after substantial compensation. For example, the New York Mets baseball team paid the New York Yankees \$10,000,000 for the right to share New York City. Similar deals were arranged to enable the California Angles to play in Los Angeles and the Oakland A's to play in the San Francisco-Oakland metropolitan area (see, Noll 2003).

outcome of accepted collective bargaining procedures. The independent club owners are employers and can be seen as one side of the labour market. On the other side of the labour market, players founded trade unions. “Normal” collective bargaining processes become possible: the representatives of the owners and the player union bargain and set up a collective bargaining agreement. As in all other fields of labor relations, the state respects the results of collective bargaining. If the owners had unilaterally dictated salary caps and the draft, these measures would for sure face antitrust challenges because of the restrictive effects in the labor market.

5.2. Clubs’ incentives to invest in playing strength in European football

The tendency in European club football to overinvest is to some extent “normal” in the sense that even profit-maximizing clubs tend to dissipate resources by systematically investing in playing strength beyond the point where marginal investment costs equal marginal investment returns.¹⁴ Win-maximizing clubs, as most European football clubs are best described as, are even more likely to overinvest.¹⁵ It is important to note in this context, that the majority of the 700+ clubs in the national top division of the 53 UEFA national associations are governed as members’ associations (42%).¹⁶ By definition, there are no residual claimants in clubs governed as members’ associations. No economic actor has the right to extract profits from a members’ association.

In an environment where clubs tend to spend as much as possible on playing strength to be as successful as possible on the pitch, spending power is the key driver of competitive advantage.¹⁷ Any profit requirement is in fact a handicap in this specific spending power game because profits limit the maximum amount of funds to be channelled into playing strength.

However, whereas Major League clubs – profit-maximizing or not – manage to control the overinvestment problem, European club football is characterized by systematic overinvestment. The 700+ clubs’ aggregate net losses had almost tripled from €0.6bn in 2007 to €1.7bn in 2011. 38% of clubs reported negative net equity facing a situation with debts larger than reported assets in the financial year 2011. 45 of the 53 European top divisions reported aggregate net losses (UEFA, 2013). The market interventions that effectively prevent overinvestment in the Major Leagues are either not applied in or not applicable to the European context.

5.2.1. Limited revenue sharing arrangement

¹⁴ See e.g. Dietl, Franck, and Lang (2008) and Müller, Lammert, and Hovemann (2012) for a detailed analysis and discussion of overinvestment phenomena in sports leagues.

¹⁵ See e.g. Késenne (1996, 2000) for formal analyses or Garcia-del-Barro and Szymanski (2009) for empirical evidence for Spain and England.

¹⁶ Alternative club governance structures are incorporated companies (38%), and in some cases a stock exchange listed (4%), state owned (3%) or as specifically defined sporting incorporated companies (13%) (UEFA, 2012).

¹⁷ See Franck (2014) for a detailed discussion of the importance of spending power in club football.

In contrast to their North American counterparts, European football clubs' use of revenue sharing arrangements as a means to curb clubs' investment in playing talent is limited to broadcasting revenues. In most national leagues, clubs sell their broadcasting rights collectively and then split the revenue. The distribution formula varies from league to league and principles of financial solidarity are consistently important. Performance-dependent distribution criteria, however, are also important. The English Premier League, for example, generated broadcasting revenues in 2013/14 season of about €1.9 bn. The largest share went to the FC Liverpool (€17 mn) and Cardiff City received the smallest share (€75 mn) (goal.com, 2014). The clubs of the first and second Bundesliga in Germany collectively generated about €628 million in the 2013/14 season. The clubs of the first Bundesliga received a share of 80 percent. Among the clubs of the first Bundesliga, Bayern Munich received the largest share (€ 33.2 mn). Eintracht Braunschweig received the smallest share (€16.6 mn) (Fernsehgelder.de, 2014). Spain is a notable exception in Europe with its model of individual selling since 1996. The biggest clubs, FC Barcelona and Real Madrid, both generated about €140 mn in broadcasting revenues in the 2013/14 season. Their league competitors had to satisfice with about a tenth of that sum (goal.com, 2014).

