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Anatomy of a "Fiscal Crisis"

Rising Medical Care Expenditures:
A Growing Role for the Public Sector

Restrictive Labor Practices
In Baseball: Time for a Change?

FEDERAL RESERVE BANK of PHILADELPHIA

# business review


1975

**On our cover:** In Philadelphia at Pier 11 on the Delaware River is the *U. S. S. Olympia,* one of the few reminders left of the Spanish-American War. Flagship of Commodore (later Admiral) George Dewey at the Battle of Manila Bay in May 1898, she is the oldest steel Navy vessel in existence. A museum aboard contains pictures of the *Olympia,* uniforms of officers and enlisted men, and memorabilia of the ship.


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# Anatomy of a "Fiscal Crisis"

By Anthony M. Rufolo

Although the fiscal plight of New York City has been making headlines, most local governments now complain that expenditures are growing faster than taxes. Many residents demand increased services despite rising costs, but they quickly rebel at attempts to raise more tax dollars. Nearly everyone wants more goods and services for less money, so these demands don't seem unusual. It's one way for citizens to remind City Hall that every expenditure decision involves a budget tradeoff. After all, as economists never tire of pointing out, resources are limited and budgets limit their use. However, mayors in certain areas—particularly central cities—fear that if they fail to maintain the same level of services or to clamp a lid on taxes, the exodus of jobs and wealth to the suburbs may accelerate. Many of them call this a "fiscal crisis," conjuring up visions of nothing but abandoned buildings and jobless poor. Is such alarm justified, or are some city administrators simply rebelling against the constraints of their budgets?

Taxpayer Smith may forsake the paved sidewalks of the city for the manicured lawns of suburbia for any number of reasons. He may commute a greater distance for more open living space. He may want his children to attend a suburban school. If he moves from one suburb to another, generally no one would care. But a move from city to suburb makes him another statistic to furrow the city mayor's brow. The likeliest candidate for such a move is the relatively wealthy taxpayer.[1] For example, Smith's contributions to the city's coffers may be more

[1]One author found that "between 1959 and 1969, the median income of central city families dropped from 89 percent of that of suburban families to 83 percent." See Joseph A. Pechman, "Fiscal Federalism for the 1970's," *National Tax Journal* 24 (1971): 285.

than it actually costs to provide him with government services, so he pays for services for relatively poor taxpayer Jones as well. This redistribution of income provides an incentive for Smith and others like him to leave the city, thereby putting increasing pressure on city budgets. Thus, income redistribution at the local level may be a major force behind the "fiscal crisis."

So far, no major cities have folded. Perhaps the danger signals were heeded before the situation became hopeless. Recently Federal revenue-sharing funds have helped relieve the pressure on city budgets. But the underlying source of the problem may still be with us. An analysis of what makes a fiscal crisis is in order, so that the pros and cons of proposed solutions can be weighed intelligently. Perhaps there is a solution which attacks the source of the problem rather than its symptoms.

## CITY VERSUS SUBURBS

Every government has budget constraints, so why must *only* major cities face crises? One reason for the difference in ability to cope is that suburban communities have been more successful in attracting the "Smiths" and banning the "Joneses."[2] This creates a problem for the city because the poor require relatively more services from government but have less ability to pay. More low-income residents force a larger tax burden on city businesses and wealthier residents or shift services away from them, or both. Some of these businesses and individuals avoid this increased burden by just moving to the suburbs. This movement in turn leads to greater tax burdens and/or decreased services for those remaining in the city. The poor don't emigrate because of inadequate low-cost housing or poor public transportation in the suburbs as well as barriers such as zoning restrictions.[3] This population shift then affects government budgets, and a quick review will show that cities' tax bases relative to expenditures are not keeping pace with the suburbs'.

The property tax is the primary source of most locally raised revenue. In the early '70s, property taxes accounted for 82 percent of all tax revenue of local governments in metropolitan areas and 40 percent of their total revenue from all sources.[4] However, this important component of the tax system has its base rising more slowly in central cities than in the suburbs. For example, real estate values in Philadelphia increased by 29 percent from 1962 to 1972 while those in the surrounding counties of Delaware, Montgomery, and Bucks posted increases of 38, 77, and 100 percent respectively (see Table 1).

At the same time population has been growing fairly fast in the suburbs while it has actually declined in Philadelphia (Table 2). The result is that tax base per person has grown at a similar rate for each county (Table 3). However, expenditure per person is rising fastest for Philadelphia (Table 4) so that even adjusting for population, total expenditures are growing faster in Philadelphia (Table 5). Thus, while expenditures are rising faster than the value of the property base in all four counties, the difference is largest for Philadelphia.

Several major cities have turned to a wage or income tax to pay for services without increasing the tax burden on real estate. In Philadelphia, for example, between 1962 and 1972 property tax revenues increased by less than 45 percent while total tax revenue almost doubled. In large part the wage tax took up the slack. Unfortunately, however, shift-

[2]There are exceptions, of course, and those suburbs which have not been successful at this face the same type of problems as the central cities.

[3]A recent New Jersey Supreme Court ruling has as its intent the removal of these barriers with respect to housing, but its impact cannot yet be determined. See "Zoning and the Citizen" in the *New York Times,* April 1, 1975.

[4]U.S. Department of Commerce, Bureau of the Census, *1972 Census of Governments, Local Government in Metropolitan Areas,* p. 8.

## TABLE 1
## THE TAX BASE* (MARKET VALUE OF REAL ESTATE) IS RISING FASTER IN THE SUBURBS**

| | Philadelphia County | Bucks County | Delaware County | Montgomery County |
|---|---|---|---|---|
| 1962 | $5889.8 | $1237.9 | $2142.8 | $2664.5 |
| 1972 | 7617.0 | 2474.8 | 2961.2 | 4708.5 |
| Change (1962–72) | $1727.2 | $1236.9 | $ 818.4 | $2044.0 |
| Percent Change (1962–72) | 29.3% | 99.9% | 38.2% | 76.7% |

*Dollar figures are in millions.

**Chester County is not included because it is not contiguous to Philadelphia County.

SOURCE: Pennsylvania Department of Commerce, *Pennsylvania Statistical Abstract*.

## TABLE 2
## BUT SO IS THE POPULATION

| | Philadelphia County | Bucks County | Delaware County | Montgomery County |
|---|---|---|---|---|
| 1962 | 2,002,512 | 308,567 | 553,154 | 516,682 |
| 1972 | 1,950,098 | 415,056 | 601,425 | 623,921 |
| Percent Change | −2.6% | 34.5% | 8.7% | 20.8% |

SOURCE: U.S. Department of Commerce, *Census of Governments—Compendium of Government Finance,* Table 53.

## TABLE 3
## LEAVING TAX BASE PER PERSON GROWING AT SIMILAR RATES

| | Philadelphia County | Bucks County | Delaware County | Montgomery County |
|---|---|---|---|---|
| 1962 | $2941.2 | $4011.8 | $3873.8 | $5156.9 |
| 1972 | 3906.0 | 5962.6 | 4923.6 | 7546.6 |
| Percent Change (1962–72) | 32.8% | 48.6% | 27.1% | 46.3% |

SOURCE: Tables 1 and 2.

## TABLE 4
## EXPENDITURE PER PERSON IS RISING SIGNIFICANTLY FASTER IN PHILADELPHIA THAN IN SURROUNDING COUNTIES*

| | Philadelphia County | | | Montgomery County | | | Delaware County | | | Bucks County | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1962 | 1972 | Percent Change | 1962 | 1972 | Percent Change | 1962 | 1972 | Percent Change | 1962 | 1972 | Percent Change |
| Expenditure per Person | $209 | $635 | 203.8% | $183 | $436 | 138.2% | $155 | $326 | 110.3% | $213 | $463 | 117.4% |
| Revenue per Person | $209 | $590 | 182.3% | $169 | $432 | 155.6% | $145 | $338 | 133.1% | $185 | $455 | 145.9% |
| Intergovernmental | 34 | 216 | 535.3 | 29 | 92 | 217.2 | 26 | 96 | 269.2 | 44 | 150 | 240.9 |
| Own Sources | 175 | 374 | 113.7 | 140 | 340 | 142.9 | 119 | 242 | 103.4 | 154 | 305 | 98.1 |
| Intergovernmental as Percent of Total | 16% | 37% | 131%** | 17% | 21% | 24%** | 18% | 28% | 56%** | 24% | 33% | 37%** |

*Dollar figures are in millions.

