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# Value Creation Through Employer Loans: Evidence of Informal Lending to Employees at Small, Labor-Intensive Firms

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**Abstract.** At small and medium-sized enterprises (SMEs), cash-strapped employees frequently request loans from employers because they cannot obtain money on reasonable terms elsewhere for exigent needs. In turn, employers decide whether to lend the money through formal (i.e., written, contractual) loans or more informal "off-the-book" (OTB) loans. Our exploration of this understudied source of credit unearths important questions about the reasons employers lend money to employees, the manner in which they decide to make formal or informal loans, and the coveted benefits employers derive from lending to their workers. Considering the pervasiveness and significance of loan choices among small firms, and the absence of studies on the topic, we tackle these questions through an analysis of 459 informal and formal loans issued by 83 small business owners to their employees. The results show that the issuance of OTB loans is a key tactic for employers to manage resource dependencies with valued workers.

**Keywords:** decision making • resource dependence • strategic human resource management • trust • social psychology • culture • SME



*Felix Veloz is tapped out. He is broke again, despite the fact that yesterday he received his net weekly pay of $547 from the roofing company where he has worked for three years. Felix's financial bind is not his fault, but it has become his problem. Last month, he lent $1,600 to his unemployed brother to pay for his niece's quinceañera. This month, he is being pressured to make a payment on his mother's medical bills. Since he was cosignatory at the hospital, a collection company is garnishing Felix's weekly checks until the $2,700 balance is paid off. To get through the week, Felix considers applying for a payday loan; however, he discovers that payday lenders charge $17.50, per $100 borrowed—rates that rival the local loan sharks. Although Felix is reluctant at first to ask his employer for a loan, he is out of time and out of options. Much to his pleasant surprise, the owner, Tom Dolan, hands Felix $2,000 in cash and says that there is no need to worry about repaying the loan right away. As long as Felix continues to perform quality work for TD Roofing, says Tom, he can repay the loan when times are better. There is no discussion of interest, and there is no written loan agreement. Felix could not be happier with how things went. What Felix could not possibly realize as he holds the cash in his hands is that Tom also got what he wanted.*[1]

## Introduction

According to the U.S. Department of Labor (2016), businesses with fewer than 20 workers comprise almost 90% of all firms in the United States, with over 50% of all U.S. workers employed by those firms. At these businesses, labor costs often comprise more than 60% of sales (Bryson et al. 2013). For owner-employers ("employers"), losing key employees can prevent them from winning and completing high-quality work (U.S. Department of Labor 2016), making the retention of committed, high-performing workers essential to their firms' profitability and, in many cases, survival (Hunt 2015). For their part, employees who live paycheck to paycheck frequently face cash crises that are outside employers' control (e.g., family emergencies) but that nonetheless can affect work performance, as illustrated by Felix Veloz's situation. All too often, these employees lack access to conventional forms of credit, making them susceptible to rapacious terms from predatory lenders (Cohen-Cole 2011, Weller 2007). Because these workers lack strong credit ratings and thus cannot obtain cash from financial institutions on reasonable terms, they often turn to their respective employers for money (Botkin 2012, Glasscock 2017), albeit reluctantly (Hunt 2013). In turn, the manner in which employers respond to employees' cash needs can affect workplace relationships and firm performance.

Small business owner lending to employees is highly pervasive (Needleman 2010) and yet we could not identify systematic research on the nature and implications of this practice. We found one study of Italian employers who sought credit from employees (Guiso et al. 2013) and another on how debt peonage has historically bonded workers to employers (Alston et al. 2009). Yet, by and large, most studies in the economics and human resource management literatures on employee lending have been situated in large firms and tended to treat employees' personal and social circumstances

as exogenous to the firm, often because of data collection constraints (Greenberg and Baron 2003, Moorman et al. 1998, Ulrich et al. 1995).

