POLICY SPOTLIGHT

The Problem with a Federal Ban on Noncompete Agreements

ALDEN ABBOTT AND LIYA PALAGASHVILI | MAY 2023

The Biden administration has expressed concern over the supposed harm of noncompete agreements—clauses in employment contracts that limit employees from competing in the future with their current employer. Believing that such clauses unreasonably limit competition, the Federal Trade Commission (FTC) may promulgate a rule aimed at prohibiting the use of noncompete provisions in employment contracts. Doing so would raise substantial economic and legal issues. A more prudent option would be a targeted approach that requires employers to inform prospective employees about noncompete agreements before employment offers are finalized. Such a rule would be far more likely to pass statutory cost-benefit requirements (which also represent sound economic policy) than would more expansive regulatory proposals.

AN AFFRONT TO COMPETITIVE FEDERALISM

In the United States, noncompete agreements historically have been the province of state, not federal, law. Forty-seven states permit noncompetes in some fashion. In recent years, many states have restricted noncompetes to prevent abuses, to define the circumstances in which they will or will not enforce noncompetes, and to ensure procedural protections.

- In general, federalism yields more effective and efficient policies than a centralized directive imposed by the national government.
- State laws on noncompetes differ substantially, and those differences foster "natural experimentation," with the changes between varying jurisdictions facilitating comparisons of the effect of the different approaches on noncompetes.
- Having each state create its own regulations on noncompete laws will allow for best practices to emerge and thereby drive welfare-enhancing reforms across multiple jurisdictions.
- FTC promulgation of a final rule that effectively preempts this state policy experimentation would freeze in place a one-size-fits-all approach that could harm economic welfare.

UNDERSTANDING POTENTIAL COSTS AND BENEFITS

Bans on noncompetes are being considered without sufficient empirical foundation. The limitations in existing research in this area preclude the FTC from adequately assessing the potential costs and benefits of noncompete agreements for high-skilled workers. Making hasty reforms risks ill-conceived public policy decisions.

There is no research consensus on whether noncompetes positively or adversely affect training, wages, information sharing, firm entry, innovation, and ultimately consumer welfare for high-skilled workers. Until there is a better understanding about these matters for high-skilled workers, policy responses may generate unintended negative consequences or seek to address a situation that is not substantial enough to merit policy change.

A BAN ON NONCOMPETES COULD REDUCE INNOVATION

The FTC claims that noncompete agreements decrease innovation. It makes this claim by relying on one unpublished working paper that finds that noncompete agreements cause a decrease in the value of patents and by assuming—mistakenly—that innovation is derived only from an increase in the value of patents. The FTC also assumes that risk, failure, experimentation, and breakthrough innovations are not indicative of innovation, which is the opposite of the empirical evidence.

A ban on noncompete agreements for high-skilled workers could reduce innovation through (a) fewer investments in human capital, (b) a reduction in riskier research and development investments that are necessary for breakthrough innovations, and (c) a decrease in the quantity of new innovations.

ADVANTAGES OF A MORE TARGETED APPROACH

The FTC's traditional tools of case-by-case litigation, competition advocacy, and even informal guidance are superior options to a broad rule in addressing unreasonable noncompetes.

If the FTC does choose to go ahead with a rule, it could use a more targeted approach—for example, a rule that requires employers to inform prospective employees about noncompete agreements before employment offers are finalized. Such a rule would be far more likely to pass statutory cost-benefit requirements, could prove to be an efficient and beneficial use of FTC resources, and would substantially advance the public interest.

FURTHER READING

Alden Abbott. "The FTC's NPRM on Noncompete Clauses: Flirting with Institutional Crisis." *Truth on the Market*, January 10, 2023.

Alden Abbott. "The New FTC Section 5 Policy Statement: Full of Sound and Fury, Signifying Nothing?" *Truth on the Market*, November 22, 2022.

Alden Abbott and Andrew Mercado. "FTC Rulemaking on Noncompete Agreements" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, September 28, 2021).

Alden Abbott and Liya Palagashvili. "Federal Trade Commission's Proposed Noncompete Clause Rule Requires Rethinking, as a Matter of Law and Policy" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, April 10, 2023).

Comments of FTC alumni, including former General Counsel Alden Abbott, to Federal Trade Commission: Non-compete Clause Rulemaking, 16 CFR Part 910, RIN 3084-AB74, March 20, 2023.

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