**Dealing with Private Losers: Sports Governance, the Coase Theorem, and Public Choice Theory**

**Stephen F. Ross**

**Pennsylvania State University**

A prolific scholar of the economic analysis of law, Michael Trebilcock, has just added another important contribution to the literature, *Dealing with Losers: The Political Economy of Policy Transitions.* The book concerns when and how to compensate those who are adversely affected by changes in government policy. Trebilcock rejects fundamentalist one-size-fits-all arguments, principally emphasizing the need for compensation (he prefers the term “transition mitigation strategies”). He bases his preference both on theories of justice widely shared in society as well as an important pragmatic argument that stakeholders who perceive they will be seriously injured by a new public policy may be able to block proposals otherwise in the public interest unless they are compensated.

The related question of when and how law should require private compensation of those who are adversely affected by acts of private parties is the subject of the Nobel-prize winning contribution by another law and economics scholar, Ronald Coase.[[1]](#footnote-1) This work is also fairly characterized as a work of political economy, arguing that legal rules need only to be clear and consistently enforced. Adopting a standard economic model that assumes all parties have perfect information and there are no bargaining costs, the Coase Theorem holds that private parties will bargain toward the optimal result for all concerned regardless of how legal rules allocate rights. The simple illustration is the problem caused by two farmers, one with wandering cows and the other with crops. The Coase Theorem says that with the key assumptions of perfect information and no bargaining costs, the legal rule is irrelevant: if liability is imposed on Farmer Jones when his cow tramples Farmer Smith’s crops, Jones will build a fence; if no liability is imposed, Farmer Smith will build the fence.

A critical corollary to this insight, however, is Coase’s view that where imperfect information or significant transaction costs are likely to inhibit efficient bargaining, the legal system has to consider how best to allocate rights.

As Trebilcock astutely notes in his new book, both formal mechanisms (such as the design of the United State Senate, giving disproportionate representation to farm states), and the insights of public choice theory (describing how a minority of citizens can use the political process to block legislation that would serve the public interest) effectively give those adversely affected by legislation the ability to preclude the majority from enacting welfare-enhancing laws.[[2]](#footnote-2) His book is a study on how compensation schemes might be used to facilitate passage of these laws with a minimum of social harm. His key thesis (p. 29) is that properly designed transition mitigation strategies can assuage these “losers” – those who are adversely affected by legislation or other policy changes that on balance promotes the overall public welfare -- through direct cash compensation or a variety of creative and complex alternatives, so that society is the ultimate “winner.”

The author selects a brilliant case study to begin his analysis: the abolition of slavery in the British Empire (p.1). Unlike the United States, where abolition was effectuated by a constitutional amendment following a bloody civil war at a cost of over 600,000 soldiers’ lives, British slavery was abolished by an ordinary legislative act of Parliament. However, because at the time the House of Lords had the power to defeat legislation and that chamber was dominated by aristocratic landholders, many of whom owned slaves on colonial properties, the Act provided for massive compensation (equivalent to US$21 billion in present day value) that constituted forty percent of the government’s budget.

These insights can be applied in another important context: private collaborative agreements. For a variety of reasons, private parties will often find it desirable to enter into contractual relationships, particularly in multi-party ventures, that grant individual stakeholders, or a minority of stakeholders, the ability to veto changes in venture activities that might affect them adversely. Adopting the Williamsonian approach of explaining business structures as techniques to minimize transactions costs,[[3]](#footnote-3) one can explain these veto rights as means to avoid costly ex ante contracting about unforeseen future events; parties can be assured their own concerns will be protected as long as they have these veto rights.[[4]](#footnote-4)

Trebilcock’s insights regarding public policy apply to private strategy as well. The book discusses “losers” in public policy settings and their power to claim public compensation, and the challenges at providing transition mitigating strategies in a manner that is consistent with other public policies. But this is quite similar to the ability of “private losers’” to claim compensation based on contract rights, when their business partners wish to pursue innovations that cause them harm but make most of the parties better off. This essay considers a variety of specific suggestions Trebilcock makes and how they might be applied by private parties seeking to profit from positive innovations (“winners”), where consent to proceed is contractually assigned to private “losers.”

1

In a variety of contexts, the application of the Coase Theorem to private arrangements suggests that that allocation of rights under the initial contractual agreement will have no effect on the ability of the parties to achieve an efficient result. Once again with the critical assumption of perfect information and no bargaining costs, if an innovation creates more economic benefit for Party A than it causes harm to Parties B and C, then Party A will easily secure the other parties’ assent to the change by making appropriate side payments. However, Coase’s analysis suggests a significant strategic and management problem if the parties lack sufficient information about the true costs and benefits of the innovation, [[5]](#footnote-5) or if other transaction costs preclude the assent of B and C.[[6]](#footnote-6)

One common scenario where this might occur include multi-party real estate ventures whose foundational contract gives each party veto over major sales or acquisitions, where a particular deal is highly profitable for the entire venture, but might have an adverse impact on unrelated business interests of one of the parties. Another fairly common example might be a supply chain where one of the parties seeks to change long-standing agreements to implement an innovative way to save itself lots of costs, where the change will have an adverse effect on its immediate upstream and downstream partner.