**Represents rate of growth of intergovernmental as percentage of total revenue.

SOURCE: Same as Table 2.

## TABLE 5
## WHILE TOTAL EXPENDITURES ARE RISING ONLY SLIGHTLY FASTER

| | Philadelphia County | | | Montgomery County | | | Delaware County | | | Bucks County | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1962 | 1972 | Percent Change | 1962 | 1972 | Percent Change | 1962 | 1972 | Percent Change | 1962 | 1972 | Percent Change |
| General Revenue | $418.6 | $1151.6 | 175.1% | $87.4 | $269.5 | 288.4% | $80.0 | $203.8 | 154.8% | $57.0 | $188.5 | 230.7% |
| Intergovernmental | 67.8 | 421.9 | 522.3 | 14.8 | 57.2 | 286.5 | 14.2 | 58.0 | 308.5 | 13.6 | 62.2 | 360.3 |
| Own Sources | 350.9 | 729.7 | 108.1 | 72.5 | 212.3 | 192.8 | 65.8 | 145.8 | 121.6 | 47.4 | 126.4 | 166.7 |
| Taxes | 279.4 | 557.0 | 99.4 | 58.5 | 168.1 | 185.9 | 53.2 | 118.7 | 123.1 | 32.1 | 96.2 | 199.6 |
| Property | 162.9 | 231.3 | 42.0 | 53.2 | 152.6 | 186.8 | 49.4 | 111.4 | 125.5 | 27.6 | 84.8 | 207.2 |
| Other | 116.5 | 325.7 | 179.6 | 5.5 | 15.5 | 181.8 | 3.8 | 7.4 | 94.7 | 4.5 | 11.4 | 153.3 |
| Direct General Expenditures | $417.6 | $1237.9 | 196.4% | $94.7 | $272.2 | 186.4% | $85.7 | $196.1 | 128.8% | $65.6 | $192.2 | 193.0% |

*Dollar figures are in millions.

SOURCE: Same as Table 2.

ing to a different tax is not likely to alleviate the problem (see Box 1). City residents paying more in total local taxes than it costs to serve them are still likely to have an incentive to move to the suburbs. It is this incentive that is at least partially behind the fiscal plight of many major cities.

### LOCAL INCOME REDISTRIBUTION: AN INCENTIVE TO MOVE?

Most people consider political factors as the primary determinants of the tax rates and services provided by a local community. Residents as voters register their desires through elections, and the elected representatives try to coordinate the often conflicting goals of various groups. Some economists, however, emphasize a rather different aspect of this process. They point out that communities can be considered as sellers of a package of goods and services who charge a certain tax-price for the package. So while a resident/voter can try to influence what local government does, he can also decide to move to a community more tailored to his

**BOX 1**

## HIGHER RESOURCE COSTS VERSUS INCOME REDISTRIBUTION

There are, of course, many reasons why a central city might have faster growing expenditures per capita than do the suburbs. However, most of these phenomena do not create distortions in the economy. When the higher expenditures and, hence, higher taxes represent the cost of serving residents, then the movement of residents to find more services for fewer tax dollars is beneficial to the economy. For example, if wages and land costs are rising fast in the city and this raises the cost of running local government, then someone who moves out frees the resources which were used to provide him with services. This person is made better off and no one is worse off. However, if taxes are high in order to pay for the services which someone else receives, then moving out lowers the city's income by more than it lowers expenses. In this situation, even people who would be willing to pay the cost of service to them may be driven away. This then raises the tax burden and/or lowers service levels for those remaining and may lead to the cumulative process discussed in the text.

The same situation arises no matter who is being subsidized. For example, some people argue that suburbanites directly exploit the central city. They commute in and impose costs on the local government and then leave without paying any taxes. Partially in response to this argument, some central cities levy wage or income taxes; however, there is very little evidence to support this allegation.* To the extent that this does happen, a wage tax can offset the income redistribution to suburbanites; but if it does not happen, the wage tax will distort location decisions in favor of suburban jobs. The discussion in the text is equally applicable to all types of local income redistribution.

*For a detailed discussion, see "Suburban Exploitation of Central Cities," by David F. Bradford and Wallace E. Oates, presented at the Urban Institute conference on "Economic Policy and the Distribution of Benefits," held in Washington, D. C., March 23–24, 1972.

preferences. Consumers in a sense "shop" among communities much as they shop among stores for goods.

Unfortunately, though, this analogy has its limitations. There are easily recognizable differences between the way stores sell and the way local governments "sell." Stores charge directly for the items bought while governments charge indirectly by taxing sources such as property or income. This difference affects people when they are "community shopping."

The major effect is that people do not necessarily contribute equally to the cost of public goods and services, even if they receive the same benefits. For example, with a property tax, a person with a small house might pay much less in taxes than a neighbor with a big house although both may send the same number of children to the same school. This local redistribution of income may be desirable on equity grounds (if we accept "ability to pay" as our equity criterion), since presumably the resident of the larger house is wealthier. (See Box 2.) However, such a situation motivates the person paying higher

BOX 2

## EQUITY, PRODUCTION EFFICIENCY, AND SOCIAL EFFICIENCY

There are two criteria which appear to be used most in judging governmental actions—equity and efficiency. Equity relates to "equal treatment." Unfortunately, this is about all that can be said in this area without provoking some controversy. Does it relate to equal treatment of equals or equal treatment of everyone? Should the poor get the same as the rich, or more, or less?* Government is often in the position to provide different levels of services to different groups or to charge them different taxes. When government actions in this regard favor the poor, there is essentially a transfer of income. This transfer of income is carried out for equity purposes. Thus, one goal of government could be to promote equity through income redistribution.

Efficiency can be broken down into production versus social efficiency. We can look at production efficiency as being the least costly production of a given good or service and social efficiency as being the production of goods and services most desired by consumers. For example, a firm may be a very efficient producer of buggy whips in terms of keeping the cost per whip down, but it may be wasting resources because no one wants buggy whips. This would be a case of production efficiency which is not social efficiency. In a competitive economy, such a firm would go out of business; however, government subsidies might allow it to remain in operation. Similarly, other firms in some noncompetitive positions may be producing desirable goods but in a very costly manner. As long as the goods are worth more than the resources used in producing them and they would not otherwise be produced, then it may be socially efficient to provide them although we don't have productive efficiency. Thus, productive efficiency and social efficiency are two other possible goals of government.

*For a treatment of some of the issues, see Anita A. Summers, "Equity in School Financing: The Courts Move In," *Business Review* of the Federal Reserve Bank of Philadelphia, March 1973, pp. 3–13.

taxes to try isolating himself from the person paying lower taxes, since the wealthier resident is, in a sense, paying part of the poorer person's bill. Each person has an incentive to live in a community in which he has less property (and hence lower tax payments) than anyone else in the community. Of course, everyone cannot have less than the average amount. The only stable solution to this type of system would seem to be one in which each resident of a community has approximately the same amount of property and makes similar tax payments.[5] All persons who want smaller houses or apartments would be kept out by zoning laws or similar arrangements.

[5]Renters are assumed to pay property taxes through their rent payments.

**Redistribution and Efficiency.** Economics tells us that if the price of something corresponds to the costs of providing it, then our scarce resources will be channeled to their most highly valued uses. When local governments charge tax "prices" unrelated to the costs of the services they provide, these resources may end up in inefficient uses. For example, consider our friend Smith's decision to move from the city to the suburbs. Suppose he was entirely happy with the services he received but discovered the same services could be received in suburbia for lower taxes. If the cost were the same in the two places, but taxes were higher because of local income redistribution, then Smith's move would waste both the resources involved in the actual move and those used in his daily commuting. However, if taxes were different because the suburban government had lower costs, then Smith's move would result in the saving of resources employed in providing the services. This saving would be balanced against the cost of Smith's moving and commuting. In this case moving would mean not only a cost saving to him, but more efficient use of society's resources would result (Box 2).

