



## DO WE REALLY NEED FINANCIAL FAIR PLAY IN EUROPEAN CLUB FOOTBALL? AN ECONOMIC ANALYSIS

HENNING VÖPEL\*

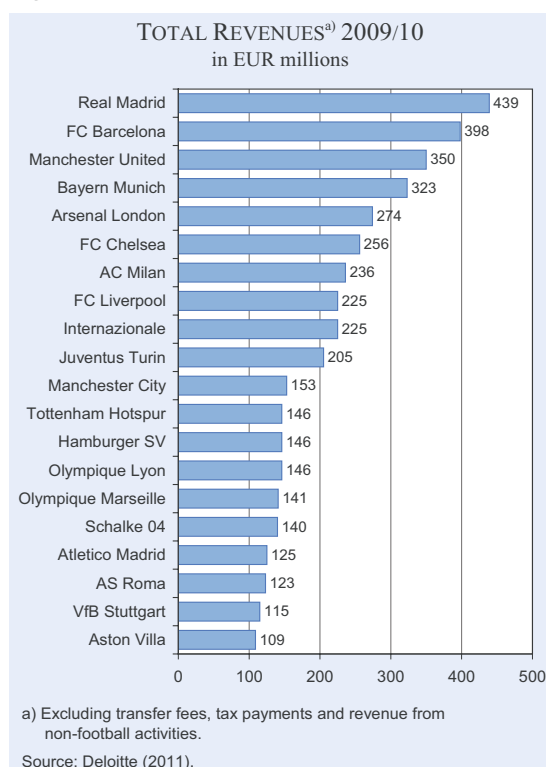
### Introduction

The UEFA (Union des Associations Européennes de Football) and above all the UEFA president Michel Platini are very concerned about recent developments in European club football. Many clubs have reported repeated and worsening deficits which have led to record-high debt levels during the last years. In addition, private investors and other equity participants have increasingly extended their influence into professional football clubs. Hence, some clubs have experienced liquidity shortfalls and have been unable to pay other clubs or their players in time. In contrast others have climbed up to the top of European club football with the help of external money. The best-known example is FC Chelsea with its patron Roman Abramovitch, who has spent about half a billion euros within the past decade to finance the club's quick ascent to being one of the leading teams in Europe. Moreover, today's European club football is basically an oligopoly consisting of about ten clubs (including FC Barcelona, Real Madrid, Manchester United, FC Chelsea, AC Milan or Bayern Munich and others, called the "Untouchables" by Deloitte), who will continue to move further away from other clubs until the gap can no longer be closed (Figure).

These developments are thought to threaten the financial stability and distort the competitive balance not only between clubs but also between leagues in European club football. In order to ensure

long-term financial stability and to restore the competitive balance, the UEFA's Executive Committee, in agreement with the European Club Association (ECA), unanimously approved a set of rules called "Financial Fair Play" that will come into force with the end of the current season in 2012 (UEFA 2011a). From the 2013/14 season on, all clubs will have to fulfil the new rules and requirements in order to obtain a license, the precondition for participating in the UEFA Champions League (UEFA 2010a). Financial Fair Play implies that for the first time there will be a harmonized, European-wide and much tighter regulation for all European clubs. According to the UEFA, Financial Fair Play provides a regulatory framework that prevents clubs from fall into a debt spiral while ensuring competition based only on the resources they generate on their own. Furthermore, Financial Fair Play is based on a more general philosophy of sports as recently published in the UEFA's "eleven key values of sport", which draws primarily on the European sports model of solidarity and subsidiarity (UEFA 2011b).

Figure



\* Hamburg Institute of International Economics (HWWI) and Hamburg School of Business Administration.

There is an ongoing debate on how Financial Fair Play will affect European club football and how “fair” Financial Fair Play really is. So far national regulations have been very different in European leagues. Therefore, Financial Fair Play is expected to trigger some asymmetric adjustments among clubs and leagues, thereby leading to changes in the competitive balance and probably to a new competitive equilibrium in European club football.