Closer inspection reveals that employer loans to employees in small firms are commonplace, and many of these loans are made informally, or "off the books" (Hunt 2013). Intriguingly, off-the-book (OTB) loans are made without written record of the transaction in any form and involve ambiguity as to how the employee will honor the obligations set forth by loan (Hunt and Kiefer 2012). In light of the potential for OTB loans to invoke moral hazard and other opportunistic behavior of recipients, we asked, why would employers make informal, undocumented loans when instead they could issue formal, written loans replete with clear terms, legal protections, and fiduciary safeguards, loans that can be executed easily and with protective, contractual recourse? More broadly, research on such phenomena promises to complement and extend resource dependence perspectives of organizations that studied when and how formal mechanisms and tactics help firms secure resources inside and outside the firm (e.g., Hayward and Boeker 1998, Hunt and Ortiz-Hunt 2017, Pfeffer and Salancik 1978), as well as arguments by economists that comprehensive contracting provides security for managing business relationship risks (e.g., Hart 1995).

Overall, the research here keys on when employers will make formal versus informal loans and how this decision impacts the value of their firm, as reflected by the retention of high-quality workers. Considering the unconventional context underlying this research and the lack of prior studies that would inform core research questions, we approached employers and employees through extensive surveys and interviews to gain a richer understanding of the nature and prevalence of employee loans in small, labor-intensive firms. We now turn to the business environment facing these actors, together with the commercial insights that we gained from them.

## OTB vs. Formal Loan Choice in Small Labor-Intensive Firms

### Specialty Contracting Context and OTB Loans

Specialty contracting firms face broadly similar economic and industry challenges across the United States and other jurisdictions in that they rely on labor as the critical resource for completing work promptly, reliably, and profitably. Consistent with most service sector industries, labor costs are, by far, the largest cost of doing business, and managing workers is among the largest challenges faced by business owners. An author of this article was a former small business owner who wondered why he and his industry counterparts made OTB loans to employees. Why would profit-seeking small and medium-sized enterprise (SME) owners with relatively limited resources eschew the legal protections afforded by signed loans when simple written documentation that stipulated the loan amount and repayment terms was readily available? This puzzle led us to scores of interviews with contractors and, eventually, the hand collection of detailed, transaction-level information for 459 employee loans issued by 83 specialty contractors operating in the residential and commercial service sectors for painting, asbestos abatement, plastering, roofing, masonry, glazing, and wall construction in Colorado. As we elaborate later, this sample was compiled through a process that was designed to ensure that businesses included in the sample were representative of the larger pool of SMEs. These employers never considered themselves to be quasi bankers; rather, they viewed lending to employees as a means of managing their most critical resource contingency: valued workers (Pfeffer and Salancik 1978). In a similar vein, employers eschewed the notion that the loans served as "makeup payments" or alternative compensation instigated by the employer. On the contrary, workers tended to approach their employers because they urgently needed cash.

As previously mentioned, formal loans are typed or handwritten documents that specify dates and amounts for loan repayment and are filed for future reference. When making these loans, employers reminded workers when loan repayments were due and were prepared to extract repayments from wages if necessary. Conversely, as highlighted by the case of Felix Veloz, OTB loans are "handshake agreements" made with informal language along the lines of, "Here is the loan. We'll work it out later." When describing the OTB loans, employers told us that recipients knew the exact amount being lent and usually received it in cash at the time of a handshake agreement. OTB loan recipients were also informed of the general obligation to eventually repay the loan, since employers were neither inclined nor in a financial position to simply gift the money. The loans were made without any clear repayment terms or other kind of formal or contractual agreement; that is, in contrast to formal loans, OTB loans inherently involved ambiguity and open-endedness regarding when and how a loan would be repaid, indicating that the loan issuance was an act of goodwill that could be repaid, somehow, in kind. The clear intentionality of this ambiguity-generating dynamic—issuing an informal, OTB obligation rather than a formally documented obligation—opened the question as to whether OTB loans are issued by rational, profit-maximizing employers to elicit greater commitment from conscientious, high-performing, and otherwise valued workers.