If suburban communities succeed in keeping out low-income residents, they reduce the incentive for *current suburbanites* to move around. This can cut the loss of resources resulting from a game of "musical chairs" among communities. However, this cannot reduce the loss of resources because of excess movements out of the city, and it reinforces the result of little or no income redistribution at the local level.

This description of how people choose a community may seem an extreme case, and it certainly omits other important factors which shape a location decision. However, tax-benefit considerations may have significantly influenced the movement to suburbia and may have helped create communities where all the residents have very similar characteristics. To the extent that this process really operates, it can thwart the attempt of cities to pay for the services they provide by redistributing income through taxes. In fact, attempts to redistribute income locally through taxes can not only influence the movement of people and jobs out of the city, but can also backfire and deepen the plight of the poor.

**Redistribution and Low-Income Residents.** If attempts to redistribute income lead to separation of families by income class, then the poor could be worse off than if no income redistribution were attempted. This is because current financing only allows communities with a large tax base per person to provide large amounts of goods and services per person. Thus, it is usually necessary for each resident of such a community to buy a large house or rent an expensive apartment. A poor family desiring high levels of some public services (education, for example) would then have to pay for large amounts of housing as well as for the services they desire. While low-income families might be able to afford payments for the services, they obviously cannot also afford large payments for housing. Efforts to encourage low-income housing in the suburbs have encountered stiff opposition, with income redistribution probably a major objection. The likely outcome is that the poor with their demand for services are "locked" into the central city. And, there's the heart of a "fiscal crisis."

So, cities face the problem of providing goods and services which are increasingly more costly to a population which has a growing percentage of those with the least ability to pay. This leads to high-tax and low-service levels for those who can pay. To avoid income redistribution payments at the local level, some people who would otherwise have stayed in the city may incur the costs of moving and commuting. They might also move to a community which provides a different amount of public services than they would choose if they were bearing the direct cost.

The net result is likely to be some waste of society's resources, very little actual income redistribution at the local level, and forces continuing to militate against locating in the central city. While there are many factors creating fiscal pressure on the city, this one may truly be called a "fiscal crisis," for the situation cannot be controlled from within the city. However, this does not imply that all cries of "crisis" should be treated the same. If the city is driving away jobs and residents because it has high production costs or is inefficient, the situation should be labeled an internal management problem, not a crisis.

## PROPOSED SOLUTIONS

Two often-proposed methods of aiding the central city are the formation of a metropolitan or regional government and the sharing of revenue by the state or Federal Government. Either method can achieve the goal of relieving the fiscal pressure on central cities, but each also has shortcomings.

**Metropolitan Government: A Loss of Competition.** A metropolitan government consists of a central city and all of its suburbs replacing many local governments. Proponents of this approach argue that it would eliminate competition for the tax base at the local level.[6] Individuals or businesses would have to move outside the metropolitan area to escape paying their share of taxes. The problem with this solution is that local government competition can be desirable.

Local government, locally financed, is beneficial in two important respects. The first is that to some extent it forces people to reveal what they are willing to pay for government services. Suppose property taxes were used only to finance goods and services whose costs are approximately proportional to the amount of property people own. It is then likely that the "shopping" element of community choice would direct people with similar preferences for government services to the same communities. They would not have any incentive to move to communities that provided more of these services than they wanted because they would have to pay the cost. Similarly, people would not have an incentive to move to communities providing too little of these services because the resultant tax savings would not compensate them for having less of these services.

The second benefit (and perhaps that which advocates of local government stress most) is the wider range of choice which results from many "suppliers" (governmental units). For example, suppose that Jones would like more police protection than would Smith. If they live in the same community, both cannot be satisfied. Voting may lead to some compromise, perhaps less than Jones would like to "purchase," but more than Smith wants to pay for. However, if Jones and Smith each move to other communities populated with residents of similar tastes, each may be able to achieve his desired level of police protection. A more inclusive metropolitan government is not likely to offer as much variety.

This is not meant to imply that local government would not have fiscal pressures in the absence of local income redistribution. Most economists now agree that suburbanization would have occurred even if central cities had had no fiscal or social problems.[7] Also, people in every community will want to

[6]There are a number of arguments related to coordinating the actions of local governments which are also expounded by proponents but which will not be covered here. For a discussion of these arguments and alternative forms of metropolitan government, see L. Christine Grad, "Blueprint for Metropolitan Reform," *Business Review* of the Federal Reserve Bank of Philadelphia, October 1971, pp.12–17.

[7]For example, see Edwin S. Mills and James MacKinnon, "Notes on the New Urban Economics," *Bell Journal of Economics and Management Science* 4 (1973): 593–601, 596.

minimize their costs for particular services. But this type of incentive serves to inform government of what the residents want. In this case, a community may lose residents by not providing the desired level of services or by being inefficient, but it will not lose residents because another community is a "tax haven."

**Sharing Revenue Distorts "Prices."** The sharing revenues approach leaves government units unchanged but provides funds from state or Federal sources to relieve the fiscal pressure on local government. Tax collections are made from all over the state or even the country, making tax avoidance very difficult.

Sharing revenue has been with us for some time, although large-scale transfers of unconditional funds are relatively recent occurrences. Table 5 shows that funds from the state and Federal governments have been growing faster for Philadelphia than for any of its neighboring Pennsylvania counties. In fact, while Philadelphia had the largest percentage increase in expenditures, the growth of transfer funds has been sufficient to give it the smallest percentage increase in taxes and in total revenue from local sources. Thus, sharing revenue has, indeed, relieved some of the fiscal pressure on central cities and other local governments. However, this solution also has a drawback.

Revenue sharing does not force people to relate their tax payments to the cost of providing services. If one community should consistently get more in transfer funds than another, it will become more attractive relative to the second community. In addition, each community will still have incentives to attract businesses and individuals who pay more in taxes than it costs to serve them and to keep others out. Because the "prices" of services in one community versus another still do not reflect the cost of resources used in providing these services, people will expend time and money in relocating. Moreover, they will not move to the community which can best satisfy their preferences with the least use of resources.

## LOCAL FINANCING WITHOUT INCENTIVES TO MOVE

It may sound like local tax financing will always create incentives for people to separate into similar income groups, but this is not true. This result arises from attempts to redistribute income locally through the tax process. If Smith's taxes represent the cost of serving him, then it doesn't matter much to the community whether or not he lives there. Neither a new rich neighbor nor a new poor one would alter the taxes or benefits for current residents of the community. For example, if the property tax were restricted to financing services whose cost is approximately proportional to the amounts of property in the community just as the property tax is, then people with large houses would have no *tax* incentive to bar construction of small houses. Such services as fire protection are likely to fit into this category. Thus, owners of large houses on large lots (which are likely to require more fire equipment and create a bigger area to cover than do small houses on small lots) would pay higher taxes to offset the higher costs imposed on the community. No doubt there are other reasons why people might want similar houses in the same community (such as aesthetic appeal and a desire to socialize with people of similar income), but such considerations often relate more to an immediate neighborhood than to an entire town.

When a government service has costs which are not related to property, then the property tax should not be used for financing. Similarly, if the cost of serving someone is not related to his income, then a local income tax should not be used to finance that service. Certainly, we would seldom expect to find an exact correspondence between a certain tax and the cost of providing a particular service. But now taxes and services are usually completely unrelated. Take welfare as an example. Most people agree that society has some obligation to care for the indigent, but why should the burden fall on property owners in a particular community? This is definitely an area where direct payments from the Federal Government would lead to more equal treatment for the poor in different communities and would relieve an unfair burden on city property owners. This proposal would, in turn, reduce the incentive to move strictly to avoid local tax payments aimed at redistributing income.

