FTC Proposal Jumps The Gun On Banning Noncompetes

By **Daniel Gilman and Brian Albrecht** (January 19, 2023)

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The U.S. economy has a new labor regulator. Under a just-unveiled proposed rule, the Federal Trade Commission would ban the use of noncompete terms in employment agreements nationwide.

Thousands of employers and millions of jobs are potentially affected. With only limited exceptions, it would cover every income level, industry and occupation in the United States.

An employee signs many documents when they start a new job. Among them, sometimes, is an agreement to not work for the employer's competitors for a certain period of time. A 2014 survey recently analyzed in The Journal of Law and Economics indicated that roughly 18% of U.S. workers were bound by some form of noncompete agreement.[1]

Some economists and policymakers have raised concerns that noncompetes may be a way for businesses to exploit workers. In a July 2021 executive order, President Joe Biden declared, "Powerful companies require workers to sign non-compete agreements that restrict their ability to change jobs."[2]

This concern about worker exploitation isn't without reason. A 2021 study by Michael Lipsitz, an economist at the FTC, and Evan Starr, an assistant professor at the University of Maryland, shows there is good evidence that Oregon's 2008 noncompete ban raised average wages for hourly workers.[3]

While many noncompetes may harm workers, the FTC's proposed rule jumps over a hot and developing debate in economics to reach a radical conclusion: that the costs of noncompetes so greatly and broadly exceed the potential benefits that they must be banned across the board. The evidence doesn't support that contention.

Especially in high-tech industries, workers and firms both make investments before the worker contributes something of value. Workers need to learn the ins and outs of the company — everything from software systems to informal norms. Employers need to train workers. When students finish college, they have relatively few job-specific skills. Skills are acquired on the job.

Unlike investments in new equipment, however, investments in workers only retain their value to the firm if the worker remains there. The underlying economic problem is this: If the worker can take the firm's investment to a competitor before the firm recoups that investment, the firm may underinvest in worker training.

Similarly, if a worker could take company know-how and trade secrets to a competitor, the firm might under-share trade secrets with their workforce. There's the backstop of trade secret law, but that is hard to enforce.

This is known as a hold-up problem. With skills in hand, a worker can hold up the employer for more money or simply quit before their contributions offset the firm's investment. If this cut-and-run behavior happened routinely, the costs to the economy would be enormous.

Luckily, there are at least partial solutions to the hold-up problem. Some workers are paid partly in stock options that vest over multiple years, some sign agreements not to reveal business secrets and some sign noncompetes.

Contrary to Karl Marx's vision, the real-world economy is not a zero-sum struggle between workers and capitalists. People work together because it's mutually beneficial. Sometimes, by some miracle, workers and firms sign agreements because both believe the agreement to be profitable. A total ban on such agreements would hurt those workers and firms alike.

That both workers and firms can benefit from noncompetes is not merely theoretical. Evidence supports what theory predicts: The greatest benefits of noncompetes accrue to high-skilled workers.

A 2019 study published in The Journal of Human Resources finds that the wage returns to employee tenure that doctors enjoy are greater where there are agreements to bar them from poaching patients.[4] CEOs with enforceable noncompetes likewise have lower turnover and higher pay, according to a 2021 paper published in The Review of Financial Studies.[5]

This is not to suggest that noncompetes are always beneficial. For example, they may tend to suppress wages and mobility for low-wage workers. And California famously banned the enforcement of noncompetes in 1941 without stifling growth.

A 2019 paper published in Cornell's IRL Review finds that the average worker receives 14% more training from their employers in states where noncompetes are generally enforced than in a state like California, with no enforcement.[6]

This suggests that many workers are compensated for noncompetes with extra training. But that same average worker's wages are 4% lower, suggesting that there is a trade-off between training and wages.

To justify a universal ban, we should know more than we do about the use and effects of noncompetes. The FTC could use its vast powers to collect more and better data, for a start. The current regime is imperfect, but the proposed ban would exceed both the evidence and, not incidentally, the commission's rulemaking authority.

The question of whether a noncompete is enforceable has traditionally been a matter of state law: Each state has its own restrictions on noncompetes for one or another section of its workforce. That permits experimentation by firms and by the states.

The FTC's rule would terminate these experiments.

The U.S. Department of Labor should move over; the FTC has named itself labor market regulator.

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[1] https://www.journals.uchicago.edu/doi/10.1086/712206.

[2] https://www.whitehouse.gov/briefing-room/presidential-actions/2021/07/09/executive-order-on-promoting-competition-in-the-american-economy/.

[3] https://pubsonline.informs.org/doi/abs/10.1287/mnsc.2020.3918.

[4] http://jhr.uwpress.org/content/early/2019/02/04/jhr.55.3.0617-8840R5.abstract.

[5] https://academic.oup.com/rfs/article-abstract/34/10/4701/5909665?redirectedFrom=fulltext.

[6] https://journals.sagepub.com/doi/full/10.1177/0019793919826060.