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Does it pay to treat employees well? International evidence on the value of employee-friendly culture

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ABSTRACT

We examine the valuation impact of an employee-friendly (*EF*) culture. Using a sample of 3446 firms from 43 countries for the period 2003 to 2014, we show that firms with a more *EF* culture are valued higher and perform better (*ROA*, *ROE*). Consistent with the good governance view, the impact is stronger for firms in countries with better investor protection and for firms with better governance and lower agency costs. We further document a positive valuation associated with the enactment of laws aimed at improving parental leave policies. The impact on valuation stems from improved technical efficiency. Using various approaches, our results suggest that the impact of an *EF* culture on firm value is causal.

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1. Introduction

> "*Train people well enough so they can leave, treat them well enough so they don't want to.*"
>
> [*Sir Richard Branson*]

Is there value in creating a more employee-friendly (*EF*) culture? The quote above by Virgin Atlantic's founder signals what could be the start of a global shift in the way firms view and treat employees, raising important questions about efficiency for financial economists to consider. While firms in the tech sector (e.g. Google, Yahoo, Netflix, Microsoft) are well known for offering employees perks that include free meals, generous paid leave packages and in-building fitness and entertainment amenities, in addition to paying competitive wages, such perks have not been as prevalent in other industries.[1] Yet, the media, government agencies, and corporations are beginning to pay closer attention to the treatment of employees. For instance, San Francisco recently became the first city in the United States to pass a law guaranteeing fully paid parental leave, while Virgin Group made headlines recently with its generous paternity leave policy in which new dads get up to 12 months paid leave.[2] Are these firms following value-maximizing objectives when they offer employees perks like free meals and in-building fitness amenities? Or are these costs simply unnecessary extravagances that come at the expense of shareholders? To date, the evidence on this issue is limited.[3]

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[1] See a recent article by Forbes (http://www.forbes.com/sites/karstenstrauss/2013/05/31/how-to-keep-employeeshappy-and-to-just-plain-keep-them/).
[2] Tuttle, Brad, "Virgin's New Paternity Leave Policy Puts Google and Facebook to Shame." *Money* 10 June 2015.
[3] Using the KLD STATS database, Ghaly et al. (2015) provide evidence that treating employees better is associated with a greater desire by the firm to hold cash.

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We study whether, in general, there are financial benefits to a firm by having an employee-friendly culture. There are two competing views on whether policies that create a more *EF* culture are value enhancing, and the evidence to date is relatively scarce and mixed.[4] The good governance view argues that employee treatment is value enhancing. Building on the reciprocity view (Akerlof, 1982), by treating employees well managers may motivate workers to exert high effort, which should lead to improved performance and valuation. Edmans (2011), and Edmans et al. (2015), provide indirect evidence consistent with the good governance (and reciprocity) view and document that employee satisfaction is associated with superior long-term returns and valuation in countries with flexible labor markets. On the other hand, the agency view, based on the agency theory of the firm (Jensen and Meckling, 1976), argues that employee treatment may be driven by ulterior motives due to misalignment of managerial and shareholder incentives, and thus be value destroying (Pagano and Volpin, 2005). Consistent with the agency view, Cronqvist et al. (2009) find evidence that entrenched managers pay their workers more to enjoy private benefits (e.g. lower effort wage bargaining). Landier et al. (2009) also document that geographic dispersion is inversely related to employee treatment, and further find that divisions that are closer to headquarters are less likely to experience layoffs, and that such layoffs are less sensitive to divisional performance.

There is also evidence that employee treatment affects a firm's capital structure (Bae et al., 2011) and the level of corporate innovation (Chen et al., 2016; Mao and Weathers, 2015). A related literature documents a positive impact of employee stock ownership programs on productivity and innovation (Kim and Ouimet, 2014; Chang et al., 2015). Studies that directly assess the impact of employee treatment on firm value and performance have focused primarily on the impact of compensation, yielding mixed evidence. There is some evidence that higher wages are tied to superior performance (e.g. Mas, 2006; Propper and Van Reenen, 2010; Ouimet and Simintzi, 2015), yet other studies show that managers may derive private benefits by paying higher wages, leading to suboptimal outcomes (Pagano and Volpin, 2005; Cronqvist et al., 2009; Landier et al., 2009). Based on the conflicting views and mixed evidence, the question of whether having an *EF* culture is value enhancing is an empirical matter.