Although these problems are certainly worthy of serious thought by executives, management consultants, and business school professors, they are typically not a serious public policy concern; most firms lack any kind of economic power, so that if they are unable to implement an efficient innovation, the harms are suffered by the companies and their shareholders, not the public. These inefficiencies become a source of genuine public policy concern when consumers cannot easily switch their patronage to other sellers.[[7]](#footnote-7)

2

The sports industry, in particular, features business entities – sports leagues – that possess dominant market power and are structured so that individual firms – clubs – can veto potentially innovative and efficient changes that are in the best interests of the entire venture, but contrary to their club’s parochial interests. In a world where all parties had very good information about the costs and benefits of a change, and where bargaining costs were not significant, the contractual power possessed by “losers” should not significantly affect the efficient result. Economic analysts seem generally to agree, for example, that the Retain and Transfer Rule employed by agreement among all English football clubs in the 1950s (similar to the Reserve Clause used in Major League Baseball, tying a player to his club for life) did not significantly affect where players played, even though a player could not leave the club to whom he was under contract without the team’s permission under most circumstances. As clubs routinely sold the right to contract with a particular player to other clubs for cash, there was a robust market.[[8]](#footnote-8) If Scunthorpe United had the right to a player’s services, and Manchester United valued the player’s services more, the latter club would pay a transfer fee to the former. If the contract did not exist, and the player was free to accept competing bids for his services, Manchester United would pay the same amount to the player in increased salary.

In some cases, the lack of information can demonstrably preclude efficient re-allocations. One example publicized during antitrust litigation was the case of American football player Dick Gordon.[[9]](#footnote-9) In 1970, Gordon led the National Football League in pass receptions. When his contract with the Chicago Bears expired at the end of the 1971 season, he sought competing offers for his services. None were forthcoming because of an agreement among owners to abide by the “Rozelle Rule” that required compensation to the Bears for losing Gordon’s services. After NFL Commissioner Pete Rozelle intervened to announce that the compensation would be set at one first round draft choice, several clubs bid on Gordon’s services and he signed with the Los Angeles Rams. In many cases, owners do not know how to quantify the effect of change, and therefore resist it instinctively.

In other cases, significant bargaining costs can result in a sports league enduring sub-optimal results for many years. A well-known sports example is the relocation of Montreal Expos baseball franchise. Taxpayers in Montreal showed no inclination to spend public money to upgrade the stadium in which the Expos played, creating serious revenue problems that caused the team’s performance to suffer, creating serious loss of patronage. At the same time, taxpayers in Washington, DC were eager to provide public support for a new stadium, as well as a metropolitan market capable of supporting a highly successful franchise. While relocating from Montreal to Washington would clearly be a profitable move for the club, it had potential adverse effects on the nearby Baltimore Orioles. Orioles owner Peter Angelos engaged in protracted negotiations (enhanced by his credible threat to undertake costly litigation based on his career as a famous trial lawyer) before the parties agreed to an enormously complex compensation scheme.

3

Trebilcock observes that virtually no major changes in life are Pareto optimal (p.1), and one of the challenges in dealing with losers is the behavioral economics insight that we tend to overestimate losses from what we already have (p.22). This is particularly true in sports. Because on-field success is so important to both the economic and non-economic motivations of club owners, the zero-sum aspect of competitive sports exacerbates this problem. Club executives object to innovative changes not only when their own club is made worse by the specific change, but even when the innovation is likely to improve the club’s fortunes, if they perceive that a rival club will improve even more.

Although the public choice theory literature about these problems is often pessimistic and cynical, Trebilcock is more upbeat, particularly focusing on the need for leadership and expertise. Applying his insights to private multi-party agreements containing veto rights (brackets are my application, not his), his “nuanced view” (p. 151) suggests that “[business] leaders with a sensitivity to deep-seated cultural beliefs and historical development as well as an understanding of the currents and cadences of [business] discourse and debates are often able to craft policies that move a generally [profitable] reform agenda forward.”

His key practical insight is the need for innovation advocates to properly frame the issue for stakeholders (p.26):

Because individuals’ normative values, such as notions of fairness and justice, are conceived of as general principles and may often be in competition with one another, the way in which those values are manifested in assessments of the fairness of policy proposals and the justice of (non) compensation or (non) mitigation will vary based on the way in which they are framed.

This is where lawyers and strategic consultants can add value: by devising ways to frame the issue for stakeholders.

