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Regional disadvantage? Employee non-compete agreements and brain drain

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ABSTRACT

A growing body of research has documented the local impact of employee non-compete agreements, but their effect on interstate migration patterns remains unexplored. Exploiting an inadvertent policy reversal in Michigan as a natural experiment, we show that non-compete agreements are responsible for a “brain drain” of knowledge workers out of states that enforce such contracts to states where they are not enforceable. Importantly, this effect is felt most strongly on the margin of workers who are more collaborative and whose work is more impactful.

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1. Introduction

Why has Silicon Valley become the most entrepreneurial area not only in the U.S. but also arguably in the world? More generally, how can policymakers achieve “regional advantage” (Saxenian, 1994) at the sub-national or state level? Understanding the microfoundations of clustering is of interest both to scholars of agglomeration and to policymakers who wish to encourage enterprise and growth. Although natural advantages have been shown to contribute to agglomeration (Ellison and Glaeser, 1999), recent evidence suggests that Marshallian mechanisms such as labor pooling have an even greater effect (Rosenthal and Strange, 2001; Roos, 2005; Ellison et al., 2010). The benefits of labor pooling are often attributed to the interorganizational mobility of workers, which not only facilitates better job matching (Helsley and Strange, 1990) but also encourages individual investment in human capital (Diamond et al., 1990; Rotemberg and Saloner, 2000) given the expanded market for one’s expertise and reduced risk of holdup by one’s employer. Given that the economic vibrancy of a state and the positive externalities from agglomeration are increasing in the size and quality of its labor pool, it is important to understand factors that shape the dynamics of how the stock of talent in a given state might accumulate or deplete over time.

A high-quality state-level workforce may be built up and maintained in several ways. Unskilled workers may be (re)trained at some expense. Skilled workers not in the state may be enticed to relocate (Bresnahan et al., 2001). Local universities produce high-quality graduates year after year. Most importantly, all of these, as well as skilled workers already working in the state, must be retained. In other words, a key policy challenge, especially in today’s knowledge-based economy, is to prevent a “brain drain” of talent. Although the term is most commonly discussed in the context of out-migration from less developed countries to the U.S. or other nations (Kwok and Leland, 1982; Gould, 1994; Grubel and Scott, 1996), talent retention is a priority in advanced economies like the U.S., especially as sub-national regions such as states seek to maintain or enhance their economic competitiveness relative not just to foreign locations but also to one another. Indeed, the fiercest competition for talent may come from not from abroad but from within the same country as domestic relocation is not inhibited by immigration policy. In addition to being an important issue in itself, focusing on intra-national migration provides a cleaner setting for examining the role of migration-related policies more generally.

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States within the U.S., although by no means homogenous, are typically more similar than different countries tend to be. This makes it easier to come up with a research design that disentangles migration effects attributable to policy versus those caused by confounding factors like language differences, cultural differences, macroeconomic conditions and immigration restrictions that are naturally more prominent in shaping migration patterns across national borders than state borders.

Skilled workers are essential not only to staff existing firms in the area but also to attract firms outside the state to relocate as well as to facilitate the launch and growth of startups (Zucker et al., 1998). Indeed, tax and other incentives may fall short if businesses worry about the local labor supply. As just one example, Borjas et al. (1992:148) use data from the Current Population Survey to show that Massachusetts "exports its most able workers". These data are corroborated by a report entitled *Talent Retention in Greater Boston* (Guzzi, 2003), which indicated that "fully half of graduates leave the area after receiving their degrees." Addressing similar concerns, major cities including Milwaukee, Denver, Tampa, Louisville, Detroit, and Birmingham have launched initiatives designed to entice skilled workers to remain in the state. Noted Tami Door, CEO of the Downtown Denver Partnership, "Before moving or opening an office, companies strongly consider the workforce available in a particular place. Employers will follow the workforce" (Door, 2012). Hence, an understanding of factors that promote (or discourage) the retention of talent—especially actionable policies—may promote economic competitiveness.

Scholars have sought to understand the determinants of within-nation-across-state or "internal" migration at least since Ravenstein's (1885) exploration of mobility among U.K. workers (see Greenwood, 1997 for a review). Individual characteristics such as age (Plane, 1993) and social connections (particularly among immigrants, see Reher and Silvestre, 2009) as well as regional characteristics including geographic distance (Lansing and Mueller, 1967) and climate (Graves, 1979) play a key role in the relocation decision. A particularly frequent finding within this literature is the role of economic constraints in spurring out-migration. Sjaastad (1962) may have been the first to formally model the decision to emigrate as an investment in one's human capital, an intuition subsequently borne out in studies using microdata as states with more attractive job prospects enjoy greater in-migration (Treyz et al., 1993; Blackburn, 2010). Moreover, out-migration is not limited to the un(der)employed but rather appears to be increasing in opportunity cost. Better educated and more highly skilled workers are more likely to relocate in response to economic constraints in their current state (Borjas et al., 1992).

