

# BACON'S REBELLION

The Op/Ed Page for Virginia's New Economy

## Hidden Advantage

**Flexible labor markets are Virginia's unappreciated competitive edge. They speed the redeployment of workers from low value-added industries to high-performance enterprises.**

By James A. Bacon

Classical economists inquiring into the wealth of nations have long distinguished between land, labor and capital as the three primary factors of production. Land, which represents the stock of real estate and natural resources, was the dominant factor in the agricultural era, while the accumulation of capital drove growth in the industrial era. In the post-capitalist era that we call the "knowledge economy," labor is emerging as the key differentiator explaining disparities in economic performance and living standards.

Unlike the old days, when labor input was measured in raw numbers of peasants, serfs or factory workers, the *quality of labor* and the *structure of the labor markets* are what count today. Indeed, in the knowledge economy, we rarely even refer to labor as "labor" anymore: We speak of "human capital." The economic contribution of human beings varies in proportion to which we invest in their education and training. Brainpower leverages a worker's economic contribution by orders of magnitude over the strength of his back or nimbleness of her fingers.

As Virginia seeks to build more prosperous, livable and sustainable communities, it is useful to examine "labor" -- or, more spe-

cifically, the state's workforce -- from three perspectives.

### Flexibility of labor markets.

The first perspective is the flexibility of labor markets. How free is labor to redeploy to more value-added pursuits?



Flexible labor markets and an abundant supply of venture capital are key competitive advantages of the United States.

Together, they ensure that labor and capital are readily reallocated to the fast-growth companies that account for the greatest innovation and job creation (more than offsetting the U.S.'s inefficient use of land, as reflected in its dysfunctional human settlement patterns). As I shall describe below, Virginia lawmakers have considerable sway over the flexibility of local labor markets.

### Development of human capital.

The second perspective is the development of human capital: how much and how effectively we invest in education and training. Judging by standardized test scores, the U.S. does a poor job at the K-12 stage of human capital development. But the country does a superior job of providing access to college/university-level education. The performance of state and municipal government in the education/training arena shapes the extent to which workers possess

critical thinking skills, communication skills, and the specialized fields of knowledge required to engage in fields as varied as management, law, finance, engineering and the sciences.

### Recruitment and retention.

The third perspective is the ability of regions to recruit and retain human capital. A region can spend heavily on schools and colleges in order to build human capital, but the investment will yield little if the best educated graduates migrate to other regions that are more livable or offer superior job prospects. Mill towns like Danville and Martinsville bleed human capital, making it difficult to support high value-added businesses. By contrast, the Washington New Urban Region can boast of the best educated workforce in the United States largely through its ability to recruit and retain human capital.

A world-class economy needs to pay attention to all three attributes of labor. I shall explore the first of these perspectives, the flexibility of Virginia labor markets, in this column and address the other two in subsequent columns of the "Economy 4.0" series.

### Labor Flexibility, Creative Destruction and Wealth Creation

Flexible labor markets are critical to economic growth because they permit people to migrate from low value-added jobs to high value-added jobs, bettering their personal prospects and improving the productivity of the economy generally. Flexibility enables workers to move geo-

graphically: from declining mill towns, for example, to prosperous technology centers. It allows workers to shift from decaying industries, such as apparel and shoe making, to fast-growth industries such as information technology -- assuming workers can acquire the necessary skills along the way -- and to move from failing, inefficient enterprises to high-productivity enterprises.

"Creative destruction" is the phrase coined by Austrian economist Joseph Schumpeter to describe this entrepreneurial transformation of the economy. Although the process does cause temporary hardship for employees who lose their jobs, society as a whole benefits from the reallocation of resources to sectors supporting greater productivity and innovation. In the U.S., a social contract tempers the destructive aspects of creative destruction with a social safety net and the re-training of workers to acquire new, marketable skills.

Labor flexibility also allows enterprises to move employees within the organization to positions where they add greater value. An example can be seen at DuPont's Spruance fiber manufacturing complex in south Richmond. In 2004, the chemical giant faced a major decision: whether to expand local production of its Zytel polymer, used in products ranging from auto parts to chainsaw casings, or to expand off-shore, mostly likely in China. After extensive review, DuPont decided to stick with Richmond, where high-performance work teams had proven their ability to compete.