In exploring this proposition, we took every care to identify, isolate, and control for intuitive explanations of the OTB loan choice. One such explanation is that

OTB loans are de facto gifts, incentive compensation, or makeup payments (Akerlof 1982). For each OTB loan we studied, the employer made clear that the loan needed to be repaid in due course. Employers in our sample did not extend cash as "gifts" on the grounds that they lacked the funds to do so and worried that gifts would prevent them from invoking norms of reciprocity (Homans 1961). Another alternative explanation is that OTB loans sidestep accounting requirements by firms that lacked bookkeepers (even if the bookkeeping involved with registering the employee loan is simple), and so we excluded employers who did not use trained professionals to maintain their financial records. Also notable was that most firms issued both formal and OTB loans, such that there was a willingness and ability to administer both. Additionally, employers told us that they were not motivated by tax avoidance in loan choice, noting that tax withholdings were not material. Again, this perspective was supported by the willingness of many employers to switch between OTB and formal loans regardless of tax implications.

### Sampling Procedure

Using Colorado trade association websites and directories, we compiled a list of over 900 contractors for initial screening, as a representative list of firms in specialty building trades. To identify lenders, we sent a three-question screening questionnaire to potential employers, via email, asking (a) whether the business was still operating, (b) how many full-time employees worked for the firm, and (c) whether the employers had ever loaned money to employees (the complete, survey instrument is available upon request). We sampled firms with at least three employees to capture firms that are large enough to issue loans and engage a bookkeeper. A total of 689 employers completed the screening survey, for an initial response rate of 77%. Of these, 465 lent money to employees; however, 302 firms had three or fewer employees, reducing the addressable population of firms to 163. One hundred twenty-four of these firms were willing to complete the more detailed survey, generating a 76% response rate for the addressable population of firms larger than three employees that also issued loans.

The detailed survey was completed in person for the remaining firms, consisting of questions regarding company-specific, employer-specific, employee-specific, and loan-specific data. It required between 45 and 90 minutes to complete, depending on the extent to which a firm engaged in lending to employees. Responses were hand recorded by the interviewer and checked for accuracy by the respondent. Overall, 124 employers were willing to share the details of their lending. Of these, 93 surveys were fully completed, representing a 75% response rate for the targeted participants. As a final adjustment, 10 completed surveys were discarded because the employer was unaware of the tax implications of OTB loans. In total, usable data were obtained for 459 loans from 83 businesses. Of the 459 loans, 262 (57%) were nontax-compliant, OTB loans.

### Interviews with Employers and Employees

To gain further insight into employers' motivation for the choice of loan we conducted wide-ranging interviews regarding the lending details. In particular, we asked when the employee approached the employer for cash, what the employer did in response, and how the employee was informed of the decision. One employer told us that "[nonpayment on the loan] is a huge risk when you're as small as I am." Another said, "I make some loans with just a handshake. I know it's appreciated, or at least I think it is, but in the back of my mind I wonder if I'll ever see the money again." Said a third, "The first time I loaned big dollars to an employee—we're talking $2,500 with no paperwork—my wife said I was either the stupidest person on the planet or the smartest. Well, I know I'm not the smartest and I didn't sleep for a week after making the loan, but I cannot make do without Luis, period." According to another, "There is a lot at stake. I can't afford to lose any amount of money and definitely can't afford to lose my reputation. But, I take the risk [issuing OTB loans] because if I lose my top hands, then I lose my customers." Significantly, one employer told us, "In a business where employees will jump ship for fifty cents more per hour, loans to top hands are my secret weapon." On the basis of these responses, research interest centered on why employers would make OTB versus formal loans rather than the question of whether or not a loan would be made. Refusals of loan requests among firms in our sample were rare because employees in poor standing were unlikely to make such a request, and employers had other means of dismissing them. A lingering question was whether employers who made loan refusals were more or less likely to make formal or informal loans, and employers told us loan refusals reflected employee qualities, not employer loan preferences.

Where we could, we also discussed the OTB versus formal loan choice with employees. Employees welcomed OTB loans because they were averse to the liabilities and commitments of the formal loan repayment schedule, they preferred the ambiguity associated with how they would discharge the obligation associated with the OTB, and they saw the OTB as an act of employer goodwill. Employees told us that they recalled feeling relief and gratitude upon receipt of the OTB loan, with one saying that he would "take a bullet" for his boss. Conversely, one recipient of a formal loan described receipt of the formal loan as "kicking the can down the road," meaning that one obligation was simply being replaced by another.