Given the responsiveness of talent to relocation incentives, identifying actionable policies to attract and retain key workers would seem a key potential contribution of this literature. But as Greenwood (1997:648) acknowledges, despite several decades of scholarship "few direct links have ever been drawn between policy tools. . .and internal migration". In this article, we identify an employment policy governed at the state level that might influence interstate migration of skilled workers: the enforcement of employee non-compete agreements. Non-compete agreements are employment contracts that place restrictions on the sorts of jobs ex-employees may take after leaving the firm, usually for a term of 1–2 years. Although companies frequently ask employees to sign non-disclosure agreements that bar them from sharing trade secrets, violations can be difficult to detect whereas it is more straightforward to determine whether an ex-employee joined a competing firm.

Prior work on employee non-compete agreements has focused primarily on how they affect dynamics *within* a state. Using the Current Population Survey, Fallick et al. (2006) found cross-sectional evidence of higher mobility among computer engineers within California, where non-competes are not enforceable. Marx et al. (2009) added causal evidence for within-state mobility using a natural experiment among the larger population of patent-holding inventors. Similar results were recovered by Garmaise (2011) for public-firm executives. That these studies find employee non-compete agreements to be a brake on in-state mobility is particularly significant given that scholars have found interorganizational worker mobility key to the localization of knowledge spillovers. Almeida and Kogut (1999) established strong correlations between in-state mobility of semiconductor engineers and patent citation localization, particularly in California. Similarly, Breschi and Lissoni (2009) found only weak spillover localization in the European biopharmaceutical industry once citations from mobile inventors were excluded. Building on these findings, Belenzon and Schankerman (2013) demonstrated that non-competes lead to fewer local knowledge spillovers within the state.

The in-state implications of employee non-compete agreements are thus well established. Unexplored however is whether non-compete agreements affect the flow of knowledge workers *across states*. In this paper, we argue that highly skilled technical professionals (such as inventors) who live in states where employee non-competes are enforceable have incentives to relocate to states where such agreements are not enforced and their career flexibility is hence less constrained. Within the U.S., employment lawyers routinely counsel clients subject to non-competes to take jobs in states that do not sanction non-competes; moreover, hiring managers and headhunters alike advertise the benefits to prospective employees of working in a state where they are not subject to non-competes (Marx, 2011). Moving to a non-enforcing state in order to avoid a non-compete is facilitated by the "public policy exception" whereby judges are not obligated to uphold out-of-state contracts which would be contrary to the laws of the focal state.[1]

This paper makes two contributions relative to the prior literature. First, we find that enforceable employee non-compete agreements not only reduce within-state mobility among firms (as shown in prior literature) but also induce inventors to exit the state. Moreover, these exiting inventors migrate specifically to states where employee non-compete agreements are unenforceable. Our evidence is based on a difference-in-differences analysis of an inadvertent reversal of non-compete enforcement policy in Michigan, which has been exploited previously but only to analyze within-state trends. The results are not dependent on a particular industry and cannot be recovered in a series of placebo tests.

Second, the "brain drain" driven by employee non-compete agreements is most visible on the margin of workers who are more collaborative and whose work has greater impact. Elite inventors both have higher opportunity costs and may enjoy preferential access to professional opportunities at firms outside the state, which is reflected in their disproportionate likelihood of departing Michigan for non-enforcing states following the policy reversal. While several scholars have explored the impact of non-competes on individual workers (Fallick et al., 2006; Marx et al., 2009; Garmaise, 2011), this paper is the first to show that more valuable workers are more substantially affected by non-competes. Such workers may be particularly painful for a state to lose, given their

[1] The governing case is *Application Group Inc. v. Hunter Group Inc.*, 61 Cal 4th App 881, 72 Cal. Rptr. 2d 73 (1st Distr. 1998), in which an employee of a Maryland firm took a new job in California. Although the employee had been subject to a non-compete, the CA judge refused to enforce the agreement because it violated CA law. Note that although contracts typically stipulate a "choice of law," in their 1971 *Frame v. Merrill Lynch* ruling (20 Cal. App. 3d 669) the California courts forbade corporations from specifying out-of-state jurisdiction as a means of cherry-picking one's non-compete enforcement regime.

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