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.
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 → ↓D/E
  - **Shareholders** may fight back by:
    1. increasing leverage → ↑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. → ↑D/E
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:

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

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.
Table 3. Capital structure.

<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>D/E</th>
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<tbody>
<tr>
<td></td>
<td>(1)</td>
</tr>
<tr>
<td>Represented</td>
<td>-0.1100*</td>
</tr>
<tr>
<td></td>
<td>(-1.65)</td>
</tr>
<tr>
<td>Firm Size</td>
<td>0.6597***</td>
</tr>
<tr>
<td></td>
<td>(9.01)</td>
</tr>
<tr>
<td>Sales</td>
<td>-0.6638***</td>
</tr>
<tr>
<td></td>
<td>(-7.36)</td>
</tr>
<tr>
<td>ROA</td>
<td>-2.5919***</td>
</tr>
<tr>
<td></td>
<td>(-11.23)</td>
</tr>
<tr>
<td>Sales Growth</td>
<td>0.5629***</td>
</tr>
<tr>
<td></td>
<td>(4.28)</td>
</tr>
<tr>
<td>Tangibility</td>
<td>1.3267***</td>
</tr>
<tr>
<td></td>
<td>(14.59)</td>
</tr>
</tbody>
</table>

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 R²: 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.