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Steering through the Economic Ramifications

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# PILOTS and Public Policy: Steering through the Economic Ramifications

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## Abstract

A recent IRS ruling has allowed the new Yankees Stadium construction project to be financed by a tax exempt bond offering backed by payments in lieu of taxes (PILOTS). This decision appears to contradict the spirit of the Tax Reform Act of 1986. From an economic standpoint, the question is whether it is desirable to significantly expand the number of projects eligible for tax subsidies in exchange for a more direct connection between those receiving benefits from the projects and those paying the taxes, or should the state and municipal bond tax exemption narrowly extend only to true public works even if this means taxing the populace more broadly when certain segments of the population are more apt to benefit from certain projects.

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## *Introduction*

In the spring of 2009 a replacement for venerable Yankee Stadium will open in the Bronx at a cost of more than \$1.3 billion, making it the most expensive stadium construction project to date in the United States. The financing of this stadium project differs significantly from most other new sports facility construction projects and represents a significant change in public policy on the financing of professional sports facilities. Early indications suggest that the financing method used to build the New Yankees Stadium could serve as a model for many other sports facility construction projects across the country.

In 2006, the Internal Revenue Service (IRS) issued two Private Letter Rulings, Internal Revenue Service (2006a) and Internal Revenue Service (2006b), that enabled the New Yankees Stadium construction project to be financed by a tax exempt bond offering backed by payments in lieu of taxes (PILOTS). This ruling effectively allowed the Yankees access to low interest tax exempt bonds, as opposed to privately issued taxable bonds that carry a higher interest rate, to finance the construction of a privately owned sports facility. The IRS Private Letter Ruling was significant because it appears to circumvent provisions in the Tax Reform Act of 1986 that were intended to curb the use of tax exempt bond financing for the construction of professional sports facilities.

Following the IRS rulings, tax exempt public bonds were issued to pay for the construction of the New Yankees Stadium; since interest paid to holders of these bonds are exempt from federal income taxes, the bonds carry a lower interest rate than private bonds that are subject to federal income taxes, and over the 30 years between issuance and maturity, this interest rate differential results in a reduction in interest payments of hundreds of millions of dollars. The principal and interest on these bonds will be paid by the Yankees out of revenues

generated in the new stadium. The explicit justification for the PILOT financing scheme was economic development: the parties involved claim that the new stadium will lead to significant new economic development in New York City.

This ruling, and the subsequent tax exempt bond issuance, opened the floodgates to an additional wave of PILOT backed tax exempt bonds for the construction of sports facilities that shows no signs of slowing. The Yankee PILOT decision raises a number of important economic policy issues. In this paper, we discuss these policy issues and examine the behavior of the Yankees following the decision.

#### *MLB's Anti-Trust Exemption, Franchise Moves, and Public Subsidies*

Major League Baseball (MLB) has enjoyed an exemption from anti-trust law for nearly 100 years since the 1922 ruling in *Federal Base Ball Club of Baltimore v. National League of Professional Base Ball Clubs et al.* (259 U.S. 200). Subsequent Supreme Court decisions, notably *Toolson v. New York Yankees* (1953) (346 U.S. 356) and *Flood v. Kuhn* (1972) (407 U.S. 258) have upheld the *Federal Baseball* precedent while noting that the decision's underlying reasoning, that baseball is not interstate commerce, is unquestionably flawed, at least given the modern development of national media contracts. The courts, however, have not seen fit to extend the exemption to other sports such as boxing (*United States v. International Boxing Club of New York*, 1955, 348 U.S. 236), football (*Radovich v. National Football League et al*, 1957, 352 U.S. 445, or basketball (*Haywood v. National Basketball Association*, 1971, 401 U.S. 1204).

