Failure To Jettison: The Cost of Labor on the Path to Recovery

Guanmin Liao[1], Xiaoyun Yu[2], Yaya Yu[3], Zihan Zhang[1]

[1] School of Business, Renmin University of China, Beijing, China

[2] Shanghai Advanced Institute of Finance, Shanghai, China [3] Ant Financial, Shanghai, China

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INTRODUCTION

■ Zombie firms are detrimental to the real economy growth

- They crowd out their healthy counterparts and distort resource allocation. Nevertheless, zombies are prevalent in both developed and emerging economies.

■ Motivating question

- How to expedite the recovery from financial distress and safeguard firms against slipping into zombies?
- Do labor costs affect the employment decisions of distressed firms and impede the likelihood and speed of distress resolution?

■ China provides a unique setting

- We can identify financial distress based on actual incidences of **bank loan defaults**
- **The 2008 Labor Contract Law** helps to establish causality
- Mandated disclosure on **workforce composition information** helps to investigate how workforce structure affects firm recovery from distress

METHODOLOGY

$$y_{i,t} = \beta_0 + \beta_1 Post_t \times Distress_{i,t} + \beta_2 Distress_{i,t} + \boldsymbol{\gamma X_{i,t-1}} + \alpha_i + \theta_{p,t} + \phi_{c,t} + \epsilon_{i,t}$$

■ y ➡ Employment decisions

- Employment Growth and Layoff Rate

Total number of employees | Number of low-quality employees | Number of high-quality employees

■ Workforce composition

College degree ← Education

Technical skills → Technology, R&D, Financial services

■ Distress

- Set to one if the firm defaults on its short-term or long-term loans

CONCLUSIONS

■ Distressed firms decelerate the layoff rate of low-quality employees post LCL

■ Following an increase in the cost of laying off employees, distressed firms with a pre-existing larger share of low-quality employees

- Experience a decline in performance and a higher cost of debt financing
- Increase sales of assets and cut wages to a greater extent
- Have a lower probability of survival and a higher likelihood of turning into zombies

➢ The prolonged recovery process exacerbates the departure of high-quality workers and allows more resources to be sunk into distressed firms

➢ A larger share of distressed firms crowds out resource allocation to non-distressed local firms

RESULTS

Employment Decisions

Labor Quality Classification:		Education		Technical Skills	
	All Employees	Low-quality Employees	High-quality Employees	Low-quality Employees	High-quality Employees
			Employment Growth		
Distress × Post	**0.054*****	**0.059*****	0.034	**0.057*****	0.050
	(2.94)	**(2.98)**	(1.43)	**(2.72)**	(1.62)
			Layoff Rate		
Distress × Post	**-0.035*****	**-0.035*****	-0.019	**-0.036****	-0.029
	(-2.75)	**(-2.72)**	(-1.30)	**(-2.55)**	(-1.29)
			Mass Layoff		
Distress × Post	**-0.043*****	**-0.040*****	-0.001	**-0.040****	-0.031
	(-2.90)	**(-2.59)**	(-0.04)	**(-2.35)**	(-1.20)

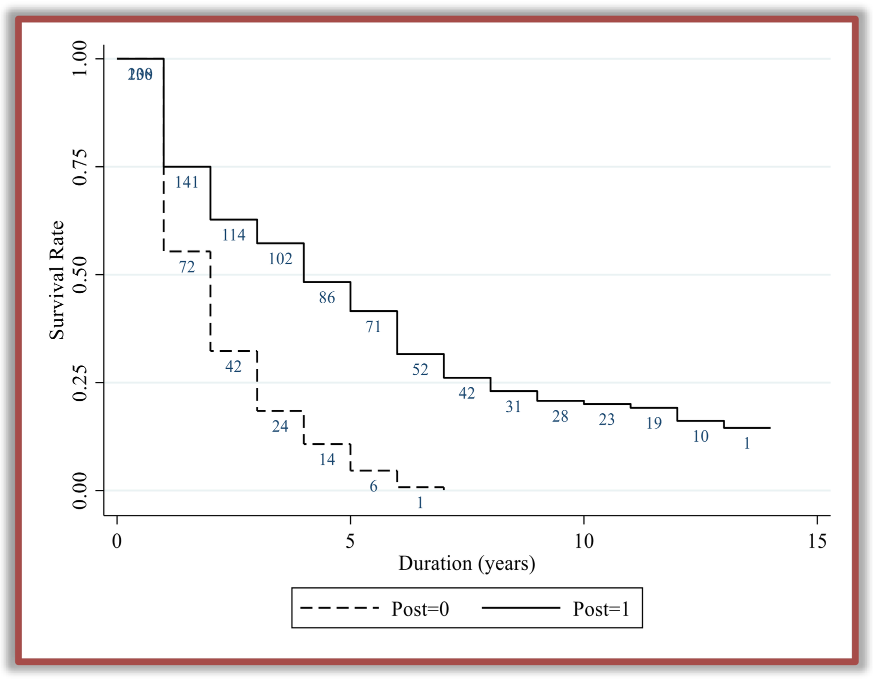
■ Cross-sectional analyses

- Provinces with a higher enforcement efficiency, more frequent labor unrests and ex-ante more employer-friendly local courts

■ Consequences of workforce adjustment

- Higher cost of capital Lower ROA and wage growth
- More asset sales (High Capital-Labor Substitutability)

Survival Analysis



Post LCL, financially distressed firms have 64.5% lower hazard rate of **survival** and 1.2 times higher hazard rate of **becoming zombies**

Particularly pronounced among firms with a workforce comprised mostly by **less skilled workers**

Delay in Recovery

■ The longer the firm stays in financial distress

- The lower the fraction of high-quality employees remaining in the firm
- The more government subsidies it absorbs

Spillover in Non-Distressed Firms

Labor Quality Classification:		Education	Technical Skills
		Government Subsidies	
Fraction of Distressed Firms	-1.520***		
	(-6.05)		
Fraction of Low-quality Labor-Intensive Distressed Firms		-1.433***	-1.400***
		(-4.01)	(-3.88)
		Bank Loans	
Fraction of Distressed Firms	-0.100*		
	(-2.83)		
Fraction of Low-quality Labor-Intensive Distressed Firms		-0.108**	-0.117***
		(-2.52)	(-2.89)
		Financial Constraint	
Fraction of Distressed Firms	4.754*		
	(1.78)		
Fraction of Low-quality Labor-Intensive Distressed Firms		5.582*	4.875
		(1.95)	(1.47)
		TFP	
Fraction of Distressed Firms	-0.355***		
	(-3.42)		
Fraction of Low-quality Labor-Intensive Distressed Firms		-0.495***	-0.490***
		(-3.93)	(-3.85)

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