One key reason why there are substantially less revenue sharing arrangements in European club football is that competitive balance is less important in the European than in the North American context. In the closed Major Leagues, staging the same teams year after year, “forever”, competitive balance in the sense of “closeness between perennial competitors” is the sole concept that gives meaning and adds value to single games. The entertainment value of the meta-game derives only from one question which club will become the champion. The more uncertain the outcome of the championship race, the more entertaining becomes each individual game. In contrast, the open European league system has many concepts that give meaning to single games. The suspense of the championship race in every league of the entire system is supplemented by the suspense generated by other “fights” such as achieving promotion, avoiding relegation, qualifying for the UEFA Champions League or UEFA Europa League, etc..

5.2.2. *No territorial exclusivity*

Due to the open league system with promotion and relegation, exclusive territorial rights, which protect each member club from local competition, do not exist in European club football. In England, for example, between one-fourth and one-half of the Premier League is typically comprised of teams from London. Three of these, Arsenal, Chelsea and Tottenham Hotspurs, have been more or less permanent members of the league. The claim that the “winner-take-all” logic, which explains the emergence of monopolistic leagues, also applies to clubs in their local market (Frank & Cook, 1995) is evidently not accurate. Rather, several clubs can successfully co-exist in large cities as they tend to appeal to somewhat non-overlapping groups of fans, taking advantage of rivalries between different parts or milieus of the same city. In comparison to Major League clubs with their uncontested home

territories, clubs who face direct competition in their local market will chose higher levels of investment, *ceteris paribus*. Overinvestment is more likely.

5.2.3. *Free player market*

The labor relations approach employed by the hermetic Major Leagues is not feasible within the European association-governed football pyramid. Football associations cannot be compared to the Major League club owners, who represent the demand side of the player labour market. Instead, Football associations are sports governing bodies which represent all the important stakeholders of football in a certain geographic region, including the players. Thus, there is no option to produce an accepted collective bargaining result in an environment characterized by governing bodies.

In theory, democratic sports governing bodies could regulate labor relations due to the accepted self-regulation of sports in all European states. The self-regulation of sports was in fact understood as an important expression of European civil society (Arnaut, 2006). In practice, however, European institutions such as the European Court of Justice and the European Commission have increasingly limited the scope for regulation by UEFA or FIFA over the last decades. The Bosman ruling of the European Court of Justice in 1995 is probably the most prominent case in which a regulation issued by the football associations – in this case the player transfer system of the FIFA – was found to violate EU law, in particular, the principle of freedom of movement in the labour market. Today, there is simply no institution in European club football with the power and the ability to implement labor market regulations. In contrast to the strongly regulated player markets in North America, there is a genuine “free market” in European club football.

Even if, say, UEFA had sufficient power to regulate and no player agent, player or club had the chance to enter into legal litigation in European courts – even in such an “ideal world” for sports governing bodies –, there is another obstacle for player market interventions. European club competitions are played by clubs that simultaneously compete for the league championship in their extremely heterogeneous national markets. Whereas the English Premier League clubs’ revenues reached a level of more than £3 bn in the 2013/14 season, the clubs competing in the Estonian League earned perhaps a thousandth of this sum (Deloitte, 2015).

If UEFA would pursue a strategy of implementing a Major League-style absolute salary cap in European club competitions, the adequate level to curb overinvestment and ensure close competition in England would have no effect whatsoever in Estonia and in almost any other national league. Likewise, the adequate cap for Estonia would be too restrictive for almost any other national league and would presumably drive the rest of Europe to break away from UEFA and organize alternative competitions.

National salary caps reflecting the specific domestic revenue potential would not only be detrimental to the attraction of European competition as the clubs’ salary expenditures would be capped at different levels. They would also raise various incentive problems. For example, if a clubs from a

national league with a low salary cap won several millions in prize money from the European competitions, that club might not be allowed to spend it on players. Thus, why should the club even participate in European competitions?