Among other consequences, the baseball's antitrust exemption results in fewer MLB franchises than would exist absent the exemption. The restriction in the number of MLB franchises means that markets capable of supporting a MLB franchise do not have one, and the

existence of these “open” markets provides existing MLB franchises with important leverage when negotiating with state and local governments over subsidies for the construction of new baseball stadiums. In addition, this antitrust exemption also provides the league with significant power to prevent any existing franchises from moving into New York City to fill any void left by the Mets’ or Yankees’ departure. While the National Football League (NFL), like MLB, also possesses significant monopoly power, the Ninth Circuit Court of Appeals decision in *Los Angeles Memorial Coliseum Commission v. NFL* (1984) (726 F.2d 1381) demonstrated that, absent an antitrust exemption, the NFL was unable to prohibit the Raiders’ owner, Al Davis, from moving his football team to Los Angeles despite the league’s wishes for him to stay in Oakland. Similarly, any threat by the Yankees to leave the New York City metropolitan area would be an empty one absent the antitrust exemption as any number of small market owners would jump at the chance to play in a major market like New York City, even in an unrefurbished Yankees Stadium. Due to the antitrust exemption, however, the Yankees, in collusion with MLB, could prevent such moves from occurring.

The public financing of the both the new Yankees Stadium and the new Mets stadium scheduled to open in New York City in the next few years was influenced by threats made by both the New York Yankees and New York Mets to leave the city of New York. In a memorandum from Andrew M. Alper to New York City Mayor Michael Bloomberg explaining why the Yankees were granted an exemption from New York City Industrial Development Agency (NYCIDA) policy, then director Alper stated that failure to give the Yankees what they wanted would “result in the New York Yankees relocating the Team to a stadium outside the City.”<sup>1</sup> In another memorandum from Alper to New York City Mayor Michael Bloomberg

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<sup>1</sup> New York City Industrial Development Agency memorandum “Deviation from Uniform Tax Exemption Policy for Yankees Ballpark Company.”

explaining why the Mets were granted a similar exemption from the NYCIDA policy, Alper stated that failure to give the Mets what they wanted would “result in the New York Mets relocating the Team to a stadium outside the City of New York.”<sup>2</sup>

Based on these two memoranda from the NYCIDA, it appears that both of the MLB teams in New York City used the threat of leaving to extract concessions from the City of New York. Again, economic theory provides a clear explanation for why professional baseball teams have this power: they have significant market power and operate as unregulated monopolies. Unlike most other industries in the United States, MLB receives special treatment under federal anti-trust law. Economic theory predicts that monopolies restrict output in order to realize monopoly rents. In the case of MLB, monopoly power is exercised by limiting the total number of teams in each league. In this specific case, it means that the Yankees and Mets were able to force state and local governments to grant them special benefits not available to other firms because of the anti-trust exemption granted by the *Federal Baseball* decision. If MLB did not have this special protection, the Yankees and Mets would not have had another viable alternative market to threaten to move into. The new stadium construction projects would have been finance through other, traditional means like private bonds with a higher interest rate or public tax exempt bonds that would be paid for out of general revenues or other public financing methods. The IRS ruling effectively turns state and local government into investment bankers for professional sports teams in New York City, and gives these privately held corporations access to tax exempt bond funding that was explicitly prohibited by the 1986 Tax Reform Act.

The justification for the deviation granted to both the Yankees and Mets stadiums was a threat to move out of New York City to another market that would support a professional

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<sup>2</sup> New York City Industrial Development Agency memorandum “Deviation from Uniform Tax Exemption Policy for Queens Ballpark. L.L.C.”

baseball team. Again, the ultimate cause of the New York PILOT mess is MLB's anti-trust exemption, a public policy decision made by the federal courts that Congress has refused to overturn for nearly a century.

### *How PILOTs Differ from Other Stadium Financing*

The PILOT decision has resulted in a financing deal for construction of the new Yankee Stadium that differs in important ways from the way that other new professional sports facilities have been financed in the post 1986 Tax Reform Act era. Two examples make these differences clear. Nationals Park opened in Washington, DC on May 4<sup>th</sup> 2006. The stadium cost \$610 million and was financed through the sale of tax exempt bonds issued by the city of Washington. Because tax exempt bonds were used to finance this stadium, the DC government had to raise taxes in order to pay the principal and interest on these bonds; these payments must come out of general tax revenues to comply with the Tax Reform Act of 1986. The requirement that the principal and interest on tax exempt bonds used to finance professional sports facility construction represents an important limit on the use of tax exempt bonds for this purpose, as well as a limit on construction costs. Local politicians and bureaucrats are held accountable for the condition of their budgets by voters, and paying the principal and interest on these bonds out of general tax revenues has budgetary effects. Because general tax revenues are collected from a broader group of local residents than the sports fans that enjoy the benefits of a new stadium, this requirement reduces the amount of money spent on new sports facilities financed using tax exempt bonds, and may reduce construction costs as well.