Because the logics and preferences surrounding OTB versus formal loan issuance were unclear, we developed framing questions to generate stylized facts that we could contrast with existing perspectives on managing resource dependencies (Moeen and Agarwal 2016, O'Neill and Rothbard 2017). As a starting point, and to gauge the significance of the phenomenon in question, we investigated the pervasiveness of OTB versus formal loans. Next, we examined when OTB versus formal loans would be made. Then we considered whether OTB loans were a functional and effective resource dependence tactic by considering benefits to employers from them.

## Framing Questions

### How Pervasive Are OTB Loans Relative to Formal Loans?

Among employers who make loans to employees, we asked, to what extent are these loans OTB versus formal ones? And to what extent does loan selection reflect preferences and biases of employers? Studies have shown that formal mechanisms, including contracts, are used to resolve resource dependencies because they involve greater specificity in the terms of exchange, thus providing mechanisms to secure key resources, including labor for SMEs (Drees et al. 2013, Hillman et al. 2009, Pfeffer and Salancik 1978). Yet without clear expectations for repayment, employees potentially had more options for honoring the obligations, especially through effort at work that could promote goodwill with employers. Perhaps employers were, at some level, aware of the value creating potential of OTB loans, as a kind of heuristic, and were, as a result, more likely to make those loans as a result. Accordingly, the first question examined the extent to which employers made OTB loans and actively selected between OTB and formal loans.

**Question 1.** *To what extent are OTB loans made by SME employers*? *To what extent do SME employers issue both OTB loans and formal loans*?

### When Do Employers Issue OTB vs. Formal Loans?

As discussed above, employers in our sample never sought to actively encourage employee borrowing. Rather, workers approached employers for cash, and employers evaluated employee characteristics in choosing the kind of loan to make. As seen, both formal and OTB loans were issued, and the decision choice process seemed to resemble the enactment of heuristics and biases seen in other studies of entrepreneurs (Bingham and Eisenhardt 2011, Hayward et al. 2017). On the one hand, formal loans might help to bind the employee to the firm at least until the loan is repaid. On the other hand, better-performing workers, including more conscientious ones, might receive OTB loans as an instrument of employer goodwill. We reasoned that if OTB loans would better serve employer wealth creation, then better-performing workers would be more likely recipients (Gulati and Sytch 2007, Janssen et al. 2003, Pfeffer and Salancik 1978). This brings us to our second research question.

**Question 2.** *To what extent are OTB loans made to better-performing workers*?

If employers were prepared to make OTB loans without security, then how much risk would employers assume in light of evidence that some loans exceeded US$10,000 and, theoretically, employers would have no recourse in the event that employees absconded with the funds? The employer's vulnerability is clearly compounded through the issuance of larger OTB loans, where there is no legal means to collect. However, larger OTB loans also increase the perceived obligation of the worker to the employer, meaning that higher-performing workers would become more dependent on the employer's goodwill. Hence, we have the following framing question.

**Question 3.** *To what extent are OTB loans larger than formal loans*?

Employers invariably asked employees why they wanted the money. In the course of interviews, employers indicated that the purported purpose for the loan was consequential to the loan issuance decision. Requests based on social and personal reasons that signified the workers' conscientiousness and propensity to remain at the firm were viewed more favorably than loans requested for reasons that reflected what employers called "poor choices" (e.g., debts related to gambling, substance abuse, criminal penalties). We distinctly observed that some workers sought the loan for opportunistic or transactional reasons, while others sought the cash for prosocial reasons, especially to support their respective families (Grant and Gino 2010). We reasoned that employers would be able to generate more goodwill among employees who sought loans for prosocial reasons, and so we asked the following.

**Question 4.** *To what extent are OTB loans made to better-performing workers who seek the loan to meet prosocial obligations*?