Often, proposed policy changes will have uncertain effects on stakeholders. Their evaluation of the direction and magnitude of effects is critical when they have a veto over implementation. In this regard, Trebilcock observes (p.22) from the psychology literature the “availability heuristic” that individuals tend “to base their estimates of probability and importance on particularly salient information they can readily call to mind (often because of historic personal experiences). The problem with this proclivity is that memorable events are often unrepresentative. Relatedly, individuals also tend to improperly weigh new information.” All this suggests the need for careful advocacy and leadership. (A well-known example of success in addressing this particular concern is the famous patience and marathon phone-call leadership style of former MLB Commissioner Bud Selig.)

Another key insight for those who seek to frame issues comes from experimental research that suggests that “individuals are willing to make personal sacrifices in order to punish what they believe to be unfair or unjust behavior (p.23).” In private settings, this insight might be useful in persuading stakeholders to forego compensation, but can also be used strategically by those adversely affected by innovation to solicit others to join them in their opposition. This is particularly true because of another insight about group dynamics that Trebilcock notes (p.23): “when people find themselves in groups of like-minded people who perhaps share a moderate predisposition to a particular view of an issue, they are likely to move to more extreme versions of this view through group interactions and reinforcement...” Sports labor negotiations might be useful illustrations of these phenomena working in tandem: not only do collective bargains involve significant trade-offs between labor and management, they involve trade-offs within labor and management as well. Agreements are inhibited by the ability of those who perceive they are unjustly victimized (particularly by demands from the other side of the table) can mobilize allies to harden positions.

The literature Trebilcock cites provides the transition to another key part of his analysis that may seem to play a much broader role in public rather than private discourse: the rule of fairness and justices in implementing policy changes. It appears more difficult for private as well as public stakeholders to oppose innovations that they perceive as fair, even if harmful to parochial self-interest. (Of course, for this very reason adversely affected parties often perceive the proposed innovation as unfair to them.) Here, Trebilcock emphasizes the role of reliance (p. 27). Where a policy change’s impact is adverse because of a party’s previous investment decisions that were based on existing rules, the opposition to implementation without compensation becomes much greater. Here is also where appeals, in understandable lay terms, concepts of moral philosophy (efficiency, utilitarianism, Rawlsian theories of justice, communitarianism) can be brought into the rhetorical mix (pp. 9-15).

In his case studies, Trebilcock returns to the broader theme of loser’s needs (captured in some sense by notions of reliance) in a number of different ways. Two are most salient for private multi-party deals, such as sports ventures. Trebilcock observes that a policy change that will deprive a stakeholder of necessities is one where there is particular cause to devise appropriate compensation. At the same time, by refocusing policy on compensation for the needy, the costs of compensation can be minimized, and the claims of non-needy losers might be overruled. (He uses the case of pension reform to illustrate the point, see chapter 3.)

Another important policy insight is to identify when current policies have been capitalized into the value of an investment, so current owners may not be earning vast profits. Trebilcock’s example is agricultural subsidies and their effect on land values (p.82):

Farm groups threatened by such changes will often have strong financial incentives to oppose reductions in support, and may be aided in opposition efforts by a concentrated interest group advantage, public sympathy for farmers, concerns about food security and foreign dependence, ignorance among consumers or taxpayers, and institutional features of local political systems, such as the disproportionate weight accorded to rural electorates and the high number of “veto players.” The presence of these factors increases the likelihood that compensation or other forms of transition cost mitigation will be necessary in order to implement reforms that are in the general public interest.

Here, Trebilcock suggests that creative phase-out provisions are necessary.[[10]](#footnote-10)

Related to Trebilcock’s key theme -- that the effective way to deal with “losers” is to frame the issue in a manner that permits innovations to go forward with either loser acquiescence or compensation – is his summary of what he calls (p. 24) “ideational claims.” These include “beliefs about the appropriate ordering of society.” These core beliefs tend to remain relatively static, “and serve as an important foundation to which policy proposals must generally be tied, in one form or another, in order to gain popular acceptance.” Because these values and beliefs tend to be understood and articulated at a high-level of generality, skilled innovation advocates can translate and simplify their arguments “in order to appeal to individuals’ senses of fairness and appropriateness.” Again, as with other insights, this emphasizes the importance of “strategic framing and communication.”

The gains from trade where business entities can overcome information and bargaining costs to achieve optimal results presents valuable opportunities for those who are experts, both in providing information and developing effective strategies to overcome opposition or create compensation schemes necessary to secure acquiescence. Experts can “construct cognitive frames that successfully link their preferred approach to existing values, ideas of fairness, and other underlying currents of [business] culture” (p. 25). These can include “construction of simple right-versus-wrong frames,” “invoking symbols and stores to enable actors ... to make sense of the situation,” calling on those with power and influence to employ their skills to accomplish the desired objective, and to hold more powerful actors accountable.