### Competition and regulation of professional sports leagues

Competition in professional sports leagues is quite different from competition in regular markets since it strictly implies a zero-sum game for the participants. One team’s victory always means another’s defeat. And in the final ranking of a season each position is assigned only once: there is only one champion and a team’s ranking can fall regardless of how well it plays in absolute terms. “Positional” competition of this kind is similar to a “rat race” that induces specific, short-term biased incentives for the competing teams. If it is only the victory that counts at the end, competitors are likely to take a higher risk. Moreover, the business objective of professional football clubs typically is to gain prestige and success rather than making profit. This is even exacerbated by fans, sponsors and the media putting short-term pressure on clubs. Moral hazard between a club and its functionaries pursuing different interests may also play a crucial role in this regard. All this could lead to over-investment behaviour resulting in a kind of a debt fallacy since not all teams can succeed simultaneously. At least some of them fail to fully refinance their initial investments due to unexpected low revenue. In an unregulated league this could end up in an insolvency of clubs leading to an unwarranted discontinuation of games, especially during the course of a competition.

In contrast, those teams who succeed in the competition and qualify for the Europa League or the Champions League receive much higher revenue. They can use additional income to invest in new players, thereby becoming an even stronger team which most likely will manage to re-qualify the following year. In this way an upward spiral of self-sustaining development is triggered by an initial success. In the long run this process could end up with the dominance of a few teams predetermining the championship and making it less interesting. As a re-

sult fans and spectators – followed shortly thereafter by the media and sponsors – would increasingly turn away from football leading to a lower aggregate revenue for the league as a whole.

As a result, there is an inherent conflict between individual clubs pursuing their own interests and trying to be as successful as possible at the expense of the other competing clubs as opposed to the league as a whole whose common interest is to ensure an attractive championship in order to maximize aggregate income. This kind of competition is sometimes called “associative competition” indicating the inherent conflict between individual and collective rationality in professional sports leagues which is similar to a “common resource” that tends to be excessively used until it exhausts and therefore needs to be protected by regulation (for a more detailed discussion of the specific properties of competition in professional sports leagues, see, e.g., El Hodri and Quirk 1971; Sloane 1976; Vroomann 1995).

One might conclude that such a competition needs to be regulated exogenously in order to prevent the common commercial basis of doing business from eroding. A specific regulation can be regarded as a bargaining solution whose allocation must lie inside the “core” in order to be stable. The “core” is a concept used in Game Theory for solving coalition games and is defined as the set of all distributions of pay-offs for which no sub-coalition would be better-off with a deviation (Osborne 2004). A bargaining solution contains an institutionalized rule according to which aggregate income is distributed among “market participants”. But a national regulation of the domestic football league cannot be set independently of other leagues since they compete with each other in several supranational contests like the Europa League or the Champions League. Hence, a specific regulation implicitly reflects also national preferences regarding the competitive balance of the domestic league and the international competitiveness of national champions representing the domestic league in supranational contests. A redistribution of income among domestic clubs can lead to a more favourable competitive balance within the national league but can weaken the international competitiveness of the national champions and therefore constitutes a trade-off. Thus, a European-wide harmonized regulation may violate national preferences. On the other hand it can be argued that an exogenous institution like the UEFA is needed to solve the coordination failure that arises from a pris-

oner's dilemma problem. Unless there is a binding agreement among the various national football associations each would have an incentive to abstain from cooperation at the expense of the others, even if restoring the competitive balance can make all participants better-off (according to the "associative competition" as defined above).

As has been shown professional sports leagues tend to cause market imperfections for two reasons: First, the competitive balance is inherently unstable since initially successful clubs can enhance endogenously their dominance leading to an oligopoly in football. Secondly, the "positional" competition in a professional sports league, which is similar to a "rat race", implies a biased incentive for participants to take too high of risks. Hence, regulation might be needed at least from a theoretical point of view to remedy market failure occurring presumably in a professional sports league (see also Sloane 1976; Szymanski 2003, e.g.).

