

# **Re-Negotiating the NBA Collective Bargaining Agreement**

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The current collective bargaining agreement (CBA) between the National Basketball Association (NBA or League) and the National Basketball Players Association (NBPA or Union) was signed in January 1999 and runs through June 2004. The agreement gives the League the option to extend the contract for one additional year as long as it informs the NBPA of its intention by December 15, 2003. Initial talks between the NBA and the NBPA about possibly extending the agreement past 2005 began in April.

Since the introduction of the Salary Cap in 1983, the League has used subsequent contracts, including the current contract, to achieve its primary goal of containing salary costs. The League appears to be relatively satisfied that the current contract is meeting its objectives and thus has expressed a desire to begin discussions with the NBPA to extend this contract beyond 2005. On the other hand, the players (and a handful of owners) are unhappy with many aspects of the current contract and before they agree to extend it past 2005, they will require a number of modifications to the contract.

## **History of Recent Collective Bargaining**

The principles in the current collective bargaining agreement had their genesis in what is arguably the most revolutionary contract in the history of professional sports – the 1983 collective bargaining agreement between the League and Players. Central to this agreement were three innovations, including (1) the first sports salary cap, (2) a revenue guarantee of between 53 and 57 percent for the players, and (3) a pioneering substance abuse control program that has been emulated in other sports and industries.

Since 1983, the development of collective bargaining agreements can be characterized as a cat and mouse game where the owners and players repeatedly found (or created) loopholes in the agreements with subsequent agreements seeking to close (or limit) some of those loopholes. So-called “salary slots,” balloon payments, and immediate Bird rights (notably used by both Danny Manning and Chris Dudley) are examples of loopholes that were closed by collective bargaining. The League and the Union have agreed to several exceptions which make it easier for teams to re-sign their own players (the Bird exceptions), sign rookies, or sign non-superstar players (the mid-level exception, the million dollar exception, and the minimum salary player exception).

Alarmed by expensive rookie contracts signed by Glenn Robinson, Jason Kidd, and others, the 1995 agreement instituted maximum salaries for players drafted in the first round during their first two years in the League – maximums that depend on a player’s draft position. In their third year, these players were allowed restricted free agency with teams retaining the right of first refusal on any contract signed by their players.

The 1999 agreement extended the period under which rookies were subject to the scale contracts to four years with restricted free agency not occurring until the players’ fifth year in the League. Perhaps more importantly, over time the value of these scale contracts has decreased dramatically relative to the average salary, resulting in a deterioration of the relative compensation of young Players over time.

In 1995 the League and the Union reached a secretive agreement that included a tax on high salary players (paid by the teams). After a contentious Fall in which a number of prominent players spearheaded an effort to decertify the Union, this tax was dropped from the agreement. This decertification effort also demonstrated the increasing leverage of prominent agents in the bargaining process. The League returned to this issue in the 1999 agreement, setting maximum salaries for all new player contracts. These maximum salaries are set as a percentage of the League's revenue and thus, unlike the rookie scale contracts, have not deteriorated over time.

Despite the salary cap, the closing of various loopholes, and rookie scale contracts, player salaries and benefits continued to grow to 58 percent of Basketball-Related Income (BRI) in the 1997-98 season. Thus, in the 1999 agreement an escrow tax on players and a luxury tax on teams was instituted as an additional control on players' salaries, although these taxes did not start until the 2001-02 season.

Since the 1999 agreement, the owners agreed to distribute the hundreds of millions of dollars of escrow tax and luxury tax money in such a way that serves to dramatically increase the penalties on high spending teams. The players lost an arbitration case arguing that this distribution policy was against the spirit of the 1999 agreement.

### **The League's Objectives in the Current Negotiations**

#### **Cost Containment**

The League believes that if it can contain costs, particularly player salaries, it will help to guarantee the financial health of its franchises. The salary cap itself has not been effective in containing costs, because numerous exceptions have allowed enterprising teams to circumvent the cost containment of the salary cap. On the other hand, the luxury tax and related luxury tax and escrow tax distribution policy has effectively contained salaries. Teams are extremely reluctant to sign players who might take their total team salary into luxury tax territory, and even high-spending teams have started to control their spending. For this reason, the League is pleased with the current contract and wants to extend it, even though some individual owners may be very dissatisfied with the current luxury tax/escrow tax system.

#### **Decreased Player Movement**

The League believes that decreased movement of players between teams serves to increase fan loyalty to their home teams, resulting in increased team revenues. Several provisions in the current contract help to inhibit player movement: the rookie scale contract with its restricted free agency provision, the base year compensation rules, as well as the salary cap and the luxury tax.