Likewise, in the vein of prosocial signaling, we sensed that employers could extract a greater sense of obligation from workers who faced greater difficulty obtaining work elsewhere. These workers would be particularly mindful of the challenges of joining a new employer, one who may not be prepared to lend them the money in their hour of need. While various factors impeded workers ability to find another job, we learned that minority workers often had limited employment options beyond their current employment relative to nonminorities. Would employers try

to bond better-performing minority workers through formal loans? Or would they extend goodwill to these employees in the form of an OTB loan so as to gain more enduring service from better workers?

**Question 5.** *To what extent are OTB loans made to better-performing workers who require more cash or who are less well positioned to gain work elsewhere*?

### What Are the Benefits to Employers of OTB Loans?

We also wondered why employers would make OTB loans virtually on the spur of the moment. If OTB loans were instrumental in retaining higher-performing workers, and if they created valuable options for how those workers would discharge their obligations, then would employers intuitively seek to capitalize on such potential (Gigerenzer 2007)? Because the principal mechanism for achieving this would be retention of valued workers, we asked the following.

**Question 6.** *To what extent do OTB loans increase the loyalty and longevity of employment of better-performing workers*?

Moreover, with respect to overall financial outcomes, we asked the following.

**Question 7.** *To what extent do OTB loans increase the profitability of SMEs*?

## Data Collection on Employer Loan Choice

Because we could not find systematic evidence on the nature and implications of SME loans to employees, we sought to assemble a large database that could gain institutional review board approval from our university. Accordingly, we selected a broadly representative subset of Colorado-based, labor-intensive, specialty construction businesses that were prescreened for the presence of employee loans (Hunt 2013). In collecting these data, we recognized and addressed several sampling and survey design considerations that were discovered through a pilot study.

### Retrospective Self-Censoring

Since employers would have to be the primary source of transaction-level information on loans to employees (employers were not, in general, receptive to surveying employees on the sensitive issue of employer-issued loans), we took measures to reduce errors associated with retrospective accounts of unrecorded data (Miller et al. 1997, Schwarz 1999). Through the pilot study, we first confirmed the interpretability and intelligibility of all survey questions. Second, we encouraged participants to make notes prior to the detailed surveys regarding the circumstances of each loan issued so that they could be more comprehensive in survey responses. Third, we supplied clarifying definitions for all data fields. Surveys were conducted by telephone or in person, resulting in high survey completion rates and comprehensive responses from employers, including those who had issued numerous loans for many years. Sampling on employers raised the prospect of common method bias or variance related to the survey instrument versus the respondent (Podsakoff et al. 2003). In part, we addressed these issues by situating subjective items (i.e., those involving opinion) prior to questions on the transaction details (i.e., facts of the loans including size) and randomly sequencing questions involving opinions or judgments (Podsakoff et al. 2003). While the data derived from the surveys were potentially at risk of underreporting the incidence of OTB loans, we lacked reason to believe that employer biases would skew their reporting of other data since most employers readily reported that they issued both formal and OTB loans.

### Exclusion of Smaller Firms and Employers Lacking Insight About Tax Implications

Quite commonly, specialty contractors have three or fewer employees. Data from the pilot survey indicated that many such firms lacked administrative support or legal expertise. At firms with few employees, employers typically work shoulder to shoulder in the field with their respective employees, and they may grant OTB loans without regard to documentation or legal safeguards. Since many of these employers were unfamiliar with the distinction between formal and OTB loans, we decided to exclude data on these businesses. Similar to the very small firm exclusion, 10 employers who completed the detailed survey were excluded from the final data set because they had not considered the option of documenting loans. In sum, the very small firm and ignorant actor exclusions decreased the sample slightly to help provide more accurate inferences about the motivation for loan choice.