AT&T Park, home of the San Francisco Giants, opened on March 31<sup>st</sup>, 2000. The stadium cost \$357 million to build (\$426 million in 2007 dollars) and was privately financed.

No tax exempt bonds were issued to pay for the facility construction by any state or local government. The team had to pay a higher interest rate on the borrowed money than they would have if they had access to tax exempt financing, making the construction project more costly to the team.

Clearly, the PILOT decision has had a profound effect on the Yankee Stadium construction project. The access to lower interest rates offered by tax exempt funding, coupled with the lack of budgetary-related limits on costs has combined to produce the most expensive stadium construction project in the history of Major League Baseball, and indeed all of professional sports in North America.

#### *Ticket Prices and New Facilities in MLB*

Major League Baseball teams produce a product with only a few imperfect substitutes in the local economy. Unlike other firms, MLB teams face little competition in the marketplace. This market power gives MLB teams significant latitude when setting prices. In most cases, firms facing competition set their prices at a level “that the market will bear,” meaning that these businesses face significant price competition from other firms that limits their ability to raise prices. A business with many competitors cannot raise prices too much because their customers will turn to other suppliers. MLB teams do not face this type of competition. Their product has few close substitutes, so they can set prices based only on the market demand for their product. In large markets, like New York City, this market demand can be quite large compared to the number of tickets sold in any season. The only constraint on price increases faced by professional sports teams is the willingness of fans to pay in sufficient numbers.

Porter and Thomas (in press) recently analyzed the political economy of ticket pricing in new publicly subsidized sports facilities. The model developed in this paper predicts that teams seeking public subsidies for new facility construction projects price their tickets below the profit maximizing level prior to the awarding of the subsidy, and then raise ticket prices significantly after moving into the new facility. This model provides important insights into the price setting behavior of the Yankees as they move into the new stadium.

Professional baseball teams offer tickets for sale at a wide variety of prices. Although the cost of attending a MLB game is often expressed in terms of an “average” or “median” ticket price, this simplification abstracts from actual choices facing consumers, who can have as many as fifteen different ticket prices to choose from when buying a ticket to a baseball game.

The increase in ticket prices in their new stadium announced by the New York Yankees has drawn a great deal of attention in the media. In the 2008 season, the Yankees offered season tickets at 15 different prices, ranging from \$12 per game for a full season ticket in the bleachers to \$325 per game for a full season ticket in the “Field Championship” section. The average price of a season ticket to the Yankees was \$106, and the median price was \$70. The price of Yankees’ season tickets in the new stadium in 2009 will range from \$2500 per game for a full season ticket in the “legends” section to \$12 per game for a full season ticket in the bleachers.<sup>3</sup> This represents a 139% annual change in the average price of a Yankees ticket, and a 669% annual increase in the price of the highest ticket price offered.

The average increase in the median price of a Yankees ticket from 2008 to 2009 was 7%, and the per game price of a season ticket for the bleachers remains unchanged at \$12 per game in the new stadium. Although the team has heralded this as evidence that the “average fan” would not be priced out of the new stadium, at this time the price of game day bleacher tickets has not

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<sup>3</sup> *Relocation Program Guide for the New Yankee Stadium*, Yankees.mlb.com.

been announced, only full season ticket prices. While there has been no change in the per game price paid by fans who purchase 81 bleacher tickets in advance, it remains to be seen how much a game day bleacher ticket (a better indicator of how much the “average fan” will have to pay) will cost in the new stadium.

Most research on ticket pricing in professional sports focuses on simple average ticket prices based on the price of all tickets offered by a team. Fort (2004) recently surveyed the literature on ticket pricing in professional sports; much of this literature uses average prices across all ticket categories to analyze team pricing decisions. However, as the example of recent changes in ticket prices made by the Yankees above points out, teams offer tickets for sale at a number of different price points and do not typically change ticket prices uniformly across all ticket prices offered. An analysis of changes in the average ticket price may not reflect changes in ticket prices like those made by the Yankees in advance of their move into their new stadium.