Another benefit of such a system is that the range of choices available to many people would increase. Education is a good example. "Charging" on the basis of the number of schoolchildren avoids income redistribution at the local level. Given that government has assumed the financing of the service, the funds should come from state or Federal sources. One way would be for the state to issue a voucher which would be used to "pay" for schooling.[8] Each student would receive a voucher and present it to the school he attends. The school would then redeem the voucher with the state or Federal government for its operating funds. Local communities might continue to *provide* school services, but there would no longer be any reason to restrict entrance to local residents. Thus, a family would not have to relocate to obtain the educational services it desires.

In short, let local government continue to finance those services which do not result in significant income redistribution. And, whenever possible do this with taxes that closely reflect the costs of providing services. Let the state and Federal governments finance services which entail significant income redistribution. Income redistribution can be more effectively administered at these higher levels of government. The difficulty in avoiding broader-based taxes will reduce the amount of resources spent in trying to avoid them. At the same time, the benefits of local choice can be maintained or increased.

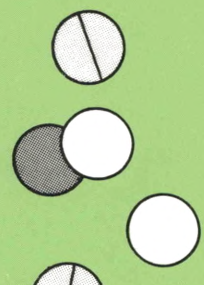
## SUMMING UP

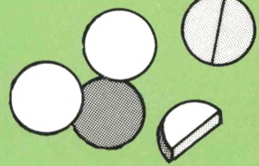
Now, what about that "fiscal crisis"? To the extent that such a crisis exists, it is at least partly caused by communities using local taxes to finance public goods and services in such a way that some redistribution of income results. When this effect is large, communities are forced both to compete for citizens who make a net contribution to the local treasury and to keep out those who are a net drain. This can lead to segregation by income, and it's possible for this to make everyone, including the poor, worse off than if no such attempt were made.

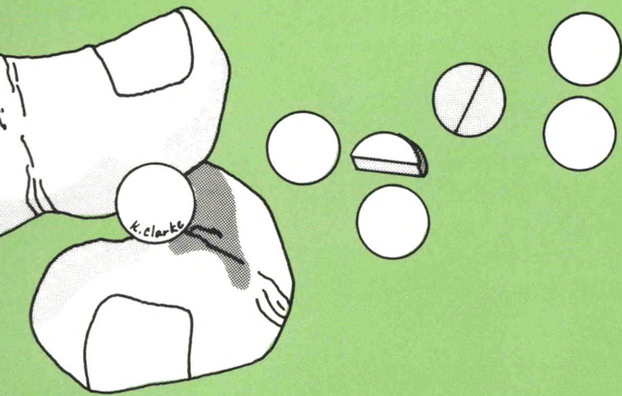
The benefits of many communities offering a range of services are very real. Financing the wrong services—ones where taxes are not linked to costs—by means of local taxes is likely to cause inefficient use of resources and excessive decentralization of people and businesses. It is time for a rational approach to financing government expenditures, and this includes a recognition that efficiency and equity may require one level of government to raise taxes while another provides goods or services. However, it also requires the recognition that competition at the local level can be beneficial. There is no reason for city governments to be spared from having to accept the tradeoff of taxes and services faced by other governments. But there is also no reason for them to shoulder most of the burden of financing services for the poor.

[8]The voucher plan allows parents to determine what school to send their children to while having the state continue to finance the education. See David W. Lyon, "Capitalism in the Classroom: Education Vouchers," *Business Review* of the Federal Reserve Bank of Philadelphia, December 1971, pp. 3–10.

# Rising Medical Care Expenditures: a growing role for the public sector



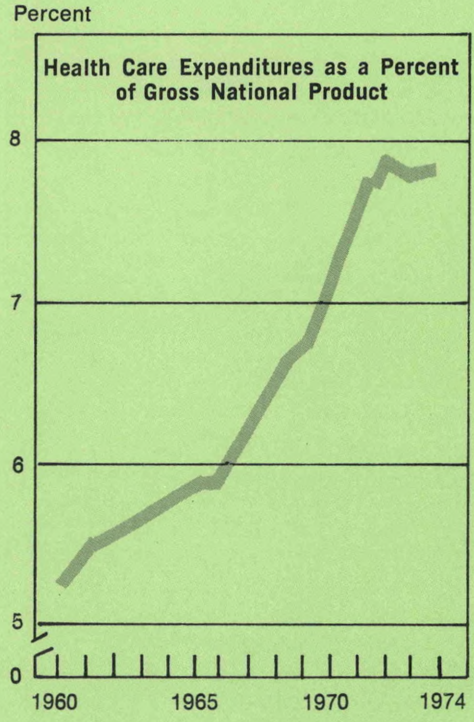





By
Robert H. Friedman

CHART 1

HEALTH CARE EXPENDITURES ARE BECOMING AN INCREASING SHARE OF OUR GNP.




SOURCES: U. S. Department of Health, Education and Welfare, Social Security Administration, *Social Security Bulletin; Economic Report of the President.*

CHART 2

ONE REASON FOR THIS INCREASE IS THE RELATIVELY RAPID RISE IN THE COST OF MEDICAL CARE.

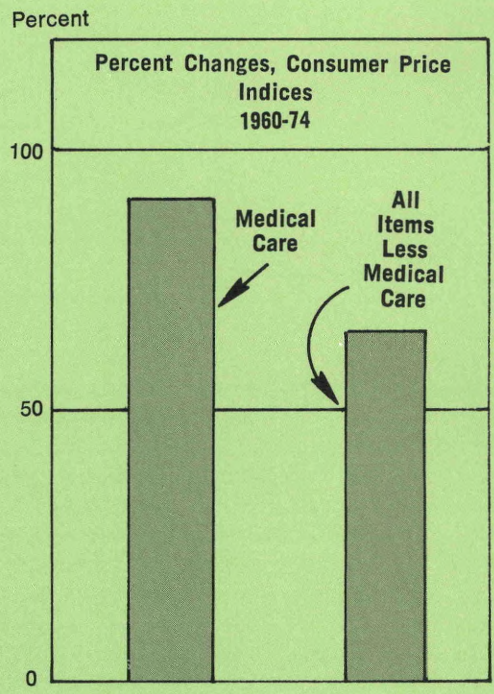


CHART 3

IN ADDITION, BOTH THE QUALITY AND THE QUANTITY OF THE SERVICES PROVIDED HAVE INCREASED, LEADING TO AN INCREASE IN REAL PER CAPITA EXPENDITURES ON MEDICAL SERVICES.