In this paper, we build on the existing literature by exploring the valuation consequences of an *EF* culture and by examining the conditions in which an *EF* culture is value enhancing. To do so we use a comprehensive measure of employee treatment for a large sample of firms covering 43 countries using data from Thomson Reuters' ASSET4 database (ASSET4). Using a broad sample of 3446 firms in 43 countries from 2003 to 2014, we show that firms with a higher *EF* culture are valued higher (higher Tobin's *q* and market-to-book) and perform better (higher return on assets, *ROA*, and return on equity, *ROE*). We test the *good governance* and the *agency views* on the valuation consequences of an *EF* culture by using various ex ante proxies of agency problems, including country-level investor protection, firm-level governance, corporate policies related to the free cash flow problem (Jensen, 1986), and managerial compensation structure (Ferrell et al., 2016). Consistent with the *good governance view*, we find that the impact of an *EF* culture on firm value is stronger for firms with fewer agency problems that may lead to a misalignment of managerial and shareholders' incentives. Further, we explore the channels through which an *EF* culture may impact firm value. Our results indicate that higher *EF* culture firms have higher sales-to-assets, lower costs, and have a greater number of patents. These findings support the *good governance* and *reciprocity* views that argue that treating employees well leads them to reciprocate by exerting high effort. The findings on patents lend support to Chen et al. (2016) and Mao and Weathers (2015) who document a positive impact of employee treatment on innovation for a sample of US firms.

Our study faces at least two problems related to identification. First, reverse causality is a concern because firms that are more profitable may be able to invest more in their employees, which results in a more *EF* culture. One aspect that may mitigate such concern is the fact that economic theories suggest that a firm's culture is specific to the firm and is largely fixed over long periods (see e.g. Lazear, 1995; Kreps, 1990). Second, there could be endogeneity bias caused by omitted variables. If the omitted variable impacts both firm value and a firm's ability to create an *EF* culture, our measure of employee-friendliness would not be exogenous to firm value, and the coefficients from OLS regressions would be biased and inconsistent.

We perform several tests to alleviate these concerns. First, we use an instrumental variables approach and project our measure of *EF* culture on two variables that capture a country's culture, borrowing from Hofstede (1980).[5] Specifically, we use two cultural dimensions: Masculinity vs Femininity (*Masculinity*) and Indulgence vs. Restraint (*Indulgence*). The identifying assumption is that cultural values in a country may shape how firms treat employees, but should not have a direct impact on firm performance, other than through their impact on employee treatment.[6] Using a Two-stage Least Squares (2SLS) approach, we continue to find that firms with greater *EF* culture have higher firm value. Second, we examine the causal effect between changes in Tobin's *q* and changes in employee-friendliness to directly address the reverse causality concerns. The results show that while there is a causal effect of changes in employee-friendliness on Tobin's *q*, past changes in Tobin's *q* have no significant impact on employee-friendliness. Third, we explore two quasi-natural experiments to examine the causal effect of employee-friendliness on firm value. We first test the differential impact on firm value for firms with high and low *EF* culture after a shock to economic activity and employment using the global financial crisis as an exogenous shock. We find that firms with greater *EF* culture prior to the crisis are valued higher during and after the crisis. We also assess whether treating employees well creates value by exploiting the staggered implementation of parental leave laws across several European countries during our sample period. Using a difference-in differences (DiD) methodology, we find that the enactment of these parental leave laws is associated with positive valuation ef-

[4] Similar views arise within the broader corporate social responsibility (CSR) literature (see e.g. Ferrell et al., 2016; Liang and Renneboog, 2017; Adhikari, 2016).

[5] In the finance literature, various aspects of Hofstede's (1980) cultural dimensions have been shown to influence momentum strategies (Chui et al. (2010)), stock price synchronicity (Eun et al. (2015)), and firms' use of external finance to fund growth (Boubakri and Saffar (2016)), among others. Karolyi (2016) provides a review of the literature on culture and finance.

[6] A recent paper by Griffin et al. (2017) show that national culture (this includes individualism and uncertainty avoidance) explains a large portion of a firm's culture through its governance.

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