### Rules of the UEFA Financial Fair Play

The main objectives of Financial Fair Play are

- to introduce more discipline and rationality in club football finance;
- to decrease pressure on salaries and transfer fees and limit inflationary effect;
- to encourage clubs to compete with and within their revenues;
- to encourage long-term investments in the youth sector and infrastructure;
- to protect the long-term viability of European club football;
- to ensure that clubs settle their liabilities on a timely basis (UEFA 2010b).

These main objectives can be summarized in the following two principal goals of Financial Fair Play:

1. Protecting the long-term financial stability of European club football;
2. Restoring the competitive balance between clubs and leagues.

In order to reach these goals, the UEFA imposes a limit to a club's deficit that restricts the influence of private investors and other equity participants in European club football. However, neither an explicit definition of what could be regarded as an acceptable or favourable competitive balance is provided

nor are the criteria on how to measure or to evaluate financial stability properly derived.

The basic rule of Financial Fair Play is the "break-even requirement". According to this rule "relevant expenses" of each individual club are not allowed to exceed the club's "relevant revenue". It is important to note that the UEFA's notion of "relevant income" does not include income from non-football operations. Externally acquired money, e.g., from equity participants or patrons, is not allowed to finance a club's expenditures unless it is used for youth development activities or infrastructure. All these expenditures are excluded from the notion of "relevant expenses" because they are considered to be "good" expenditures as opposed to excessive transfer fees.

The "break-even requirement" is assessed by the UEFA for a three-year period according to Article 59 "Notion of monitoring period" (UEFA 2010a). As an example, the monitoring period to be assessed for the license season 2014/15 includes the three previous seasons 2013/14, 2012/13 and 2011/12. The monitoring period for the license 2013/14 is an exception and covers only two periods, 2012/13 and 2011/12. Thus in general the "break-even requirement" must be fulfilled every year for a moving average over three consecutive years. A moving-average restriction ensures that there is a continuous limit while providing some leeway so that the club's management can make adjustments within a given period of time thereby avoiding irregular, unpredictable or even chaotic dynamics during the adjustment process.

Exceptions to this rule are defined in Article 61 "Notion of acceptable deviation". The acceptable aggregate deviation from the "break-even requirement" is EUR 5 million. The deviation is allowed to exceed EUR 5 million up to EUR 45 million in the license seasons 2013/14 and 2014/15. This amount will be reduced to EUR 30 million for the license seasons 2015/16, 2016/17 and 2017/18, and will be reduced further thereafter. Any deviation exceeding EUR 5 million is only allowed if the deficit is guaranteed and entirely covered by contributions from equity participants or related parties. This temporary exception to the EUR-5-million rule allows those clubs that are primarily financed by donors and private investors so far to change their management policy so as to comply with the new regulations within a reasonable period of time.

### Impact of Financial Fair Play on European Club Football

Due to currently very different regulations for national leagues in Europe the implementation of Financial Fair Play is expected to have a significant and lasting impact on the competitive balance between clubs and leagues because the burden of adjusting to the new regulation is distributed asymmetrically. Since the change in regulation will affect leagues as a whole but also hit some clubs more heavily than others, Financial Fair Play will not only change the competitive balance between the leading European clubs but also within the national leagues.