We collected data on the individual prices charged by every MLB team for all tickets offered over the period 1975-2006, with the exception of the 2002 MLB season. The source of these MLB ticket price data are the National League *Red Book* and American League *Green Book* that are published annually by MLB. The *Red Book* and *Green Book* contain detailed ticket price data, including a list of the price of every ticket offered for sale to walk up ticket buyers in each season. The *Red Book* and *Green Book* do not contain information about the price of season tickets, or how many seats were available at each price point.

Based on the ticket price data from the *Red Book* and *Green Book*, on average, MLB teams offered tickets at about six different price levels in any season, with a maximum of fifteen different ticket price levels offered by a single team, the Arizona Diamondbacks. In part, these differences in ticket prices reflect differences in the experience of fans: a fan sitting in the first

row behind home plate experiences the game in a different way than a fan sitting in the last row of the upper deck. Fans are willing to pay more for the experience of sitting in the first row behind home plate than they are for the experience of sitting in the last row of the upper deck. The large number of different prices offered by MLB teams means that they have many options available to them when changing prices. It also means that changes in the average or median price of a ticket may not reflect changes in ticket prices across the board.

**Table 1: Percent Change in Nominal Change in Ticket Prices in MLB 1975-2006**

	Teams Playing In New Facility	Teams Playing In Existing Facility
Average Price Increase, All Tickets	21.01	7.71
Median Price Increase, All Tickets	14.95	7.51
Average Price Increase, Highest Priced Ticket	34.56	9.21
Average Price Increase, Lowest Priced Ticket	7.21	9.68
Number of Team Seasons	17	767

Table 1 summarizes the changes in nominal ticket prices from season to season in these data. Over the period 1975-2006, the average annual increase in the average ticket price charged by MLB teams playing in the same stadium as the previous season was 7.71%. The average annual increase in the median ticket price was 7.51%, a similar change. Because MLB teams offer tickets at many different prices, the change in the average or median ticket price may not reflect the overall pattern of ticket price changes from year to year. An alternative way of looking at price changes is to examine how the highest priced tickets and lowest priced tickets change. The average annual increase in the highest priced ticket offered by MLB teams playing in the same stadium over the period 1975-2006 was 9.21%. The average annual increase in the lowest priced ticket offered by MLB teams over this period was 9.68%. Teams playing in existing stadiums tend to raise the price of tickets at the upper and lower end of the price range more than tickets in the middle of the price range. These annual price increases are not adjusted

for inflation, for reasons that will be explained shortly. All of the relative price increases discussed here would be unchanged if corrected for increases in the overall price level.

MLB teams playing in new stadiums have, on average, increased their prices at a higher annual rate than teams playing in an existing stadium. The average annual increase in the average ticket price charged by an MLB team playing in a new stadium over the period 1975-2006 was 21.01%; the average increase in the median ticket price was 14.95%. There were 17 new baseball stadiums opened during the period 1975-2006. In part, these ticket price increases reflect a different experience for fans in a new stadium, but they also depend on the market power of MLB teams. The increases at the top and bottom of the price range charged by MLB teams differed from the changes in the average or median prices. The average annual increase in the highest ticket price offered by MLB teams playing in a new stadium was 34.56%. The average increase in the lowest priced ticket offered was 7.21%. High end tickets tend to see the biggest price increases when a team moves into a new stadium in MLB.

No MLB team moving into a new stadium in the past 33 years has increased the price of the most expensive ticket offered for sale as much as the Yankees will in 2009. The 669% increase by the Yankees is 20 times larger than the average annual increase in the highest ticket price offered by MLB teams moving into a new stadium, and more than three times larger than the next largest annual increase in the highest ticket price offered (the Detroit Tigers increased their highest ticket price by 200% when they moved into their new stadium in 2000.)<sup>4</sup>

The annual increase in the average price of a ticket offered by the San Francisco Giants in 2000, the last team to move into a new privately financed stadium was 21.3%; the annual increase in the highest priced ticket offered by the Giants was 9.52%, and the increase in the

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<sup>4</sup> Note that we compare the increase in the nominal price of Yankees tickets to the increase in the nominal price of other tickets because we do not yet know what the inflation rate will be between now and April 2009.

lowest price ticket offered was 66.6%. Because of the lavish nature of the new stadium, the Yankees are able to pass on extraordinary ticket price increases to their fans. Access to relatively low cost tax exempt bonds under the PILOT ruling allowed the Yankees to build the most expensive baseball stadium in the history of baseball. In addition, part of these extraordinary ticket price increases may be attributed to strategic behavior on the part of the Yankees, as predicted by the public choice model of ticket pricing and subsidies developed by Porter and Thomas (in press).