#### **Make All Teams More Competitive**

By discouraging teams in larger markets from excessive spending, the luxury tax helps to level the financial playing field and enables small market teams to remain competitive. The League would argue that the success of small market teams, such as Indiana, Sacramento, and San Antonio, is evidence of the success of the League's cost containment strategy. The League would argue that the cost containment measures in the current and past CBAs have allowed small market teams to remain competitive, unlike in other sports, such as Major League Baseball.

### **Increase in Individual Franchise Value**

The League wants every franchise to have an equal shot at raising its equity value, particularly those in small markets. The luxury tax has served to rein in all but three or four of the more high-spending teams. Also, by creating a structure where small market teams can be competitive, the League has increased equity values for small market teams.

### **Limitation on Young Men Entering the League**

The League has expressed a desire that some form of limitation be instituted on young players coming into the League. The League is worried that with large numbers of young players entering the League puts the League at risk for two reasons. First, lacking the training provided by the college system, players may lack the fundamentals, which long-term could result in a deterioration of the NBA product. This claim rests heavily on the assumption that young players are not trained effectively in the fundamentals in the NBA, a dubious assumption at best. Second, when American players bypass some or all of college, the League loses access to the huge exposure these players might bring with them to the NBA. In many parts of the country, NCAA basketball is far more popular than the NBA product. Having more players come through the college system is a marketing opportunity that would benefit both the League and the players. David Stern has expressed a desire for an age limitation as a solution to this young players problem.

### **Lessen the Amount of the Distributions to Low-Spending Teams**

This objective probably is not on the radar screen of the League, but it should be. With the huge luxury/escrow tax distribution checks (between \$15 and \$20 million this year) being received by teams below the luxury tax threshold (between \$50 and \$54 million – below the average team salary), teams with salaries under the luxury tax threshold are practically guaranteed to earn profits. In one sense this is good for the League, since one objective of the League is to increase the profits of its teams. However, by practically guaranteeing profits for these low-spending teams, the League has dramatically reduced the incentives for these teams to improve or to make investments that might increase their revenues. For some of these teams, cost control appears to have become their primary objective.

This hyper-focus on cost control has the potential to alienate the fans of these teams. It also may create resentment among the high-spending owners providing the subsidies to the low-spending teams – subsidies an order of magnitude greater than those in any other professional sports league. For example, over the next two years, the Portland Trailblazers, the New York Knicks, the Sacramento Kings, and the Dallas Mavericks are likely to subsidize the rest the League's Teams by more than \$200 million – an amount larger than welfare programs in 15 states. Furthermore, many of these teams are likely to shift from earning average profits before the luxury tax to suffering huge losses with the luxury tax. The League has to be concerned about the dissension among its owners that the luxury/escrow tax system is creating.

### **The Players' Objectives in the Current Negotiations**

#### **Increased Bargaining Power in Free Agency**

The current CBA, particularly the luxury/escrow tax system, has dramatically reduced the bargaining power of players in free agency. During negotiations for the present CBA, the League touted this contract as one that was going to help the “middle class” of NBA players. In fact, what is now known as the mid-level exception was originally dubbed the middle class exception. But because of the punitive nature of luxury/escrow tax system, many teams have chosen to not use their mid-level exception. The average salary of players in the middle of the salary distribution fell precipitously (relative to the overall average salary) in the mid-1990s and was starting to rise again after the current CBA. However, it appears that the luxury/escrow tax system stopped that progress for mid-level players, and perhaps even reversed it.

### **Increased “Good” Player Movement Through Trades**

The current CBA, particularly the luxury/escrow tax system, has changed the nature of player movement. The players have ambiguous feelings about player movement through trades. Trades that increase a player’s playing time or resolve issues a player may have with a coach or general manager are preferred by the players. On the other hand, trades largely motivated by financial reasons tend to hurt players. The luxury tax system has greatly reduced the number “good” trades motivated by player concerns relative to the number of “bad” trades motivated by financial reasons.

The recent movement of Gary Payton to Milwaukee is a perfect example of this. Since Payton is in the last year of his contract, his salary will come off Milwaukee’s team salary next season if they don’t resign him. And since owner Herb Kohl has publicly acknowledged that he is looking to sell part or all of his team, a balance sheet that doesn’t include luxury tax payments has to be attractive to potential buyers. It has become increasingly difficult for players wishing to leave teams or for teams wishing to move players for non-financial reasons to accomplish such trades.

### **A Decrease in Escrow Taxes**

While the players realized the escrow tax was a possibility, they were still shocked in the 2001-02 season when the escrow tax first was deducted from their paychecks. Their dismay was somewhat ameliorated by the refund they each received last October. This coming October, however, they are in all likelihood not going to get any refund. Understandably, the Union is demanding some form of escrow tax relief in exchange for an extension of the current contract.