In general, a distinction must be made between the effects of Financial Fair Play on short-run transitional dynamics and on a new long-run competitive equilibrium. With respect to the long-term changes in the competitive equilibrium it is expected that Financial Fair Play will lead to an intentional redistribution of revenue causing a reallocation of factors of production (players, e.g.). Due to tighter regulations in the German Bundesliga national champions like Bayern Munich, for example, will tend to gain competitiveness whereas less regulated leagues, like the English Premier League or the Spanish Primera Division, will lose competitiveness. But Financial Fair Play will not only have an impact on the competitive balance between the leading clubs in Europe but also on a national level between clubs within a national league. With respect to the latter the dominance of national champions will be less contestable since limiting a club's deficit and restricting the opportunity to acquire external money will diminish their ability to close the gap to the national champions. As a result Financial Fair Play is primarily aimed at restoring the competitive balance between the leading European clubs rather than helping the poorer clubs to catch up with their national champions.

### Pros and cons of Financial Fair Play

The question arises whether Financial Fair Play should be implemented from the perspective of competition theory. The most important question when deciding whether to regulate a free market or not is: is there a kind of market failure and if so who would be protected by regulation?

Moreover, before implementing regulation an analysis should investigate whether it is

- effective with respect to the objectives of regulation;
- not contradictory with respect to different (not inherently conflicting) objectives of regulation;
- efficient regarding costs of implementing, monitoring and enforcing regulation;
- dynamically efficient by offering incentives for long-term improvements;
- competitively neutral unless otherwise intended by the regulation itself;
- of reasonable means regarding costs and benefits of regulation.

The basic instrument of Financial Fair Play is the “break-even requirement”, which is explained in detail above. Restoring the competitive balance and enhancing long-term financial stability in European club football are the two primary objectives of Financial Fair Play. First, it has to be investigated whether the “break-even requirement” is effective with regard to these objectives. The “break-even requirement” consists of a deficit limit and a definition of “relevant income” and “relevant expenses”. Limiting the clubs' deficit to an acceptable amount is clearly effective in enhancing financial stability. But just imposing a ceiling on the deficit would violate the other goal of Financial Fair Play, i.e., to restore the competitive balance. Unless donors, patrons or other equity participants are excluded from engaging in professional club football, those clubs not having access to external money would be hit more seriously by a debt limit and would suffer a unilateral competitive disadvantage. To remedy such an unintended outcome the deficit limit is supplemented by a notion of “relevant income”. All income accrued by non-football operations is strictly excluded from “relevant income”, on which the “break-even result” is based (cf. Article 58).

Thus the two primary goals of Financial Fair Play are not contradictory to each other with regard to the “break-even requirement”. But as can easily be seen, the “break-even requirement” is not sufficient to restore the competitive balance. As argued above, an unregulated professional sports league tends to increasingly monopolize due to a self-perpetuating spiral of success (“success breeds success”). An initial success leads to higher revenue which in turn can be used to strengthen the team, making further success even more likely. Therefore, an additional redistribution of income is needed in a professional sports league to remedy market imperfections and to avoid an unchallenged dominance of a few clubs. Domi-

nance of this kind could predetermine the championship, thereby violating the foundation and the objectives of sports and undermining the acceptance of fans and spectators which is the commercial basis of professional sports.

When implementing a redistribution mechanism the question arises how it should be designed, i.e., which clubs should be included in such a mechanism. A redistribution of income is much more difficult to carry out in the many “open” leagues in Europe as opposed to only a single “closed” league in the US (for a discussion of US sports, see, e.g., Vroomann 2000). Moreover, a redistribution of income is only effective in restoring competitive balance if the resulting marginal revenue curve decreases over the relevant range, as shown by Vöpel (2006). Actually, the marginal revenue curve in football falls considerably short of a downward slope and is thus ineffective in rebalancing competition.

As already indicated, Financial Fair Play is incomplete with respect to the number of goals and the number of instruments. According to the “Tinbergen rule”, the number of instruments must be at least as high as the number of goals in economic policy (Tinbergen 1978). Otherwise the outcome of regulation will be either inconsistent or indeterminate allowing for multiple equilibria.