### *The Fallacy of New Job Creation in Sports Facility Construction*

One clear theme emerges from the financing of the New Yankees Stadium: the primary economic rationale for the sequence of events that led to the PILOT decision was that the new Yankee Stadium would be a significant engine of economic growth in the local economy, and that this alleged economic benefit was sufficient justification for granting this exceptional privilege to the Yankees. The importance of job creation associated with both the construction of the new stadium and the ongoing operation of the stadium were mentioned again and again as the primary justification for the decision in the public and private debate about this project.

The claims of significant economic benefits from sports stadium construction and operation are problematic. First, they are forecasts, and not actual counts of jobs created or income earned in and around the new stadium. The new stadium is still under construction, and the team has not yet played a single game there. In the PILOT issue, and every other sports facility construction project we have studied, these forecasts of economic benefits are treated as factual assessments, rather than the forecasts that they are. Forecasts are not useful unless they contain a measure of the uncertainty associated with them, and the claimed future economic

benefits from the new Yankee Stadium are never placed in this context. This makes them useless for informing economic policy decisions. The problem has already surfaced in the Yankee Stadium PILOT decision, as the claims of thousands of full time jobs made at the time the exemption was granted has proven to be wildly overstated

Second, there is no evidence in the large body of peer reviewed scholarly research on the economic impact of professional sports facilities that indicates any professional sports facility construction project, or the ongoing operation of any such facility has generated any tangible economic benefits in the local economy. Coates and Humphreys (2008) recently surveyed this extensive literature. In fact, economists widely agree on this point, and it is backed up by decades of evidence based on peer reviewed research. Even if the New Yankee Stadium is the most expensive stadium construction project in history, it will likely not generate any significant economic benefits in New York City.

Claimed benefits from the construction jobs created during stadium construction projects are one of the most abused claims of tangible economic benefits made by those seeking subsidies, because they are so evident. One has to simply drive by the construction site and see it swarming with workers to confirm these claims of economic benefits in the community. However, there is more to this situation than meets the eye. The key to determining the actual net economic benefits generated by sports stadium construction projects is to determine how many jobs are created that would not have existed if the project did not take place, and also to determine how many of the workers filling those jobs would have been unemployed if the project had not taken place. According to economic theory, only this small subset of the total number of jobs created by a stadium construction project can be counted as part of the economic impact of the project. Calculating this number cannot be accomplished by a simple inspection of

the construction sight, and assuming that every worker observed on the job site represents new economic benefit to the local economy is erroneous.

The net economic benefit created by stadium construction projects is much smaller than the total economic benefit (which can be easily found by simply adding up the total amount of spending associated with the project) because of the presence of opportunity costs, and the double counting that typically takes place when non-economists attempt to estimate these benefits. Opportunity cost is the cost of forgone alternatives. In the case of the New Yankee Stadium, the facility generates significant opportunity costs for the City of New York and in the local community. The City could have issued a billion plus dollars of tax exempt bonds to finance any number of alternatives. The testimony of Seth Pinsky, president of the NYCIDA before the New York State Assembly on July 2<sup>nd</sup> 2008 indicates that his agency receives hundreds of requests each year for public tax exempt funding for construction projects.<sup>5</sup> The materials and supplies that are going into the construction of the new stadium could have been used on other construction projects. And most importantly, the construction workers employed on this project could have worked on other project. Economic theory tells us that only those construction workers who would not have had a job if the stadium was not built can be counted as net economic benefit from the project. According to a recent Bureau of Labor Statistics press release, the unemployment rate for construction workers in August 2008 was 1.9%.<sup>6</sup> This low unemployment rate means that the actual number of new construction jobs created by the New Yankee Stadium project was a tiny fraction of the total number of jobs created by the project.