## **Various Proposals Which Could Improve the CBA**

### **An Increase of the Salary Cap**

The original intention of the salary cap was to help control salaries. But with the institution of the luxury/escrow tax system, the salary cap itself is having a reduced effect on containing salaries. Also, the combination of the salary cap and luxury/escrow tax system creates an approximately \$10 million wedge between the salary cap and the luxury tax threshold. This large wedge increases the period of time in which teams over the luxury tax threshold must wait before they can make significant additions to their team. From the League’s perspective, this situation is both good (because it contains costs) and

bad (because teams spending several seasons deconstructing their rosters may experience severe revenue losses).

Thus, it is possible that it is in the League's and players' interests to increase the salary cap to say 52 percent of Basketball Related Income (BRI). Raising the salary cap to that level will increase players' salaries, but by helping those teams in re-building mode, it may increase players' salaries in such a way that the League finds less objectionable than other methods.

### **Certain Exceptions Will Not Count Against the Luxury Tax**

In recent months, it has been reported that various Teams have come to the League asking for some relaxation of the luxury tax rules. While one of the primary missions of the League is to protect the teams from themselves, if other conditions are met, the League may be willing to accept an exception to the luxury tax provisions. For example, allowing all contracts utilizing the minimum, million dollar and mid-level exceptions to not count as team salary (and thus not increase luxury tax payments) for the first year of such contracts would serve to help to increase the compensation (and perhaps increase the number of jobs) for the so-called "middle class" players and minimum salary players that the present contract was supposedly going to protect. At the same time, this provision is small enough that it should have a minimal impact on the League's goal of cost containment.

### **Players Receive a Share of the Escrow Tax Surplus**

As it presently stands, the players place 10 percent of their salaries in an escrow tax fund. If total team salaries plus benefits exceed 55 percent of BRI, some (or all) of that escrow tax fund is given to the teams, depending on how much salaries plus benefits exceed 55 percent. All teams under the luxury tax threshold receive 1/29<sup>th</sup> of the total escrow tax distribution. In 2002-03, teams over the threshold will receive a 70 percent share. This will decrease to 40 percent in 2003-04 and to nothing in 2004-05. Whatever surplus remains after this distribution is divided evenly among all 29 teams. It is estimated that the surplus will be about \$30 million in 2002-03, about \$50 million in 2003-04, and more than \$70 million in 2004-05.

What this actually does is reward teams that exceed the luxury tax threshold, since they receive a portion of the surplus. We propose that the surplus escrow tax funds be distributed evenly between the teams and the players. This will serve to give the players some form of escrow tax relief, while having virtually no effect on the cost containment due to the luxury/escrow tax system. Teams going over the threshold will still have to pay the salary overage, an equivalent amount in luxury taxes, and on top of that, they will lose their share of the initial luxury/escrow tax distribution. That should be a sufficient incentive for those teams to stay under the luxury tax threshold.

### **Players with Career-Ending Injuries Are Removed from Team Salary on the First July Following an Injury**

Currently any player who receives a career-ending injury or illness (and is duly waived) may be removed from team salary beginning *two* years following the injury or illness. We propose that such Players be removed from the team salary *one* year following the injury or illness. This provision will benefit both the teams and the players. The teams will not be penalized by either salary cap or the

luxury/escrow tax system for a player who, through no fault of the team, is unable to play. Moreover, there almost surely will be more NBA jobs for the players when teams are able to remove non-active players from their luxury tax equation.

The League moved a bit in this direction with adoption of a rule where teams would be reimbursed for half of the cost of their long-term injured players. This reimbursement policy simply does not go far enough to remove the financial drag injured players create for many franchises.

### **All Teams to Share Luxury and Escrow Tax Revenue Evenly**

The current contract gives the League the sole discretion of how to disburse luxury tax and escrow tax revenues to the teams, and the teams appear to have adopted a formula that dramatically increases the punitive nature of the luxury/escrow tax system. The Union has been right in considering this distribution policy as being nearly equivalent to the luxury tax itself in terms of containing salaries. This distribution policy hurts both players and high-spending teams by penalizing teams over the luxury tax threshold to the benefit of those teams under the threshold. If a team well over the threshold, like New York or Portland, wishes to sign a player it will have to pay one dollar in luxury tax for each one dollar in additional salary. A team between the luxury tax threshold and cliff provision (about \$3 million over the luxury tax threshold) will have to pay over four dollars in luxury tax plus lost luxury/escrow tax distributions for every dollar in additional salary. This penalty likely will increase to five-to-one in 2003-04 and 2004-05. (The increase is due to decreases in the escrow tax distribution share for teams over the luxury tax threshold and accounts for a likely reduction in luxury taxes in 2004-05.)