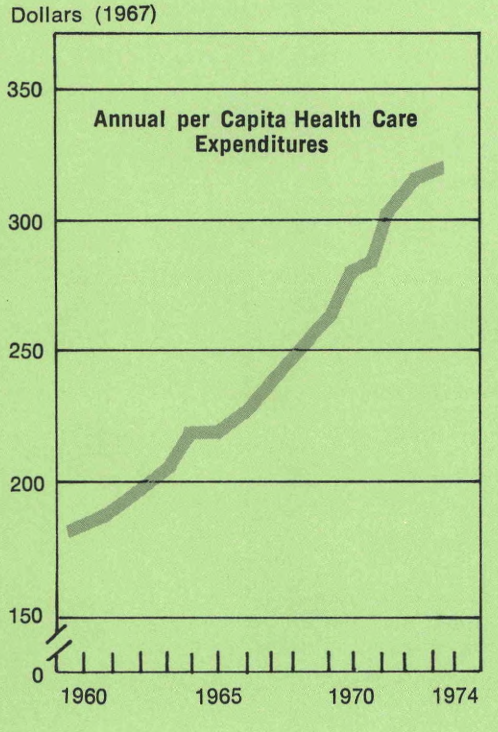
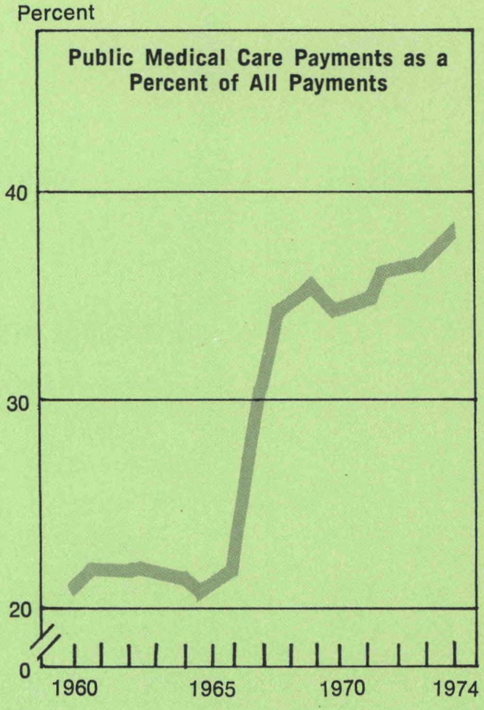
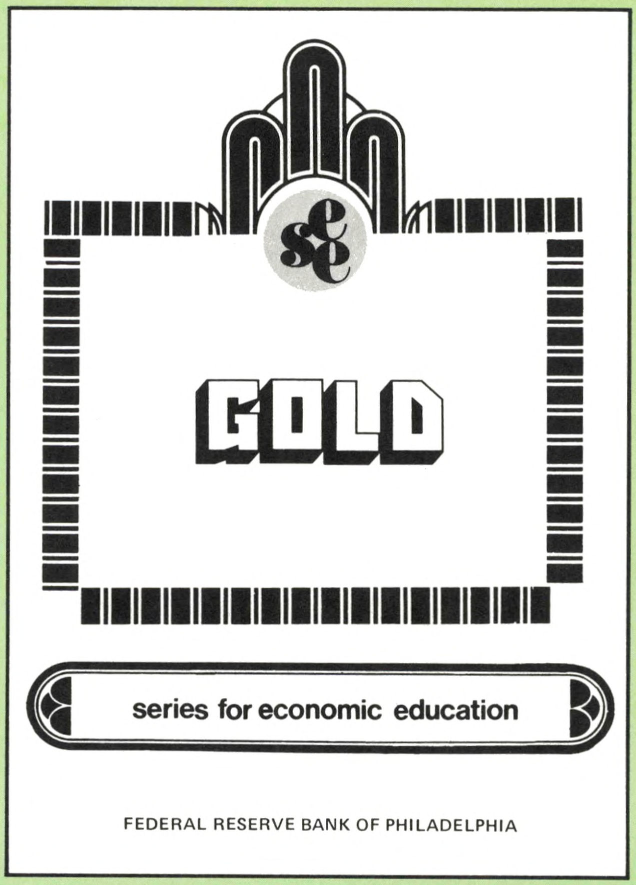



CHART 4

HOWEVER, THE PUBLIC SECTOR* IS FINANCING A GROWING SHARE OF ALL MEDICAL PAYMENTS.




* Public sector includes Federal, state, and local governments.




On December 31, 1974, Americans were permitted to buy and sell gold for the first time in some 40 years. Since then questions have been raised about the once-hallowed, almighty metal's worth and importance. For example, has its status in the United States and in the international monetary system changed? If so, in what manner? A pamphlet recently produced by the Philadelphia Fed's Department of Public Information considers the role of gold—past, present, future.

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# Restrictive Labor Practices in Baseball: Time for a Change?

*By Janice M. Westerfield*

When pitcher Jim (Catfish) Hunter was declared a free agent last December, he entertained offers from 23 of the 24 major league teams in the hottest bidding war in baseball history. He finally signed a five-year contract with the New York Yankees for a record $3.75 million. Never before had an experienced player of Hunter's caliber—he pitched the Oakland A's to three consecutive World Series Championships and is considered by many experts to be baseball's top pitcher—enjoyed free-agent status.

Competitive bidding for Hunter's services spotlighted one of professional baseball's unique labor practices—the player reservation system which can keep a player from selling his skills to the highest bidder. Sports entrepreneurs defend the noncompetitive labor practices by claiming that professional teams are unique and note that the courts have exempted them from antitrust action. They argue that while an ordinary business is untroubled if it wipes out its competitors, a professional baseball team is in jeopardy if the financially weaker teams fail. The reason is that even the stronger teams need a league in order to operate profitably. Thus, while it's desirable to compete as hard as possible on the playing field, it's unwise for teams to compete against each other in a business manner, say the owners.

Team owners contend that baseball's restrictions on the labor market can be justified on other grounds as well. Their major contention is that the player reservation system equalizes team playing strengths and this is in the "public interest." Otherwise, the richer teams would garner the bulk of playing talent and lopsided games would result. Team owners also suggest that these noncompetitive practices help "maintain the integrity of the game" by assuring fans that players are loyal to their team. Finally, by preventing bidding wars (except in unusual circumstances), the weaker teams have greater financial security.

After Catfish Hunter declined the Philadelphia Phillies' offer of $2.6 million, Phillies President Ruly Carpenter said the rejection underscored the need for retaining the "reserve clause" in baseball. Does it? Or do the terms of the contract simply show the extent to which Hunter was previously paid less than his value to the team? An economic approach provides a much-needed dimension to the debate on the player reservation system and helps sports fans make some sense out of the industry's chaotic business conditions. In other words, who gains what under the current setup?

## THE RESERVE CLAUSE

Organized baseball's exemption from antitrust action has encouraged collusion among the teams, allowing them to draw up explicit business rules for the conduct of the sport. (For more on baseball structure, see Box 1.) Perhaps the most important set of rules in baseball concerns the player reservation system. This system includes rules governing the acquisition of new players, the promotion of players from minor to major leagues, and movement of players from one major league team to another.

Specifically, the reserve clause in each player's contract gives a team the exclusive right to buy the player's services for the next season. In practice, it often ties a player to a team for his entire career, because under a reserve clause exclusive rights are retained by the team whether the athlete plays or not. A player may be transferred from one team to another only if the team owning his services releases him from his contract or allows another team to buy his contract and negotiate with him.

**BOX 1**

## THE ECONOMICS OF BASEBALL STRUCTURE

Organized baseball acts like a "cartel." It restricts competition in business practices, regulates entry, and divides markets among teams in the two major leagues and several minor leagues. The antitrust exemption has encouraged teams to collude and to set up explicit business rules which are codified and open to public scrutiny. Output is limited by restricting the number of league franchises and the location of the teams. The establishment of territorial rights for each team prevents expansion teams from raiding another team's home territory. In addition to receiving income from admissions and concessions, teams benefit from the sale of radio and TV rights. Here again, rules limit competition in selling the industry's product. Leagues control the right to national broadcasts and each team holds exclusive rights to broadcast locally all home games that are not part of the league's national package. Professional baseball also has a complex set of rules dealing with interteam competition for players, the industry's most important production input. The rules governing the acquisition of new and veteran players are at the heart of the dispute on sports business practices.

In a cartel, cooperative behavior among the teams will assure greater profits than a competitive system. Yet, a particular team may increase its profits if it can convince all other teams to abide by the rules of the cartel and then itself cheat on the regulations.

BOX 1 (Continued)

For instance, a team could benefit by negotiating with players on other teams as long as the other teams do not reciprocate. To prevent secret negotiations with individual players, baseball has a "no-tampering" rule against bargaining with a player whose contract is owned by another team. Such rules, which are difficult to enforce, require serious penalties to dissuade member teams from violating them.

Organized baseball displays another cartel feature—a lack of innovation. Changes on most matters require a three-quarters majority vote in the league. Thus, on issues affecting both leagues, a mere four teams can thwart a change in major league rules. The voting rules make it difficult for organized baseball to respond to opportunities for profitable innovation. Critics claim the lack of innovation partially accounts for baseball's inability to keep its share of the total sports dollar.

Perhaps because the cartel has been slow to adjust to external changes eroding profitability, the sketchy financial data available indicates that few baseball teams are big moneymakers. The Los Angeles Dodgers and the New York Mets are probably the most profitable; they are located in large metropolitan areas and draw around two million fans apiece. In the American League the Baltimore Orioles, winner of the World Series in 1970, earned only $345,000 after taxes that year on revenues of $4.6 million—and their profit figure was believed to be the highest in the league. In 1970, a survey revealed that only half of the major league baseball teams netted an after-tax profit or broke even.* However, because of the special tax advantages of sports enterprises, such as depreciating the value of player contracts, baseball teams may actually be more profitable than the accounting figures would suggest.** Current profit figures also ignore capital gains resulting from increases in the value of the franchise.