### Final Survey Population

One hundred twenty-four employers with more than three employees indicated that they lent money to employees and were willing to share the details of that lending in an extended survey. Of these, 19 were unable to schedule a convenient time to be interviewed, 7 declined to complete the survey after starting it, and 5 provided insufficient information to be included in the final pool. Ninety-three surveys were fully completed, representing a 75% response rate for the addressable population of businesses larger than three employees who loaned money to their employees. As a final adjustment, 10 completed surveys could not be used because employers were unaware that undocumented OTB loans do not comply with the tax code. In total, usable data were obtained for 459 transactions from 83 businesses. One hundred ninety-seven of the loans (43%) involved formal loan agreements detailing interest, repayment terms, and default recourse.

Two hundred sixty-two loans (57%) were issued off the books.

The sample is representative of the specialty contractor labor market. Employee demographics closely resemble the broader industry workforce, with 73% of workers being Hispanic (all were permanent residents or citizens of the United States) and 86% male, compared with 70% and 85%, respectively, for Colorado, figures that are generally representative of U.S. specialty contracting (Pew Research Center 2015). Businesses in the study were small, ranging between 4 and 96 employees, with annual revenues between $150,000 and $12 million. The average firm age was nearly 10 years old, with a range from 1 to 42 years. Nonminority males owned more than 90% of the firms, which is also consistent with statewide business ownership rates (Pew Research Center 2015).

## Outcome Variables

We were particularly interested in loan type, postloan length of service, and incremental employer profit as outcome variables. *Loan Type* is a discrete dichotomous variable coded 0 for a formal, legally compliant loan or 1 for an OTB. *Postloan Length of Service* is a continuous variable for total length of employment after an employee receives a loan from the employer that allowed us to examine *Employer Profit* (*EP*).

*EP* measures the incremental profit or loss realized by an owner-employer from issuing OTB loans. It is calculated as

$$EP = \frac{(RV_{jl} \cdot (S_{\text{otb}} - S_{\text{formal}})) \cdot e^{1+k}}{e^{1+i}} - (L \cdot e^{1+i}),$$

where $RV_{jl}$ is the retention value in dollars for the $j$th employer at the $l$th performance rating for any given recipient of an OTB loan. Retention values were obtained from each employer for each of the five performance levels used in the employee performance ratings for this study (see Table 1). Note that this measure relies on averages at the firm level to reflect variance in the value to firms of higher-performing workers. Note also that "right-side" truncation issues mean that we cannot fully measure the value of an employee who has remained at the firm after the survey was issued, indicating that this measure of additional value is highly conservative. Employers indicated for each performance level the estimated value of retaining an employee for one additional year. The term $S_{\text{otb}}$ is the average postloan length of service for recipients of OTB loans; $S_{\text{formal}}$ is the average postloan length of service for recipients of formal loans. The difference between these two quantities, multiplied by the retention, generates a perpetuity at the employer's cost of capital $k$. This quantity is discounted to its present value at the average formal loan interest rate ($i$), which is 6.9% in our sample. The term $L$ is the loan principal, which is assumed to yield an opportunity cost of a compounding interest stream at rate $i$. To be even more conservative in estimating employer profit, we assumed that neither the principal nor any interest would ever be paid to the issuer of an OTB, even though about 20% of OTB loans were repaid, usually as recipients were leaving the firm.

*Employer Profit* was calculated for all 262 OTB loans in the study. The value is positive if the postloan length of service is, on average, greater for OTB loans than for formal loans and if the discounted retention value for the difference exceeds the perpetuity value of the original loan. If EP is negative, then the employer destroyed value by issuing an OTB loan. To illustrate, consider an employee who requested a $5,000 loan to pay for

**Table 1.** Reason for Loan Request

| Category | Underlying aim | Stated reason for requesting a loan |
|---|---|---|
| Prosocial requests | • Responding to social, cultural and familial obligations<br>• Serving as familial provider<br>• Establishing roots in the community | • Paying for special occasion (wedding, graduation, christening, holiday, funeral)<br>• Traveling (usually to Mexico or Central America) to visit or help friends and family<br>• Paying medical bills (self or other)<br>• Down payment assistance for house purchase |
| More opportunistic or transactional requests | • Acquiring a discretionary, consumable item<br>• Expunging self-induced financial exigency<br>• Perpetuating adverse behaviors | • Buying misc. personal assets (car, furniture, appliances, TV)<br>• Repaying another existing debt (credit collection, payday loan, or loan shark)<br>• Covering daily needs (e.g., food and utilities)<br>• Posting bail<br>• Covering habitual hardships (gambling, illegal drugs, nonpayment of child support)<br>• Forestalling eviction, repossession, or jail time |

