

# When Employees have their Say on Capital Structure: Evidence from a Quasi-natural Experiment

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# ESG Goals and Employee Representation

Current approach to achieving ESG Goals conforms to enlightened absolutism ideal  
“Everything for the people, nothing by the people.”

- There may be good reasons for this (*preserve shareholders' bargaining power and risk neutrality, control managers*) (Tirole, 2000).
- Still interesting to consider the possibility of stakeholders sharing control.
- Sources of employees control rights:
  - 1 **Co-determination** system gives employees formal control rights.
  - 2 **Unionization** gives employees informal control rights.
  - 3 **Information** can also give employees informal control rights.
    - Swedish participation system: **Board seats are valuable.**

# Employees and Control Rights

What happens when employees have more control rights?

- **Unclear impact on overall firm value.**

- (+) Credible self-enforcing LT contract induces employees to invest in firm specific skills.
- (?) Monitoring of managers and investment decisions:
  - (+) Information aggregation
  - (-) Conflicts of interest.

- **Evidence of re-distribution of firm value.**

- **Employees** bargain for higher job safety and or higher salaries →  $\downarrow D/E$
- **Shareholders** may fight back by:
  - 1 increasing leverage →  $\uparrow D/E$
  - 2 increasing contingent compensation for managers.
- **Debtholders** are better aligned with employees and may offer better terms to firms with more employee power. →  $\uparrow D/E$

# When Employees have a Say

- **Swedish law allows unions of firms with more than 25 employees to appoint up to 2 board members among employees.**
- We use a **Regression Discontinuity Design (RDD)** to test the impact of employee board appointments.
  - 1 **Decrease in D/E ratio** (of 16.47%).
    - Decrease in interest expense (of 13.13%).
    - Decrease in pledged assets (of 3.65%)
  - 2 **Increase in yearly salary per employee** (of SEK 5,550 (USD 669))
- **Test information channel:** Impact depends on information asymmetry.
  - Growth versus Mature firms.
  - High complexity versus Low complexity firms.

# Data and Institutional Setting

## Institutional Setting:

- High unionization rate (66%).
- High collective agreement coverage (90%).
- Single-tier board system.
- 1987 Act on Board Representation for Employees in Private Employment

## Serrano Database

- Financial statements of all Swedish firms.
- 14,415 firms (24-26 employees).
- 74,073 firms (20-30 employees).
- 170,188 firms (15-35 employees).

# Identification

We estimate the following specification:

$$D/E_{it} = \alpha + \beta \text{Represented}_{it} + f(\text{EMP}_{it} - \text{EMP}') + \text{Represented}_{it} \cdot g(\text{EMP}_{it} - \text{EMP}') + \lambda X + \omega_{jt} + \varepsilon_{it} \quad (1)$$

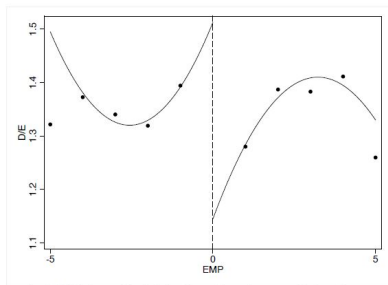
- where  $D/E_{it}$  is the debt-to-equity ratio,  $f(\cdot)$  and  $g(\cdot)$  are continuous functions of  $\text{EMP}$ ,  $X$  is a vector of control variables and  $\omega_{jt}$  are industry-times-year fixed effects.

*Sales, ROA, Sales Growth, Tangibility*

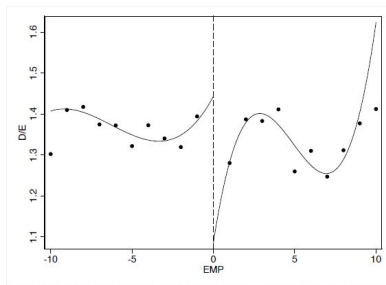
- We estimate the regression with a rectangular kernel and on a small bandwidth (1, 5 and 10 employees) around the cutoff  $\text{EMP}'=25$ .

# Results

**Figure 2. Graphical analysis: Capital structure.**



A. With bandwidth 5 and polynomial of order 2.



B. With bandwidth 10 and polynomial of order 3.

# Results (cont.)

**Table 3. Capital structure.**

Dependent Variable	D/E					
	(1)	(2)	(3)	(4)	(5)	(6)
<i>Represented</i>	-0.1100*	-0.2726**	-0.3348***	-0.0952	-0.2278*	-0.2943**
	(-1.65)	(-1.98)	(-2.65)	(-1.48)	(-1.71)	(-2.39)
<i>Firm Size</i>				0.6597***	0.6516***	0.6605***
				(9.01)	(16.48)	(22.27)
<i>Sales</i>				-0.6638***	-0.6841***	-0.6686***
				(-7.36)	(-14.56)	(-18.91)
<i>ROA</i>				-2.5919***	-2.0298***	-1.9768***
				(-11.23)	(-9.66)	(-11.47)
<i>Sales Growth</i>				0.5629***	0.5142***	0.5153***
				(4.28)	(8.61)	(12.19)
<i>Tangibility</i>				1.3267***	1.3497***	1.3527***
				(14.59)	(25.79)	(34.51)
Polynomial	None	2	3	None	2	3
Bandwidth	1	5	10	1	5	10
Industry x Year FE?	Yes	Yes	Yes	Yes	Yes	Yes
Observations	14,415	74,073	170,188	14,415	74,073	170,188
Adjusted R <sup>2</sup>	0.026	0.021	0.019	0.072	0.065	0.063



# Conclusions

- Using Swedish data we show that board seats, even if they do not impact voting power, are valuable because they give employees access to information.
- Better informed employees are able to bargain for higher job security (lower leverage) and higher salaries.
- Results for growth firms and high complexity firms confirm information channel.