

IGC Contract RA-2010-03-002 – Policy Brief

Title: *Employee Spinoffs and the Formation of Teams – Evidence from Brazil*

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Policy Motivation for Research: As employees produce goods and services and sell them to customers on behalf of their firm, they learn about the firm’s technology, the customers’ locations and preferences, and the capabilities of their fellow employees. They can and do put this knowledge to work by founding new productive enterprises of their own. In many developed countries employers commonly ask key employees to sign contracts containing “non-compete” clauses that restrict the employees’ possibilities to compete with their former employers in the event of separation. In the United States, such enforcement varies widely from state to state and has even changed within states over time. In Brazil, non-compete clauses are currently mostly used in the case of divestitures or mergers and acquisitions and only bind the employees not to join competing businesses within the same region.

Policy Impact: Governments must decide whether to enforce non-compete clauses at the risk of discouraging employee entrepreneurship. The project finds for the period 1995-2001 in Brazil that between one-sixth and one-third of new formal sector businesses are employee spinoffs, and that spinoff firms outperform new formal sector businesses without identifiable parents in terms of size and survival. These results suggest that, as developing countries increasingly reform their legal practices to resemble those of developed countries, they should be wary of importing expanded enforcement of non-compete clauses that could restrict worker mobility and formation of employee spinoff firms.

Audience: The audience includes 1) policy organizations interested in small or startup businesses, such as the Brazilian state-owned consultancy service for small enterprises SEBRAE; 2) labor-market policy makers as well as employer associations and trade unions interested in the movement of workers between firms; 3) organizations concerned with the formation of industry clusters, ranging from local promotion agencies (such as the State Secretariat of Local and Regional Development in Ceará, SDLR) or Brazil’s national policy to generate so-called “local production arrangements”; 4) organizations concerned with industrial competitiveness, such as the UN organization for Latin American development CEPAL and international organizations; and 5) international trade promotion agencies.

Policy Implications:

- *Employee spinoffs benefit the workers recruited to the spinoffs from the parent firms.* Employee-entrepreneurs are able to recruit their co-workers because their superior knowledge of their co-workers’ capabilities and preferences allows them to match them to jobs better than their current employers can. If the entrepreneurs do not have superior knowledge, their colleagues simply remain with the parent firms. The benefits of this improved matching of workers to jobs show up in the contrast between the retention at the new firm of workers hired from the parent with workers hired from the outside labor market. Cumulatively, after five years, workers hired from the parent firm are 52 percent more likely to remain with the spinoff firm than outside hires.

- *Employee spinoffs benefit domestic consumers.*
One of the most striking findings is that employee spinoff firms locate closer to their parent firms than even these parent firms' own new plants. This may indicate that spinoffs disrupt the efforts of parents to maintain local market power. The additional competition should reduce prices and increase variety for local consumers.
- *Employee spinoffs may benefit foreign consumers at the expense of parent firms.*
Spinoffs have between a fifth and two-thirds of their export destinations in common with their parents' destinations at the time of spinoff entry. Spinoffs with a larger number of destinations tend to have more destinations in common with their parents. For the first six years, the spinoffs keep these destinations largely unchanged, whereas parents diversify away from their spinoffs' overlapping destination markets as time progresses. This displacement of parent firms suggests a loss of market power and a gain for foreigners.

Implementation:

- The project identifies employee spinoffs for the entire formal sector of an economy for the first time. However, results for new firms without identifiable parents and for diversification ventures of existing firms are benchmarked against well-established findings for the United States. The strong similarities suggest that the results for employee spinoffs in Brazil may be applicable across diverse national settings.
- Employers in developing countries, especially foreign subsidiaries, may imitate employers in more developed countries and ask their key employees to sign non-compete clauses that could restrict their mobility and ability to form of employee spinoff firms. At this stage, less developed country governments should not expand their enforcement of such contracts.
- Firms in more developed countries sometimes use non-compete clauses to stop employees from "stealing" technological secrets because enforcement of intellectual property laws is too slow. This will become more of an issue for developing countries as they approach the technological frontier. Whether the use of non-compete clauses is warranted in this situation needs further investigation.

Further Readings:

- Gilson, Ronald J. 1999. "The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not To Compete." *New York University Law Review*, 74(3): 575–629
- Glaeser, Edward L., Stuart S. Rosenthal, and William C. Strange. 2010. "Urban Economics and Entrepreneurship", *Journal of Urban Economics*, Special Issue: Cities and Entrepreneurship (sponsored by the Ewing Marion Kauffman Foundation), 67(1), 1-14
- Global Entrepreneurship Monitor. Various years. London : Global Entrepreneurship Research Association
- Haltiwanger, John, Ron Jarmin, and Javier Miranda. 2010. "Who Creates Jobs? Small vs. Large vs. Young", *NBER Working Paper*, 16300.