In conclusion, player market regulations applied to all member clubs presuppose either a single closed league setting in a common product market (as in all Major Leagues) or a series of rather homogeneous leagues operating in different product markets but with comparable revenue potential. Both scenarios, the creation of a closed European league of top clubs and the transformation of heterogeneous national leagues into regional leagues of comparable market size, have been discussed extensively in the literature (e.g. Hoehn and Szymanski, 1999), but have never been transformed into practice.

As long as the European top clubs prefer to play European competitions and national championships simultaneously instead of entirely breaking away to form a Major League-style elite European league, and as long as the smaller national associations do not join efforts to create larger regional leagues, player market regulation to curb overinvestment is not feasible. Quite obviously, salary caps and drafts are North American solutions to contain clubs' spending on players in the specific North American context. They are not "importable" to the European context.

5.2.4. Financial Fair Play Regulations

The European football clubs' predominant win-maximization calculus, the limited revenue sharing arrangements, the inexistence of territorial exclusivity as well as a liberalized player market help explain why football clubs tend to be unprofitable. These arguments are, however, are insufficient to explain the extreme level of club losses.

To better explain the mechanisms that led to the alarming dimension of club losses in European football, several authors (Andreff, 2007, 2011; Storm, 2012; Storm & Nielsen, 2012; Franck, 2014) have applied concept of soft budget constraints (Kornai, 1980a, 1980b, 1986, Kornai, Maskin & Roland 2003). Hungarian economist János Kornai originally developed the concept as a means to understand the chronic inefficiency of loss-making firms in socialist economies which were repeatedly bailed out by public authorities.

Very briefly, the economic logic of soft budget constraints in football can be stated as follows. In case a club faces a deficit very often some form of "supporting organization" (Kornai et al., 2003, p. 5) – either the state or a private benefactor – steps in with a sufficiently high probability and relieves the club from the pressure to "cover its expenditures out of its initial endowment and revenue" (Kornai et al., 2003, p. 4). As a consequence, clubs with soft budget constraints can chronically overspend without the same threat of dissolution as firms in other industries.

It surely makes a difference whether the state (and thus ultimately the taxpayers) or private benefactors (i.e., individual equity participants and/or related parties) are "funding footballers' Porsches" (Kuper, 2009). Unlike the state, private benefactors are unlikely to make uninvolved citizens liable for their

football investments. Intuitively, one might think that private benefactors should therefore be free to spend their money as they please. As long as “the show goes on”¹⁸ and as long as the money injected does not originate from illegal activities, everything should be fine.

The real problem, however, is that soft budget constraints and the resulting expectation to be bailed out *ex post* create several seriously distorted incentives for decision-makers in football clubs, regardless of whether both public and private money is spent.¹⁹ The perception to run an “immortal” club shapes the expectations of club managers, adversely affects their expenditure behaviour, and increases the overinvestment problem. The rat race turns into a “zombie race”, where an increasing number of clubs operates on the verge of insolvency, chronically expending more than their earnings, but being systematically rescued by external money injections year after year (Franck, 2014).

The shared perception of club representatives, players, leagues and national associations that these developments posed an increasing threat to the financial stability and long-term viability of the entire European football system, led UEFA to enhance its Club Licensing System and introduce the UEFA Club Licensing and Financial Fair Play Regulations (FFP regulations) in 2011.

The main pillar of the FFP regulations is the “break-even requirement”.²⁰ By and large, this new rule requires clubs to live within their own financial means. More specifically, clubs comply with the break-even requirement if their “relevant expenses”²¹ do not exceed their “relevant income”²² to by more than the “acceptable deviation”²³ of €5mn in one so called “monitoring period” covering initially two and later three consecutive reporting periods combined.²⁴ Clubs which break their budget in the one reporting period carry over a break-even deficit to the next reporting period(s), when the total result for the monitoring period is not allowed to exceed the “acceptable deviation”. On top of the €5mn, the “acceptable deviation” can currently²⁵ go up to a level of €45 mn, provided that equity participants are willing to inject the respective funds. The independent Club Financial Control Body (CFCB) monitors and enforces the FFP regulations. The severest sanction the CFCB can enforce is exclusion from the UEFA club competitions. Other sanctions include fines, the withholding of prize money, and player transfer bans.