*"Who Says Baseball Is Like Ballet?" *Forbes,* April 1, 1971, p. 30.

**Tax shelters traditionally open to sports enterprises may be threatened by a U.S. District Court ruling last February against the Atlanta Falcons. The Court reduced the allowable depreciation reductions on football player contracts and ruled that TV rights could not be depreciated. The uncertainty of tax advantages from depreciation may reduce the market value of pro sports franchises.

The player reservation system is intended to limit competition among teams for the services of players. The agreement not to compete is the key to the reserve clause's effective operation. If a particular team tries to negotiate with a player to see if he is interested in changing teams, it runs the risk of being severely penalized. By restricting the right of a player to negotiate with another team while under contract to his current team, the "no-tampering" rule deprives the player of his freedom to choose his prospective employer or place of employment. The officially stated reason for the reserve rule is that it "inhibits the moneyed clubs from acquiring all of the best talent."[1] Supporters contend that the reserve clause does tend to equalize the strengths of the poor and

[1]U.S., Congress, House, Committee on the Judiciary, Subcommittee on Study of Monopoly Power, *Organized Baseball,* 82d Cong., 2d sess., 1952, p. 105.

the rich teams. This rule is also said to ensure the honesty of the game by bolstering public confidence that players are competing to win. It is feared that a player negotiating with another team would lack the "winning spirit"—this could raise suspicions of a fix if he muffed an easy play.

## DRAFTING

**New Player Draft.** Central to the player reservation system is the new player draft. This draft was established in 1965 when the baseball cartel realized that bonuses to amateur players were costing teams big money. Here's how it works. The names of the eligible amateur players are pooled and the teams draft the negotiation rights in reverse order of the won-lost standings. The lowest-ranking team then gets first pick of the new player draftees. The new player and the team that has drafted him have six months to negotiate a contract. During this period, the player may not negotiate or make a deal with any other team. If the player and the drafting team cannot reach an agreement, then the player returns to the pool to be drafted by a second team in the "secondary phase" of the draft. The six-month bargaining period in baseball puts the player in a slightly better negotiating position than in football where if a player cannot conclude a contract with the assigned team, he has no alternate means for reaching an agreement to play for another team. The limited time period in baseball also gives some encouragement for a team to offer a signing bonus.

The arguments advanced for the new player draft are essentially those given for the reserve clause. The primary purpose was to end the competitive bidding through bonuses which were transferring wealth from the club to the players. By drafting in the reverse order of standing, it was also argued that the weaker teams would benefit relatively more than the stronger ones.

**Veteran Player Draft.** Although a major league baseball team is limited to carrying about 25 players on its active roster, it may have up to 15 more players under exclusive contract. These "protected" athletes play for minor league teams affiliated with the parent club. Players *not* on the protected roster of major league teams may be reallocated by means of a veteran player draft at the end of each season. This draft attempts to equalize playing strengths by limiting direct competition for the player. First, teams draft players in reverse order of standings for a stipulated amount, currently set at $25,000. This means a team cannot bid for a player's services by promising a higher salary or offering to place him on its protected roster. Second, the drafted player must be placed under exclusive contract, thereby releasing one of the protected players and making him eligible to be drafted by other teams. Like the draft, limits on the number of protected players are alleged to equalize team strengths. Team owners argue that, otherwise, championship teams would keep too many players under exclusive contract, thereby depriving lower-ranked teams of playing talent.

**"Waiver Rule."** Sales of player contracts are also limited by the "waiver rule." A team wishing to sell a player's contract must "clear waivers"—that is, each team in the league must have the opportunity to buy, at a fixed price, the exclusive rights to bargain with the player. Acquisition rights for waivered players are tendered in reverse order of team standing. In baseball, even after a player is waived, he may not be free to negotiate with teams in the other league. The waiver rule is another means of restricting competition for veteran players.

## THE RESERVATION SYSTEM: WHO BENEFITS, WHO DOESN'T?

Economic logic and statistical studies say a great deal about the alleged benefits of the player reservation system. First of all, economic theory suggests that artificial mechanisms designed to promote equal playing strengths among teams are unnecessary. Indeed, it runs against the economic interests of a team to become overloaded with star players. Second, even if equalizing team strengths were desirable (perhaps because team owners don't behave as economic logic would predict), the player reservation system fails to perform this task. The reason is that it doesn't prevent the most talented players from being transferred from one team to another.

The player reservation system does have some economic effects, however. It increases the financial security of team owners, for example. It does so principally by keeping player salaries lower than they would otherwise be. Financial losses to the players are considerable. Lower salaries mean that prospective players devote less time and energy to developing batting and fielding skills. The overall level of individual team quality is lower as a result.

**Playing Strengths.** In their support of the player reservation system, team owners view the necessity of a mechanism for equalizing playing strengths as axiomatic. Economic theory, however, suggests it's highly unlikely that the financially strong teams would buy up *all* the star players if released from the reserve clause. Any team that tries to buy up the most capable players will reach a point where it will forego the services of an additional talented player. This happens because a team has an incentive to win by a close margin rather than by clobbering its opponents. Close contests with an element of uncertainty are considered more exciting and more likely to attract fans. If lopsided sports contests discourage attendance, it will not be in the best economic interests of a strong team to buy up all the talent in the league. At some point, therefore, a strong team will be willing to pass up the services of another topflight player and see him play for another team.[2]

Supporters of the reserve system may counter that team owners may receive psychic satisfaction from hoarding expert players. Hence, the current setup is required to prevent unequal distributions of talent. Economists retort that the reserve clause and player drafts are unequal to this task. The reason is that resources tend to move toward their most highly valued uses (given well-defined property rights and small costs of exchange). The player reservation system fails to prevent player transfers from one team to another for cash or other players. If a player's services are worth most to the team having exclusive rights to his contract, then no other team will want to pay the current owners enough to bid him away. But, if the player's services are valued more highly by another team, and if the costs of transferring the player's contract are small, the team that values him most will bid the contract away from the current owners. Thus, each player will play for the team which gets the highest return from his service—the same as in most other professions operating in a free market. Player sales and trades also probably offset any equalizing effects that the new and veteran player drafts have on team strengths.

[2]A rich team will not purchase an unlimited number of talented players. This point is well explained by Simon Rottenberg in his classic article, "The Baseball Players' Labor Market," *Journal of Political Economy* 64 (1956): 301. "Beyond some point—say, when a team already has three .350 hitters—it will not pay to employ another .350 hitter. If a team goes on increasing the quantity of the factor, players, by hiring additional stars, it will find that the total output—that is, admission receipts—of the combined firms (and, therefore, of its own) will rise at a less rapid rate and finally will fall absolutely. At some point, therefore, a first star player is worth more to poor Team B than, say, a third star to rich Team A. At this point, B is in a position to bid players away from A in the market. A's behavior is not a function of its bank balance. It does what it calculates it is worthwhile to do; and the time comes when, in pursuing the strategy of its *own* gains, it is worthwhile, whatever the size of its cash balance, to forego the services of an expert player and see him employed by another team."

Thus, in theory, the distribution of playing talent between rich and poor teams is not affected by the reserve clause.[3]

In practice, even if a player reservation system is in effect, imbalances between weak and strong teams persist. The reserve rule has not frustrated those teams willing to outbid others for players. Franchises in areas with high drawing-potential (usually big cities) have a stronger economic base and are apt to develop stronger teams than franchises in low population areas. A look at the evidence indicates that teams in high drawing-potential areas win more than their share of championships. If team strength is measured by pennants won, from about 1900 to 1970 the four largest cities in the American League won 49 out of 68 pennants while the four largest cities in the National League won 41 out of 70.[4] These big city teams tend to bid some star players away from the low drawing-potential teams, which are usually based in smaller cities that generate lower "live gate" and TV revenues for the home team.