Another important question is whether Financial Fair Play is justified by a cost-benefit analysis. Regardless of what might be the specific outcome of Financial Fair Play the costs of regulation caused by implementing, monitoring and enforcing the rules are likely to be considerably high. This is because clubs will presumably pretend to adhere to the rules while on the other hand trying to declare income from non-football operations as “relevant income” in order to avoid the restrictions imposed by the regulations. This behaviour is likely to spread widely within club football and would obviously be very costly to detect.

“Does money score?” is a well-known phrase pointing out that there are some doubts whether money really does score but also indicating football fans’ approval even if it were possible to “buy” success in sports with money. Empirically, several attempts to “buy” success in football show only very mixed results. Obviously, much more is needed than money to be successful in sports, especially in football where scores are low and to a consid-

erable extent stochastic, players can unexpectedly be in bad shape or injured, for example (Quitau and Vöpel 2009). Nevertheless, *ceteris paribus* money always helps to acquire the best players as well as the best coaches and managers, making success much more likely. But there are numerous “natural equalizers” that more or less endogenously restrict the market power of clubs and prevent them from moving too far ahead. An important reason why clubs may fail to perpetuate their initial success can be found in a permanently changing pool of players. There is a always steady inflow of young and new players entering the pool and a steady outflow of older players retiring from football and leaving the pool. Therefore, in addition to money it is the quality and reliability of private information that plays a crucial role for success in a market that is fundamentally characterized by various kinds of asymmetric information among its participants.

Empirically, neither insolvency nor monopolization has been a serious problem in professional club football. There is no clear evidence that the competitive balance has been distorted more heavily as a result of recent developments in the European club football than in previous years. The “uncertainty of outcome”, which is considered to be one of the most important determinants of the demand for football (Szymanski 2001), has apparently not diminished over time. Also insolvency has not been a problem of significant importance in European club football. Moreover, it would have to be proven that a single club’s disappearance from the market due to insolvency could have negative external effects or even exhibit systemic risks due to its high systemic importance or relevance for the European club football as could be assumed for clubs like FC Barcelona, Real Madrid or Manchester United.

Finally, the long-term competitive equilibrium in European club football is to a large extent determined by the size of potential revenue, which in turn depends crucially on the size of the domestic market (population size, income per capita and population’s average interest in football) rather than on the occasional patron or investor. Nevertheless, there might be some path dependencies that play a crucial role in determining competitive balance, such as the Premier League’s historical advantage of entry into the markets of former Commonwealth countries or cultural and language-related preferences of players coming from Africa or South America.

## Conclusions

According to the UEFA, Financial Fair Play is aimed at rebalancing competition and enhancing long-term financial stability in European club football. This is to be reached by a “break-even requirement” that limits a club’s deficit and restricts the influence of patrons and investors. Summing up all pros and cons, it can be concluded that Financial Fair Play does not seem to be an appropriate regulation because it is incomplete, of uncertain effectiveness and very costly to monitor compared to potential benefits.

Empirically, insolvency has not been shown to be a serious problem in professional football and, moreover, there is no obvious systemic risk resulting from the insolvency of a single club that would justify tighter regulation. Furthermore, imposing a ceiling on deficits and excluding private equity participants from financing or donating clubs in professional football might help to rebalance competition from a static point of view. Regarding long-term effects, a tighter regulation might turn out to be dynamically inefficient as it unintentionally protects well-established clubs from being challenged by non-established clubs. Therefore, Financial Fair Play could ultimately and counter-intuitively confirm an unbalanced competition rather than making it more even. As has been shown, a redistribution of income is additionally needed to restore competitive balance. Furthermore, a more market-based instrument would be less costly than just imposing a ban of equity participants in football. Alternatively, explicitly including income from non-football operations into a redistribution mechanism could lower the incentives for patrons and private investors to become involved in football clubs.

All in all it is highly doubtful whether such a far-reaching and costly form of market intervention like Financial Fair Play is actually justified in economic terms. But only time will show how football will respond to Financial Fair Play and how “fair” it really is.

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