Under the new FFP regulations, both public and private benefactors are no longer able to rescue a club

¹⁸ See Szymanski (2010) for a range of arguments why football clubs almost always manage to remain viable despite situations of financial distress.

¹⁹ The following discussion of the various inefficiencies induced by soft budget constraints largely corresponds to Franck’s (2014) more detailed discussion.

²⁰ The break-even requirement is defined in Articles 58-63 (see UEFA, 2012).

²¹ Relevant expenses are defined in Article 58 (2) of the UEFA Club Licensing and Financial Fair Play Regulations.

²² Relevant income is defined in Article 58 (1) of the UEFA Club Licensing and Financial Fair Play Regulations.

²³ Acceptable deviations are defined in Article 61 of the UEFA Club Licensing and Financial Fair Play Regulation.

²⁴ The initial monitoring period assessed for the 2013/14 license season covers the reporting period ending 2013 and the reporting period ending 2012.

²⁵ Article 61(2) of the UEFA Club Licensing and Financial Fair Play Regulation explains that the total acceptable deviation will then go down to €30mn for the monitoring period assessed in the license seasons 2015/16, 2016/17 and 2017/18.

for licensing purposes if the club overinvested in salaries and transfers with the result that relevant expenses exceed relevant income by more than the “total acceptable deviation”. To promote investments in stadia, youth academies and community projects, such expenditures do not count as relevant expenses and are therefore excluded from the break-even calculation.

Accordingly, Roman Abramovich, owner of Chelsea, could build a better stadium, invest more heavily in promising young talents and take measures to increase the clubs’ fan base to increase his chances of winning a second Champions League title with Chelsea under the new FFP regulations. Yet his willingness to pay for success *per se* is constrained by the new FFP regulations. He cannot inflate the club’s payroll by covering a break-even deficit *ex post* anymore.

The FFP break-even requirement creates important incentives for club managers to compete with a team based on payrolls that allow them to stay within the hard limit drawn by their football income and the “acceptable deviation”. By introducing hard budget constraints, the FFP break-even requirement terminates the “too popular to fail” problem in the football industry and corrects the contagious mentality among club managers to excessively gamble on success.

Of course, any evaluation of the FFP regulations is bound to be preliminary at the moment. To date, data is available on the first two FFP monitoring periods. Of all clubs applying for a license to participate in the UEFA club competitions in the 2013/14 season (i.e., the first FFP monitoring period covering the initial two reporting periods 2012 and 2013), 18 clubs were in danger of not complying with the FFP break-even requirement and therefore investigated by the CFCB. All nine clubs allegedly in breach of the break-even requirements eventually agreed to settlements with the CFCB.²⁶ Sanctions ranged from payroll restrictions to squad size limits in UEFA club competitions and fines. The highest fines were those of PSG and Manchester City. Both clubs agreed to pay €60 mn each (€40 mn of which are subject to the clubs’ fulfilment of several conditions imposed by the CFCB).

In the 2014/15 season (i.e., the second FFP monitoring period covering the three reporting periods 2012, 2013 and 2014), the CFCB reached settlement agreements with 14 clubs allegedly in breach of the break-even requirement. Sanctions again ranged from payroll restrictions to squad sized limits in the UEFA club competitions and fines. The two highest fines were those imposed on FC Internazionale (€20 mn, €14 mn of which is conditional) and AS Monaco (€13 mn, €10 mn of which is conditional).