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<sup>5</sup> Transcript from July 2<sup>nd</sup> 2008 public hearing: The Request for Increased Public Financing for Construction of a New Yankee Stadium in New York City, hearing before the Assembly Standing Committee on Corporations, Authorities and Commissions.

<sup>6</sup> <http://www.bls.gov/news.release/empst.t11.htm>

The prospects for long-term economic benefits as a result of ongoing operation of the stadium are equally dim. While it is undoubtedly true that the new stadium will attract in excess of 4 million fans per year to its location in the Bronx, the old stadium, which stands just one block south of the new facility, has drawn over 4 million fans per year for each of the four years, and indeed the new stadium promises to draw *fewer* fans to the area due to the fact that its capacity is nearly 6,000 seats smaller than old Yankees Stadium. Furthermore, the new stadium provides significantly improved eating and drinking options inside the stadium, driving economic activity away from the local neighborhoods and into the stadium itself.

#### *Untended Consequences of the PILOT Decision*

Despite the unseemly events surrounding the financing plan for the New Yankees Stadium in the Bronx, from one perspective, the financing of this new baseball stadium has desirable features from an economic perspective. Zimmerman (1997) pointed out that the desirability of tax exempt financing of professional sports facilities depends on the application of the benefit principle of taxation to the financing deal, and the ultimate goal of public policy on professional sports facilities. If the elimination of all public subsidies for the construction of new professional sports facilities is the policy goal, then the Yankee PILOT ruling is a disaster. It opens up a new avenue for the subsidization of professional sports and effectively guts the prohibitions against the use of tax exempt bonds to finance new sports facility construction projects in the 1986 Tax Reform Act without the consent of the U.S. Congress and will lead to even larger subsidies for the construction of professional sports facilities. Indeed, there is little reason to believe that such subsidization will stop with professional sports franchises. Given the weak theoretical and empirical foundations upon which the Yankees' claim of promoting

economic development rests, nearly any enterprise could claim that their own capital expenditures promote economic development with equal credibility.

On the other hand, if the goal of public policy on subsidies for the construction of professional sports facilities is to formulate public policies that conform to the benefit principle of taxation (also known as the “user-pays principle”), the Yankee PILOT decision is an improvement. Prior to the Yankees PILOT decision, funds to pay off tax exempt bonds issued to finance professional sports facility construction projects typically came from general tax revenues, specific broad based revenue generation programs like lotteries, rental car taxes, or hotel taxes, or other sources of funds like Tax Increment Financing (TIF) districts. Using government revenues from broad based sources like sales, property or income taxes violates the benefit principle of taxation because the beneficiaries of the subsidies, team owners, professional athletes, and fans of the team, are a small segment of the local economy while the group who pay for the subsidy, taxpayers, are a much larger group.

Under the Yankees PILOT ruling, the tax exempt bonds issued to finance construction of the new stadium will be paid using revenues generated by the team in the new facility. Fans of the team who attend games, and to the extent that the incidence of this effective tax also falls on the team are the primary source of these revenues, the team itself, will pay off the tax exempt bonds. So under the Yankees PILOT ruling, the beneficiaries of the subsidy bear the cost.

It is important to note that this is a second best outcome, because the federal government is still forgoing the tax revenues that would have been collected if the new Yankee Stadium would have been financed using private, taxable bonds. In this sense, all federal taxpayers are subsidizing the Yankees in their fans by an amount equal to the forgone federal tax revenues.

However, this subsidy would still exist if the tax exempt bonds were paid off using general tax revenues.

Ultimately policy-makers will soon be forced to make some serious decisions regarding the funding of private construction projects. The question boils down to whether it is desirable to significantly expand the number of projects eligible for tax subsidies in exchange for a more direct connection between those receiving benefits from the projects and those paying the taxes, or should the state and municipal bond tax exemption narrowly extend only to true public works even if this means taxing the populace more broadly when certain segments of the population are more apt to benefit from certain projects. The IRS's decision in the case of Yankee Stadium appears to contradict, at the very least, the spirit of the Tax Reform Act of 1986. Given this contradiction, the issue should elicit renewed legislative and judicial attention.

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