The limited evidence available also suggests that the distribution of playing talent is probably much the same with or without a player reservation system. A recent study was made of three four-year periods, beginning with the years 1876–79 before the reserve clause became operative in 1880 on a partial basis. During both of the successive four-year test periods, the reserve clause was extended to more and more players, yet the study uncovered no significant differences in talent distribution for the three periods.[5] The quality of the teams was measured by such factors as the number of years that teams won successive championships and the average percentage of games won (won-lost record) by a championship team. Similarly, more recent data for baseball, football, basketball, and hockey show no consistent relationship between talent distribution measures and the presence or absence of a free-agent draft.[6]

**Financial Security.** Although the player reservation system doesn't appear to equalize playing talent among the rich and poor teams, owners of the poorer teams do receive greater financial security. First of all, the reserve clause reduces their labor costs compared to competitive bidding. Secondly, it assures financially weaker teams exclusive rights to an asset that can be sold to richer teams. Thus, by financially aiding teams in less populous markets, the league becomes more viable.

Similarly, the new player draft is a subsidy of sorts to the weaker franchises. Since the teams draft in reverse order of standings, the weaker teams get preferential treatment. Likewise, the veteran player draft redistributes income toward the financially weaker teams. These teams purchase players from the powerhouse teams at a below open-market price; thus, the drafting teams gain wealth equal to the excess of the market price over the draft price. The rich teams apparently think it worth their while to support

[3]Under a reserve clause, a player will theoretically be transferred to the team for which he generates the most revenues. For example, suppose a player is worth $75,000 to the Philadelphia Phillies and $100,000 to the Atlanta Braves, and his contract is currently held by Atlanta. The Phillies will be willing to pay a maximum of $75,000 (and probably less if they hope to gain revenues by paying the player less than his value to the team). However, as long as the Braves are willing to top that figure, the player will remain on their roster.

Conversely, if the player is currently playing for the Phillies, both teams will benefit by transferring the contract to the Braves at any price between $75,000 and $100,000. At any price over $75,000, the Phillies will benefit from the sale of the contract while the Braves will be willing to pay as much as $100,000.

[4]James Quirk and Mohamed El Hodiri, "The Economic Theory of a Professional Sports League," in Roger G. Noll, ed., *Government and the Sports Business* (Washington: The Brookings Institution, 1974), p. 48.

[5]Michael E. Canes, "The Social Benefits of Restrictions on Team Quality," in Noll, op. cit., p. 85.

[6]Ibid., p. 88.

the league by bearing a larger share of the financial burden. Of course, the player reservation system is only one of many schemes which could be employed to redistribute income among league members. For example, a change in the way gate receipts are shared could also affect a redistribution of income.

**Player Salaries.** While the owners of the poor teams may receive some benefits relative to the rich teams, the limitations to labor mobility inherent in the player reservation system clearly reduce the financial return to the player. In fact, *the redistribution of income from the players to the owners is the primary economic effect of the player reservation system.* The player can only negotiate with the team holding exclusive rights to his contract; he cannot choose from among several bids in a free labor market where he would be paid his full value to the team. Thus, a differential can exist between the player's salary and his "worth" to the team. The cash sale of players from one team to another suggests that players receive less than they would under a competitive bidding system. The player reservation system simply gives the money acquired in exchange to the team owners instead of to the player.

The redistribution of income from players to owners leads to several secondary effects. First, lifetime player earnings are less. Not only is the player's salary lower in his first contract than it would be under competitive bidding, but he cannot expect to make up the current shortfall at anytime during his playing career. Before the free-agent draft, when big bonuses were common in the competitive bidding for new players, the bonus would at most equal the value today of the wages lost in the future as a result of the player reservation system. Thus, the player did not suffer reduced lifetime earnings. With the institution of the new player draft in 1965, direct price competition was restricted in the market for amateurs and bonuses fell considerably.

One study that estimated the extent of the wages lost under the reserve clause for three qualities of players found that baseball players suffer a financial loss of "considerable magnitude."[7] Over their playing careers, average players are paid about 20 percent of the net revenues they generate for the team. (Net revenues remain after training and other costs have been subtracted.) Star players are paid about 15 percent of the net revenues they generate. Ironically, only mediocre players are paid more than the revenues they generate over their shorter playing careers.

**Team Quality.** Since the restrictive rules in the baseball labor market reduce player salaries, skill levels and team quality are reduced over the longer haul. Amateur players can be expected to devote less effort to bettering their skills if they face lower potential earnings. Since prospective players are free to choose alternative earning possibilities, lower player salaries will also reduce the quantity of baseball talent supplied, and those amateur players who actually do become professionals will have invested less resources to sharpen their natural skills.[8] Thus, the fans as well as the players suffer under the current setup.[9]

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[7]Gerald W. Scully, "Pay and Performance in Major League Baseball," *American Economic Review* 64 (1974): 929.

[8]Disagreement exists over whether society benefits from higher average skill levels and higher salaries for baseball players. For instance, a player paid a free market salary may feel his income has increased enough for him to substitute some leisure time for time spent in his playing career. Also, if star players receive huge salaries, amateurs are encouraged to devote more effort to sharpening their skills. For those who don't make it, some people think the effort is wasted.

[9]An argument can be made, however, that a competitive system promotes too high a level of team quality because it does not account for external factors which affect other teams in the league. For a further explanation, see Canes, op. cit., p. 94.

## MODIFYING THE PLAYER RESERVATION SYSTEM

Supporters of the player reservation system claim that it equalizes team strengths. But economic logic and evidence indicate that the system hardly affects the distribution of playing talent. So, the primary benefit of restrictive labor practices in baseball may well be a fiction. At the same time, the player reservation system imposes heavy costs on the players in terms of lower wages and reduced employment choice. Thus, it may be worthwhile to consider alternative ways to achieve the secondary benefits of the reserve system—greater financial security for weaker teams—so that the reserve clause can be modified or eliminated. The player association is already moving against the player reservation system. Suits have been filed in the courts to place baseball's restrictive labor practices under Federal antitrust laws. (See Box 2.)

Some alleged benefits of the reserve clause—more equal playing strengths, greater financial gains for the weaker teams—could be met by dividing income more equally among the teams. For example, if the present 80–20 (American League) gate-sharing arrangement between home and visiting teams were altered to share revenues more equally (as in football), financial disparities among the teams would be reduced. That way a team based in a smaller population area of, say, 1.5 million would receive a larger proportion of revenues on the road and would increase its profits even if the team drew the same number of fans at home. Alternatively, it has been estimated that equal revenue sharing between home and visiting teams would reduce the number of fans needed at home to maintain the same profits, so that the minimum viable size for a franchise area would be reduced from 1.9 to 1.5 million population.[10] An even-gate split would benefit several teams by making them more financially viable. Similarly, a team's monopoly on local broadcasting revenues in its home territory—the visiting team does not receive a share of the revenues from local broadcasts—could be modified to divide income more evenly with the same effects.

If owners as a group can realize the financial benefits of the reservation system in some other way, modification of these labor practices should be easier to accomplish. One suggestion is to combine the reserve clause with some kind of an option clause. In football, an athlete who plays out his option takes a 10 percent pay cut from his previous year's salary (which may amount to a higher percent cut of what he would have earned if he were a good player). He remains with the same team for the current season and then is a free agent who can negotiate with any other team in the league. A fairly liberal option rule in baseball could go a long way toward remedying the restrictive employment choices and the reduced lifetime earnings for the player offered by the reserve clause.

U.S. Senate hearings on the proposed basketball merger in 1972 resulted in several conditions which had to be met to obtain an antitrust exemption. Some of these could be suggested to the player association for collective bargaining in baseball. The proposed bill (which eventually died) provided that veteran player contracts were to have a negotiable duration, after which the player was free to switch teams. This proposal goes one step further than the option clause by eliminating it altogether. Another proposal would retain the amateur draft but obligate the rookie to play for the team that drafted him for at least two years, then free him to negotiate with any team. Both these measures would increase player mobility and free employment choice.