While the rest of DuPont's operations are industrial hierarchies where union work rules hinder productivity-enhancing changes, the Zytel plant abol-

ished top-down management and specialized job functions. The hierarchy at the Spruance plant was the simplest conceivable: a plant manager and... everyone else. When I wrote about this enterprise in 2004 in "[Capitalist Commune](#)," employees were working in teams, cross training, rotating through job functions and learning how each part of the enterprise contributed to the whole. This hyper-flexible arrangement resulted in labor productivity that ran 25 to 30 percent higher than in peer facilities, and production quality that met the company's highest standards.

The Zytel facility is but one example of high-performance workplaces sprouting across the U.S. economy. Indeed, some economists have argued for acknowledging a fourth factor of production: organization. A significant percentage of the economy's productivity gains come not from a greater investment of capital or even the introduction of new technologies but the implementation of new business processes. Organizational innovations can be implemented most rapidly in industries that enjoy labor flexibility -- that is, free from restrictive union shop rules, government regulations and social-welfare obligations that hinder hiring and firing.

Labor market flexibility varies widely between nations. In Japan, an expectation of lifetime employment made it difficult in the 1990s for companies to lay off unproductive employees so they could seek more useful employment elsewhere. Likewise, many European countries support declining industries to avoid the pain of layoffs, with the result that aging, uncompetitive industries fail to shed workers that could support the growth of more dynamic industries. Generous welfare benefits in some

European countries also reduce the incentive for workers to find new employment, slowing the migration of labor from one sector to another.

Labor market flexibility also varies between states in the United States. The differences are not as vast as between countries, but they can be significant nonetheless. I have identified four areas in which state-level public policy affects the flexibility of local labor markets:

- Union representation and right to work.
- Employment at will
- Certification and licensure
- Employer "social overhead"

Let's take a closer look at each one.

### **Union Representation**

There is lively debate in the academic world over the impact of labor unions on worker productivity. Some scholars argue that labor unions have a minimal or even a beneficial impact. But there is little debate in the real world. Corporations overwhelmingly prefer not to deal with labor unions -- and not just so they have a freer hand in exploiting their workers (although that may be the reasoning in some industries). Union-free workplaces pose fewer obstacles to restructuring, re-engineering and reinventing the workplace in order to achieve higher levels of productivity.

Workers have well-established rights in American law to union representation. But a key differentiator between the 50 states is the Right to Work: the freedom of employees not to join a

labor union even if it has won a vote to represent other workers in collective bargaining. All Southeastern and many Western states have guaranteed a right to work; not surprisingly, the decline in private-sector union membership in the U.S. over the past two or three decades has been most dramatic in those parts of the country.

Virginia is one of the right-to-work states. Only 3.4 percent of private-sector employees in the Old Dominion are union members, making it the 11th lowest state ranked by the percentage of private-sector union membership. As Virginia's economy evolved from a manufacturing-dominated economy to a service-dominated economy between 1983 and 2004, the percentage of private-sector workers with union membership tumbled by two-thirds.

## Employment at Will

Virginia is known as an "employment at will" state, which gives employers greater legal latitude to fire employees. In an article in *Monthly Labor Review*, "[The Employment-At-Will Doctrine: Three Major Exceptions](#)," Charles J. Muhl lists three broad exceptions to an employer's untrammelled right to fire employees at will. These include:

- **Public-policy exceptions**, when firing an employee violates a well-established principle of state public policy, such as protecting employees after they have been injured on the job and protecting employees who refuse to break the law at the employer's request.

In this field of the law, Virginia is in the middle of the pack: It is one of 24 states that provide employment-at-

will exceptions based on public policy articulated in state statutes or the Constitution. Eight states confer employers more rights than Virginia, refusing to recognize public policy exceptions at all, while 17 tilt toward employees, granting exceptions based on broader notions of public good and civic duty.

- **Implied-contract exceptions**, when rights are implied through oral agreements or in employee manuals.

Virginia is one of 13 states in the country that grant no exceptions based on implied contracts. Fifteen other states lean toward greater employee rights, allowing exceptions based on oral and written assurances, and 22 states permit exceptions on even looser grounds.

- **Covenant-of-good-faith exceptions**, which subjects personnel decisions to a "just cause" standard and prohibits terminations made in bad faith or motivated by malice.

Ten states allow employees to invalidate a firing on the basis of just cause or bad faith. But Virginia is among the 40 others that grant no such exceptions.

While individual workers may arguably have fewer legal protections against firing in Virginia than they would elsewhere, the employment-at-will legal doctrine actually helps workers collectively. Employers, with greater assurances that they can fire employees who don't work out, are less guarded about hiring people in the first place.

Despite the tilt in favor of em-

ployer rights, Virginia has one of the lowest unemployment rates in the country: Standing at 3.1 percent in September, unemployment was the 7th lowest in the country. Workers enjoy commensurately strong bargaining positions in the labor marketplace, and their incomes have risen consistently faster than the national average.

