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That is what friends do: employee friendliness and innovation☆

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A B S T R A C T

Recent literature suggests that labor related issues can impact corporate innovation. In this study we hypothesize and find that firms with congenial work environments innovate more and have greater innovative efficiency. Our results also suggest that cash profit sharing and employee involvement have a positive bearing whereas union relationships have a negative impact on innovation output of a firm. In addition, subsample analysis reveals that employee-friendly policies are more important in industries having higher employee power. Our results are consistent with the logic that happy and satisfied employees tend to be more productive than the unhappy and dissatisfied ones. Our work suggests a channel through which satisfied employees contribute towards increasing firm value – by increasing the innovation productivity and efficiency of the firm. So, firms must make continued efforts towards creating and maintaining a friendly work environment.

1. Introduction

"Imagine a world where most organizations were the best place to work. Imagine what we could be getting done on the planet if it were true" – Karen May, VP of people development, Google.

Modern day corporations are trying to ensure that all employees feel a sense of purpose in their work and that they are satisfied and happy, as happy employees tend to be more productive than the unhappy ones (Oswald, Proto, & Sgroi et al., 2009). As such, employee satisfaction is a very broad term and it can be considered as a concoction of several stand-alone

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components. Besides compensation, some factors which can lead to satisfied employees are treatment with care and respect, long-term job protection and adequate retirement benefits, work-life balance, profit-sharing, etc. Several early theories (Herzberg, Mausner, & Snyderman, 1959; Maslow, 1943; McGregor, 1960) ascribe stronger corporate performance (through improved recruitment, retention and motivation) to employee satisfaction. Furthermore, Edmans (2011) finds that firms with high levels of employee satisfaction generate superior returns for shareholders. Similarly, Faleye & Trahan (2011) show that a labor-friendly corporate environment subsequently outperforms a size and industry-matched control sample in terms of value creation, profitability, and productivity. However, it is conceivable that extremely benevolent corporate policies favoring employees may cause them to shirk their duties. Bradley, Kim, & Tian (2016) find that unionization negatively impacts corporate innovation. They argue that unionization provides adequate job protection but inadequate motivation for promoting innovation. Cohen (2009) argues that union employees are less loyal to their firms. Also, one can argue that excessive retirement benefits can shorten the employee work-horizon and may cause employees to slack off. Hence, the popular view that all employee-friendly policies would pay off may not be true. So, if the manager of a firm wants to maximize shareholder wealth then it may be beneficial to focus on some but not all employee friendly policies.

Most studies, simply consider a composite measure of employee satisfaction or analyze a stand-alone component in isolation in order to study the impact of employee satisfaction on corporate outcomes. Hence, a holistic study which covers the several different facets of employee satisfaction is warranted in order to help managers channelize their efforts in the creation of a satisfied and productive workforce. We propose that employees will exert genuine effort for the firm if they are satisfied with the firm. Thus, we test whether overall employee satisfaction in a firm has influence on its innovative ability. Specifically, using multiple techniques, we establish that a firm's employee-friendly polices as indicated by a composite Employee Friendliness Index (*EFI*) escalates a firm's future innovations and innovative efficiency. However, further analyses of several stand-alone policies (components) indicate that they have differential impact on a firm's future innovation output. Specifically, our results suggest that cash profit sharing and employee involvement have a positive bearing on the innovative output of a firm whereas union relationships can lead to a negative impact on innovative output of a firm. In addition, sub-sample analysis reveals that employee friendly policies are more important in the industries having higher employee power than the industries having lower employee power. Hence, managers need to be careful when they design employee-related polices as one size doesn't fit all. To the best of our knowledge, these research questions, in a comprehensive framework, have not been empirically explored so far.

Our paper contributes to the emerging literature on finance and innovation by establishing that favorable corporate environment (for employees) as measured by the Employee Friendliness Index (EFI) positively affects firm innovation and innovative efficiency. These results taken along with the fact that firm innovation increases firm value (Hirshleifer et al., 2013) suggest that employee friendly policies which lead to satisfied employees can increase firm value. Thus, we present a novel channel through which satisfied employees can contribute towards increasing firm value – the channel of innovation. Our study can lend valuable explanation to the results presented by Edmans (2011).

Our results also suggest that firms need to consistently create and maintain an employee friendly environment if they wish to make their employees more innovative (as the impact of friendly policies diminishes over time). This idea is consistent with several media reports which suggest that reward frequency is more important than size.[1] Next, using subsamples, we study labor intensive industries with high employee power (like manufacturing and wholesale) against other industries with low employee power. We find that employee friendly policies play a more important role in industries having higher employee power and lead to generation of more patents and citations. Finally, we also find that managers need to share profits with their workforce and involve employees in strategic decision making process in order to nurture and increase innovative output. At the same time, managers need to find alternate means (rather than relying on unions) of providing adequate job protection to their employees in order to foster innovation, which is consistent with recent studies.

The remainder of the paper is organized as follows: Section 2 presents literature review and Section 3 develops hypotheses. Section 4 describes data and presents descriptive statistics of the sample. Section 5 discusses our empirical results and robustness tests. Section 6 concludes.

2. Literature review

Innovation is a knowledge producing activity which has long-term impact on a firm's success and profitability. In the ever-changing business environment, innovation is the key to success for the modern firms.[2] There is also evidence in the finance literature that innovation benefits a firm by increasing its value (Hirshleifer et al., 2013). Hence, several early studies have tried to decipher the drivers of innovation.

However, it is also important to note that innovation is a long, tedious and risky process associated with huge costs (Holmstrom, 1989). Hall & Lerner (2010) finds that R&D and other innovation investments are highly uncertain and the result of success or failure is revealed over time. Given the nature of innovation, firms need to ensure that their employees are sufficiently motivated to tread along the uncertain path. Hence, tolerance for failure in the short-term and reward for success in the long-term would foster innovation (Manso, 2011). Using extensive data (for over 11,000 industrial scientists

[1] See "How to increase productivity by employee happiness" by Martin Zwilling, Forbes, December 2, 2014.
[2] See "Innovation: key to successful business" by Chad Brooks, Business News Daily, September 23, 2013.

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