Federal legislation may well modify the player reservation system. In 1972, legislation was introduced in Congress to establish a Federal commission to regulate drafting procedures and other labor practices involving

[10]Roger G. Noll, "Attendance and Price Setting," in Noll, op. cit., p. 131.

**BOX 2**

## ASSAULTS ON THE RESERVE CLAUSE AND OTHER RESTRICTIVE LABOR PRACTICES

Baseball has been exempt from antitrust laws ever since *Federal Baseball Club* v. *National League* (1922), when the Baltimore club of the Federal League sued the American and National Leagues for attempting to buy out the members of the Federal League. The Supreme Court ruled that baseball games were exempt from antitrust because they were "purely state affairs"; interstate commerce was not the "essential thing." Thus, baseball was not subject to Federal jurisdiction over interstate commerce and the Baltimore club was not harmed "by reasons of anything forbidden in the antitrust laws." Although numerous court challenges have been made to this ruling, it has never been overturned. When professional football was placed under Federal antitrust laws (*Radovich* v. *National Football League*), the Court was pressed to make the rulings on football and baseball consistent and confessed that "were we considering the question of baseball for the first time upon a clean slate we would have no doubts" about nonexemption.*

The Court justified the continued exclusion of baseball from antitrust laws by passing the buck to Congress, which had shown little inclination to bring baseball under these laws in the preceding years, and concluded that the most appropriate way to redress the situation (if indeed, redress is called for) is "by legislation and not by court decision." Congressional reluctance to close the loophole stirred another player, outfielder Curt Flood, to turn once again to the courts. However, by 1972, the dependence of baseball structure on the legal precedents proved too difficult to overcome, and Flood lost his challenge. The majority holding reaffirmed the earlier court rulings, citing the "positive inaction" of Congress, which "allowed those decisions to stand for so long . . . and has clearly evinced a desire not to disapprove them legislatively."**

Recently hopes for a reversal were raised from another quarter. Last December a Federal judge handed down a decision concerning former quarterback Joe Kapp which could have implications for the reserve systems governing baseball, basketball, and hockey. The "Rozelle Rule" allows the football commissioner to determine compensation when an athlete plays out his option—that is, plays one more year at 90 percent of his previous salary and becomes a free agent—and accepts an offer from another team. This rule was declared an unreasonable restraint and illegal because by setting a high indemnity, the commissioner can block a player's employment choice. The decision also found that the "no-tampering rule," which operates much the same way in football as in baseball to prohibit players under contract to a team from negotiating with other teams and to provide penalties for violators, unduly restricts free employment choice. It

**Radovich* v. *National Football League*, 352 U.S. 452 (1957).

***Curtis C. Flood v. Bowie K. Kuhn et al.*, 407 U.S. at 283–84 (1972).

**BOX 2 (Continued)**

is this latter finding which antitrust enthusiasts hope can somehow be broadened to include baseball.

Meanwhile, assaults on the web of restrictive labor practices are coming from another Quarter—the player association. Although the Major League Players Association, the union, represents only players on the roster of the major league teams, it has the potential to affect labor relations greatly. Collective bargaining has resulted in major gains for baseball players, notably by allowing them to have a lawyer present when negotiating a contract. Baseball also has a three-man arbitration board to settle disputes such as that between Catfish Hunter and Charles O. Finley, owner of the Oakland A's. One member represents the players union, a second represents the major league owners, and the third is an impartial arbitrator. The board gives the players an advantage over the "one-man rule" policy in football that was found illegal in the Kapp case. Although the baseball players association has tried to place the player reservation system on the agenda for collective bargaining, so far the owners have refused to negotiate at all on the reserve system. However, the 1973 baseball agreement calls for a three-year study of ways to revise the player reservation system and will serve as a basis for negotiations in 1976.

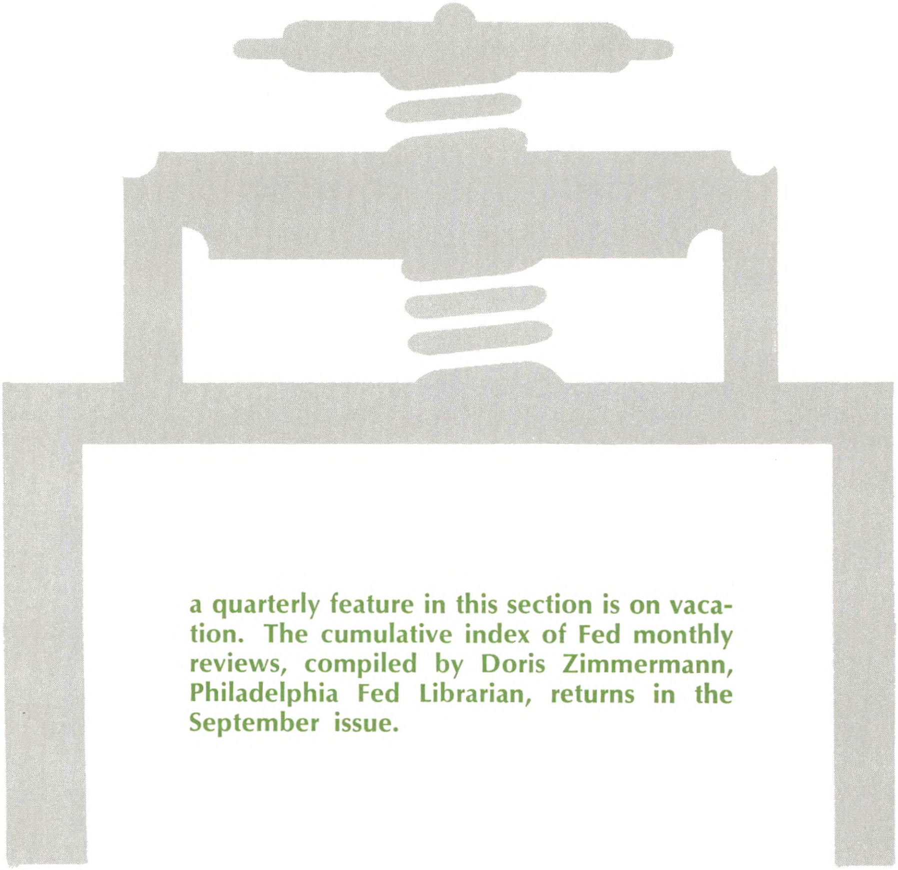
restriction on competition, but the bill died in committee. The proposed bill to set conditions under which an antitrust exemption would be granted for the proposed basketball merger also hints at the possibility of government action. In any case, after the player association, Congress may be the most likely source of change in business practices in the sports labor market.

## A LOOK AT THE FUTURE

Economic analysis of the baseball labor market sheds some light on the effects of the present system and possible ways of modifying it. Economic theory does not support the claim that the player reservation system reduces the disparity between the strong and the weak teams. Playing talent is probably distributed much the same with or without a reserve clause. Team owners benefit from the restrictive labor practices because income which would otherwise be paid to the players is kept by the owners. Financially weaker teams also benefit from the player sales which transfer funds to them at the expense of the richer teams. However, the financial costs to the players are quite high under the player reservation system. Studies have shown that players are paid considerably less than the net revenues they generate for their team. Since playing skills respond positively to salary increases, lower player salaries inhibit the amount of prospective skills produced and result in lower team quality as well.

Because of the magnitude of the economic losses suffered by the players, chances are that the player reservation system will be modified in the near future, either through efforts by the player association, through court suits, or, as a last resort, by Congressional action. The crucial test will probably come in 1975–76 when the player association and the team owners negotiate a new agreement. One way out might be to combine a more equal distribution of revenues for the weaker teams with an option clause or long-term contract for the players.

# THE FED IN PRINT...



a quarterly feature in this section is on vacation. The cumulative index of Fed monthly reviews, compiled by Doris Zimmermann, Philadelphia Fed Librarian, returns in the September issue.

FEDERAL RESERVE BANK of PHILADELPHIA
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**business review**
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