This distribution policy creates perverse incentives for teams around the luxury tax threshold to reduce salaries. An economic argument can be made for penalizing high-spending teams because their spending serves to escalate salaries for *other* teams. However, the dollar-for-dollar penalty should be sufficient to cover the negative externality that this spending creates for other teams. Imposing what in essence is a 400 percent marginal tax rate on teams around the luxury tax threshold could result in teams refusing to re-sign a player for \$2 million when that player may increase team revenue by \$5 million. This kind of distortionary effect hurts the players, the teams, and the League as a whole.

In addition, one could question the equitability of a system that reduces the bargaining power of average-spending teams near the luxury tax threshold relative to high-spending teams. It is hard to imagine how it is in the League's interest to have lower penalties for additional spending for average-spending teams near the luxury tax threshold than it does for those well in excess of it.

This disbursement policy also clearly hurts the players. Boston's decision to not re-sign Rodney Rogers and Toronto's decision to not re-sign Keon Clark are perfect examples of the spending disincentives inherent in this distribution policy. If Teams over the luxury tax threshold all get an equal share of luxury tax revenues (and perhaps escrow tax revenues), then the average-spending teams near the luxury tax threshold will only be taxed a dollar for every dollar spent, just like high-spending teams. Thus, they would be more likely to sign (or re-sign) that extra player, even if they have already crossed the luxury tax threshold.

### **Reducing the Number of Young Players in the NBA**

If the League is willing to agree to some of the above financial concessions, it would seem appropriate that the Union work with the League to reach a formula that will reduce the number of players forgoing some (or all) of their college training and exposure. The League is interested in this issue, because the flood of young players into the NBA likely has reduced the exposure of the NBA to the college basketball market and may also contribute to a reduction in the playing fundamentals of its players.

Our proposal is the following:

- Players entering the NBA without college experience (or at age 18) would receive five-year Rookie scale contracts with restricted free agency in the sixth year and team options in the third, fourth, and fifth years.
- Players with one year of college experience (or one year of professional experience after age 18) would receive four-year rookie scale contracts with restricted free agency in the fifth year and team options in the third and fourth years (the present rookie scale contract with an additional team option).
- Players with two years of college experience (or two years of professional experience after age 18) would receive three-year rookie scale contracts with restricted free agency in the fourth year and team options in the third year.
- Players with three years of college experience (or three years of professional experience after age 18) would receive two-year rookie scale contracts with restricted free agency in the third year.
- Players with four years of college experience (or four years of professional experience after age 18) would receive one-year rookie scale contracts with restricted free agency in the second year.
- At the time of signing their rookie scale contracts, players would have the option of choosing the contract for their given level of college (or professional) experience or a contract for any lesser level of college (or professional) experience.
- The match period in restricted free agency would be reduced to one week.
- Up to four years of college experience (or professional experience after age 18) would count fully as NBA experience. This provision would also apply to current players, thereby resulting in these players being subject to higher allowable maximum salaries and higher minimum salaries.
- Rookie scale contracts would be increased to a level commensurate to their average productivity and then would be tied to rises in the League's average salary. Current players on the rookie scale contracts would also experience salary increases.

This proposal has a little bit for everybody. For the current players, it increases their years of NBA experience, which likely will increase the salaries of most of the League's minimum-salary players and some maximum-salary players. This should make this proposal very popular with the players, even though the effect of that part of the proposal on overall player salaries is likely to be less than \$15 million in the first year, rising to maybe \$20 to \$30 million in future years. Increasing the salaries of players currently on the rookie contracts would benefit the players substantially in the first year (perhaps as much as \$100 million depending on the productivity increases), but for the current players, this effect would be reduced over time.

The current players may be concerned that higher rookie scale contracts may negatively affect the salaries of veteran players. Politically, the Union would need to seriously consider this option, but remember that relative to veterans, the salaries of players on the rookie scale contracts have deteriorated in the last few years, while their productivity hasn't changed much.

For the League, the salary increases would raise a red flag, but the teams are likely to be attracted to the additional team options and longer rookie scale contracts for less experienced rookies. Also, by increasing the number of players working their way through the college system, this proposal could have a more positive effect on BRI growth than any of these other proposals.

Players considering entering the League straight from high school or with only a year of college experience would no longer view entering the League at a young age as a way to get out of their rookie contracts earlier, thus reducing the long-term benefits of entering the NBA early. Also, they would need to consider the risk that team options in the players' third year might cause them if they do not become productive very quickly in the NBA.

Guaranteeing only two years of the Rookie contract and having multiple option years is a big concession to the League, but a crucial one in order to create effective disincentives for leaving college early (or not attending at all). Increasing the monetary value of the rookie scale contracts should be paired with this concession as a way to even the playing field for future young players.

Overall, we suspect that the LeBron Jameses and Allen Iversons would still enter the NBA early under this proposal, but more marginal players may strongly consider spending more time in college.

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