How labor market frictions affect capital structure

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How does labor market frictions affect capital structure?

- Modigliani Miller 1958

  Why does capital structure matter at all?

  Bankruptcy costs can be high(er) after accounting for stakeholders who might not be (fully) represented at the bargaining table.
- A firm's labor force is one such under-represented entity.
- **This paper:** How does adding capital structure to a workhorse labor market search model affect capital structure decisions?

What we do

- Highlight empirical findings in the literature that call for the models we present.
- Present a simple three period model to highlight the channels.
- Present a fully dynamic model and do something...

Main channels

- Absent any search frictions, owners of production utilize optimal quantities of debt.
- With labor market frictions, the firm partners with a risk averse worker who potentially has the option to quit the partnership.
- While this quitting in a partial equilibrium setting benefits workers ex-post, it leads to less entry, less-than-optimal debt use, lower equilibrium wages and ex-ante lower value to workers.
- The fully dynamic model does something...

Literature

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Empirical observations

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Model without Labor Market Frictions

In this simple setup, there are no search frictions and the firm owner simply considers a debt choice . The firm would be identical to a risk neutral worker.

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Simple Model with Labor Market Frictions

The worker owns the entire production unit. The firm would be identical to a risk neutral worker.

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Dynamic Model with Labor Market Frictions

The worker owns the entire production unit. The firm would be identical to a risk neutral worker.

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Conclusion