To some observers these sanctions may appear too soft to fundamentally change the club’s spending behaviour, especially when bearing in mind the enormous wealth of many clubs’ private benefactors. However, the development of the annual growth rates in wages and revenues of the 700+ European top division clubs from 2008 to 2013 clearly indicate that the FFP regulations and the sanctions that follow non-compliance influence clubs’ spending behaviour as intended (see Table 2). Annual wage growth has slowed down from 14.0% in 2008 to 4.3% in 2013. For the first time in recent year,

²⁶ See UEFA (2015) for detailed information on all cases in which the CFCB sanctioned clubs for breaching the FFP break-even requirement.

revenues increased by a faster rate (6.7%) than wages (4.3%) in 2013.

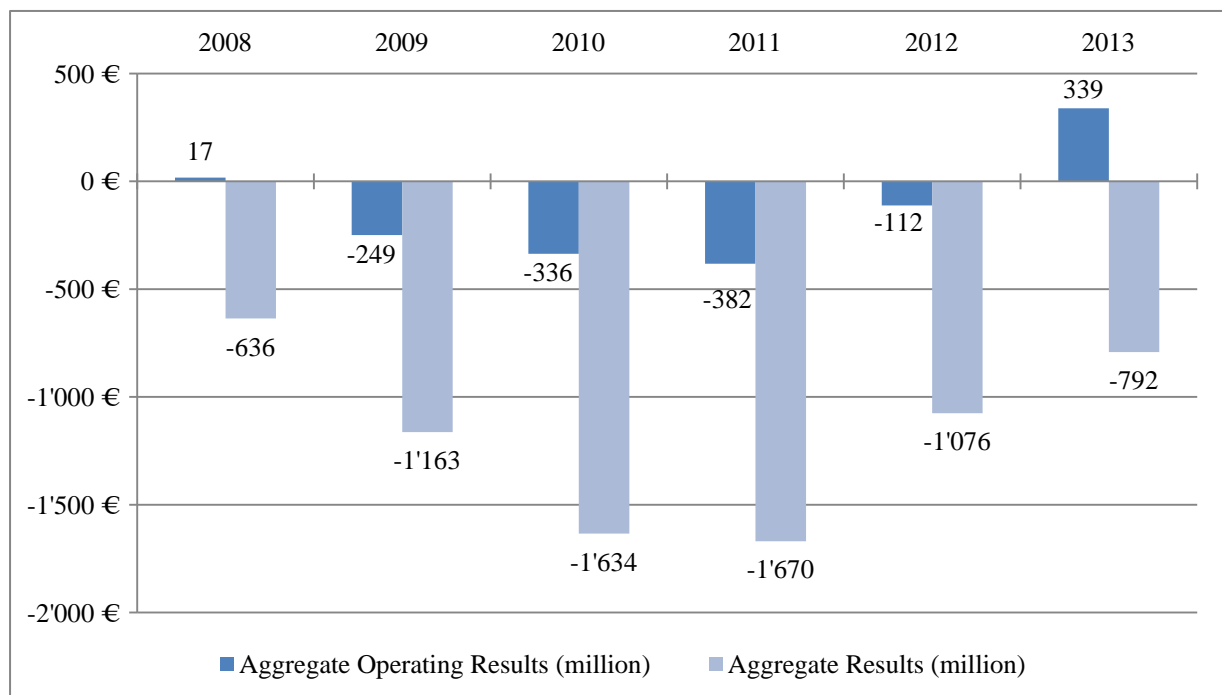
Table 2: Annual growth rates for the 700+ top division clubs

Year	Wages	Revenues
2008	14.0%	7.3%
2009	6.0%	3.2%
2010	9.1%	9.0%
2011	5.2%	3.2%
2012	6.9%	6.7%
2013	4.3%	6.7%

Source: Franck (2015)

Moreover, in 2013 clubs have reported positive aggregate operating results for the first time since 2008 (see Graph 1). Since 2012, a clear downward trend in the aggregate losses is apparent. Of course, it remains to be seen if the data for the following years will confirm this development.