## Certification and Licensure

Virginia regulates dozens of occupations and professions, ostensibly for the public good. Regulations cover 55,000 real estate agents, 35,000 architects, engineers and related occupations, and thousands of cosmetologists, soil scientists, polygraph examiners, tattoo artists, body piercers, cemetery workers, opticians and hearing aid specialists. Regulations also cover tens of thousands of health care professionals.

There is one legitimate reason to certify and license different professions: to ensure occupational standards that protect the public. But all too often, the professions wind up regulating themselves and, backed by state law, create veritable guilds or occupational cartels that raise entry barriers (usually by jack-ing up educational requirements), restrict supply and drive up the cost of the service. Many professional associations also work to restrict competition from other professions and occupations, and lobby lawmakers to require the public to engage their services.

The effect of the craft unionization of the professions is particularly baleful in the health care arena, which accounts for about 15 percent of the economy nationally and 11 percent in Virginia. Physician shortages in small Virginia towns, for instance, are aggravated by rules

prohibiting nurses from diagnosing even the most routine of illnesses. Turf restrictions also hinder the ability of hospital managements to re-engineer work processes for greater efficiency. It is no accident that, despite extraordinary technology advances in the health care field, the hospital sector has experienced meager productivity gains compared to the rest of the private sector. (There are other reasons for low hospital productivity, which I shall enumerate in a future column, but the transformation of the medical professions into modern-day guilds is a big one.)

### Social Overhead

In the United States, companies bear certain social costs, most notably the legal obligation to provide unemployment and workers compensation insurance, and the competitive necessity to provide health care insurance. The costs of this "social overhead" vary widely from state to state, reflecting local conditions and practices. The burden of social overhead in Virginia is relatively low, however, providing companies more flexibility in hiring. Social overhead takes several forms.

- **Unemployment compensation.** The state collects an unemployment tax from corporations that varies with the company's past experience in laying off workers and the needs of the Unemployment Trust Fund. Modest benefits and a consistently low unemployment rate have allowed Virginia to keep this tax low. According to the Commission on Unemployment Compensation, the average tax per employee was \$162 in 2005 and was projected to decline to \$113 by 2008. The national average stands

around \$300.

- **Workers compensation.** Employers are required to purchase workers compensation insurance to cover health care and disability costs for employees injured on the job. Rates vary widely from state to state, depending upon the occupational mix, the depth and breadth of the coverage required by the state, and the strength of measures to combat fraud and malingering on the part of employees claiming the benefit. On the one hand, the public interest demands that employees be adequately compensated for their injuries; on the other, employers need to be protected against cheating.

As of Nov. 1, 2005, Virginia's workers comp rates were the 49th lowest of the 51 states and D.C.; Virginia employers paid only 61 percent of the national median, according to the [Oregon Workers' Compensation Premium Rate Ranking](#).

- **Medical insurance premiums.** Most corporations provide medical insurance benefits to their employees as a fringe benefit. As insurance premiums escalate with no end in sight, the cost imposes an onerous weight on business and constitutes a major impediment to job creation. The cost of health insurance varies according to a wide number of factors, including the productivity of the health care system, the scope of insurance coverage provided, and the extent to which hospitals and doctors shift costs to the private sector to make up for under-funding by the Medicare and Medicaid programs and the non-funding

for indigent care.

I could not find any statistical series that compare the average cost of privately funded medical insurance to corporations, but I did locate (1) the percentage of state Gross Domestic Product devoted to health spending, and (2) health care spending per capital. Virginia is ranked 4th from the bottom for the first, and 10th from the bottom for the second. If those numbers are reflected in medical insurance premiums, this critical contributor to social overhead is less burdensome to corporations in Virginia than in most other states.

### Conclusion

Virginia has fewer restrictions on labor mobility than most of the other 50 states, creating a huge competitive advantage that lawmakers should studiously endeavor to maintain -- consistent, of course, with the goal of providing reasonable protections to workers against abuses by their employers.

If lawmakers are inclined to improve Virginia's labor markets, they could fruitfully turn their attention to the ongoing challenge of providing affordable medical insurance. Although Virginia's health care is less costly than that of other states, there is still vast room for improvement. The Commonwealth needs to bolster the productivity of health care providers, spur innovation in delivery methods, make medical insurance available to more people and reduce cost shifting onto the private sector. But that is the topic for a future chapter of the "Economy 4.0" series.

**-- November 12, 2007**

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