Overcoming contractually-assigned vetoes in private business contexts is, in some ways, easier than overcoming politically-assigned vetoes regarding public policy. While in some political contexts, the majority needs to be persuaded of the fairness of using tax dollars to compensate a minority of ‘losers,’ the need to compensate a business entity that owns a contractual veto right may be more readily apparent to other business partners.

Some cultural norms in private business (at least in the sports industry, about which I am most familiar) currently pose some challenges for those who may consider privatizing Trebilcock’s analysis. There are many skilled professionals in democratic capitals who earn substantial incomes by assembling politically salient coalitions and using a variety of in-person and public skills to “lobby” public officials to adopt public policies, including compensation schemes for ‘losers’ necessary to secure broad support.[[11]](#footnote-11) It is unusual (and, if done, perhaps confidentially) for outside parties to serve this role in private businesses, although there are surely gains from trade that would economically justify significant fees to those able to accomplish the purpose.[[12]](#footnote-12)

Michael Trebilcock’s book is an outstanding contribution on the foundation of Nobel laureates. Ronald Coase teaches that lack of information and substantial bargaining costs can prevent parties from reaching efficient results. James Buchanan and others teach that small groups can have a disproportionate impact on decisions, including blocking otherwise beneficial innovations that adversely affect their parochial interests. Oliver Williamson teaches that ex ante private contracting might deliberately grant individuals or small groups veto power over business decisions to facilitate the establishment of an enterprise and the avoidance of costly contract protections for future circumstances. *Dealing with Losers*, and effective roadmap for public policy, also provides important lessons for private business who seek to overcome information problems and bargaining to achieve optimal results.

1. Most notably, “The Problem of Social Costs,” 3 *J. Law and Econ.* 1 (1960). [↑](#footnote-ref-1)
2. To be sure, the system of checks and balances was designed to allow “virtuous” legislators to block efforts by those with disproportionate power or those who would inflame temporary passions, to pass laws contrary to the public interest. *See, e.g.,* Federalist #63. [↑](#footnote-ref-2)
3. A nice review is in the Prologue to Oliver Williamson, *Mechanisms of Governance* (1996). [↑](#footnote-ref-3)
4. Thanks to economist Phil Nelson for explaining this to me. [↑](#footnote-ref-4)
5. Related to the informational problems that may preclude an efficient agreement, a compensation scheme might call for future payments (for example the “loser” gets a percentage of the “winner’s” revenue from the innovation), and the contracting to define these future payments may be costly. [↑](#footnote-ref-5)
6. Often, sub-optimal results occur because parties don’t agree on what the law provides with regard to the allocation of rights. B might object to an innovation, A claims it has the right to innovate, B threatens to sue, and other parties hold up the deal to try to sort the mess out. [↑](#footnote-ref-6)
7. I discuss this issue from an antitrust perspective in “The Supreme Court’s Renewed Focus on Inefficiently Structured Joint Ventures,” 14 *U. Pa. Bus. L. Rev.* 261 (2011) [↑](#footnote-ref-7)
8. The practice of cash sales for players was common in Major League Baseball before World War II, but died out for a number of reasons afterward, so these conclusions did not necessarily apply by the time the Reserve Clause was challenged in the 1970s. [↑](#footnote-ref-8)
9. Mackey v. NFL, 407 F.Supp. 1000 (D.Minn.1975), *aff’d,* 543 F.2d 606 (8th Cir. 1976). [↑](#footnote-ref-9)
10. A sporting example of how some sort of differentiated, phase-in compensation might be appropriate would be the suggestion that North American “closed” sports leagues open themselves up to entry-by-merit by adopting the European system of promotion and relegation to a second-tier league. *See, e.g.,* Stephen F. Ross & Stefan Szymanski, *Fans of the World Unite! A (Capitalist) Manifesto for Sports Consumers.* The franchise values of the top clubs may not be affected by such a change; the values of marginal clubs who would be likely candidates for relegation would take a disproportionate hit, and the sharing of potential new revenues from entrants into the second-tier league might reflect this. [↑](#footnote-ref-10)
11. Trebilcock writes (p.152): “Policy entrepreneurs have the ability to share what is politically possible through advocacy, framing of issues, the provision of new information, and the creation of new fora for public consultation and debate that empower previously marginalized groups of citizens....” [↑](#footnote-ref-11)
12. Consider the recent decision by NFL owners to permit the relocation of the St. Louis Rams to Los Angeles. Perhaps “lobbyists” are just *extremely* good, but despite considerable press coverage there was very little reporting of efforts by business interests who would benefit from another Southern California location, or those who would favored or opposed the relocation of the Rams, Chargers, or Raiders, to influence individual owners whose votes determined the issue. [↑](#footnote-ref-12)