Graph 1: Aggregation operating results and aggregate results of the 700+ top division clubs, 2008 to 2013



Source: Franck (2015)

Major stakeholders in European club football, including the European Club Association (ECA)²⁷, have repeatedly assured their support of the FFP regulations (e.g. UEFA, 2014). There may still be

²⁷ The ECA is a body representing the interests of association football clubs in UEFA. It is the sole such body recognised by UEFA, and has member clubs in each UEFA member association. It was formed in 2008 to replace the G-14, which comprised a small number of elite clubs and was unrecognised by UEFA.

loopholes to keep a club's budget constraint soft (e.g. by means of inventive fair market value calculations and inflated sponsorship deals), but these loopholes are likely to shrink as UEFA gains experience and updates its FFP regulations accordingly.

The settlement procedure is a key element to the current implementation process of the FFP regulations. Settlement agreements between the CFCB and overspending clubs are, in contrast to exclusions from competitions, likely to be in the interest of both parties. By agreeing to CFCB's terms, the involved clubs can secure their participation in the UEFA competitions – in many cases one of the clubs' main revenue sources. A club's appeal in front of the Court of Arbitration for Sport (CAS) would be expensive and time consuming and its outcome would be uncertain. To UEFA, a settlement is a guarantee that the case ends there. The FFP regulations do not get challenged in front of the CAS, and UEFA can save the resources of long and costly legal battles. Moreover, the settlement procedure provides the flexibility needed for a case-by-case approach to the sanctions. The balance between and over-regulation that would make it difficult for clubs to invest and take risks, and under-regulation that would render the FFP toothless, is indeed very difficult to find. The settlement practice seems to be a sensitive way to walk this thin line.

6. Conclusion

On both sides of the Atlantic a structure of cooperative league governance in which clubs partially integrate forward to self-govern league affairs has emerged as an efficient form to jointly produce an attractive championship race.

To protect the significant value that the championship race and also the sequence of championships add to marketable single games, each North American Major League employs a commissioner as a specialized "institutional safeguard" who monitors and effectively sanctions any club's jeopardizing behaviour. In European club football the organizational solution to protect the value added of an attractive championship race is a hierarchy of monitoring institutions, reflecting the hierarchical structure of interrelated league competitions. A club like Bayern Munich is monitored by DFL at the national level and by the UEFA at the European Level (i.e., when playing in the Champions League). As the club faces other non-European clubs in the global player market, Bayern transfers are monitored by FIFA.

The Major leagues attempt to control the clubs' tendency to overinvest in playing strength, which is inherent in all forms of rank-ordered league competition, by means of different market interventions. The common interventions on the product market side in all Major Leagues are extensive revenue sharing arrangements and territorial exclusivity. Salary caps and the draft systems are common player market interventions on the supply market side. Consistently high operating profits indicate that the clubs effectively manage to curb the overinvestment problem in accordance with their predominant profit maximization calculus.

In European club football, on the contrary, many clubs chronically overinvest. To some extent this phenomenon can be explained by the clubs' predominant win-maximization calculus, limited revenue sharing arrangements, the inexistence of territorial exclusivity and a liberalized player market. Maybe even more importantly, a common "too popular to fail" logic has shaped many club managers' perception to run an "immortal" club, regardless of whether a private or a public benefactor bears the bail out costs. Instead of responsible investment decisions to balance accounts, club managers systematically took excessive risks and gambled on success. With the support of major stakeholders, UEFA has introduced the FFP regulation to preserve the long-term financial stability of European club football. In this respect, the FFP break-even requirement creates important incentives for club managers to compete with a team based on payrolls that allow them to stay within the hard limit drawn by their football income and the "acceptable deviation". By introducing hard budget constraints, the FFP break-even requirement terminates the "too popular to fail" problem in the football industry and corrects the contagious mentality among club managers to excessively gamble on success. Preliminary evidence on the clubs' behaviour to invest in playing strength indicates that the FFP regulations actually bite.

7. References

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