medical expenses incurred by an uninsured sibling and received an OTB loan. On a scale of 1 to 5 (low to high), the employer rated the performance of the requesting employee as a 4, for which the focal employer assigns an average annual retention value of $25,000 (i.e., the value to the employer of not having to find an equivalent employee in the market for trained specialty trade labor). If the length of service for OTB loans exceeds that of formal loans by 1.74 years (among those firms issuing both formal and OTB loans), then the noncompounded, nondiscounted value to the employer is $43,500. Since the value of the difference accrues permanently to the employer and can be reinvested in the business, the nondiscounted perpetuity value of the gain, compounded at the employer's cost of capital ($k$), amounts to $137,381, assuming $k$ is 15%. If the average interest rate for formal loans (denoted as $i$ in the EP formula) is 6.9%, then the discounted benefit for issuing an OTB is $47,123. However, if the loan is never repaid (as is commonly the case with OTB loans, unless an employee leaves, in which case repayment is typically required), then the cost of issuing the loan must be subtracted from the gain of $47,123. Since the opportunity cost of issuing an OTB loan was the recovery of the principal and the potential interest to be gained from issuance of a formal loan, the perpetuity value of the OTB principal ($5,000) amounts to $14,577. Subtracted from the value of the retention benefit, this yields a fully discounted, incremental loan-related employer profit of $32,546.

### Potential Explanatory Variables

*Employee Performance Rating* is a categorical variable reflecting a performance rating between 1 (low) and 5 (high) assigned by employers for each employee receiving a loan.

*Minority Employee* was coded as 1 if the employee was a minority, as designated by the U.S. Census Bureau.

*Reason for the Loan* is a categorical variable indicating the stated reason for the loan request and seeks to establish whether there was a generative, conscientious, and prosocial purpose for requesting the loan or whether the request was made for more opportunistic or transactional reasons (Grant 2012, Grant et al. 2008). By *prosocial*, we mean that the loan addresses the social responsibilities or conscientiousness of the worker and reflects helping behavior. Worthy causes included paying for a special occasion (wedding, graduation, christening, holiday, funeral), traveling to attend to the needs of family, paying medical bills, funding education expenses, and providing a down payment for a house purchase. More opportunistic and transactional requests constituted an "other" category that reflected items that could have been covered by present wages, gratuitous consumption, or problematic choices on the part of the workers (e.g., repaying payday lenders or loan sharks; posting bail; paying off debts related to gambling, illegal drugs, and nonpayment of child support). Table 1 displays the sorting mechanism that we employed.

Other explanatory variables were employed to account for unobserved fixed effects and deployed in logistic regression analyses. Firm-level controls consisted of age in years; firm size, measured through total employees and fixed assets; and financial health, expressed as revenue per employee. Dummy codes were used to account for the nonindependence of multiple loans issued by the same firm, as discussed in model specifications below. Individual controls took into account the ethnicity and gender of employers, length of employee preloan service, employee age, and the quadratic transformation of employee age (i.e., $Age \times Age$), reflecting the tendency to judge an employee's value as some combination of long-term experience and youthful physical strength. As a robustness check of our stylized findings, we also used supplementary estimation procedures (see Tables A.1 and A.2 in Appendix A) in which transaction-level controls were included for the loan amount, type of loan, and reason for the loan. Industry-level variables controlled for unobserved effects across the specialty contractor segments included in our study. Macroeconomic factors may also be significant determinants of loan request volumes in the specialty trade sector, which is susceptible to fluctuations in the labor supply as well as renovation and construction activity. Since the issuance frequency is a function of the loan request frequency, macroeconomic controls specific to Colorado were created based on the unemployment rate, new home starts, and economic growth.

### Design Specifications

The combination of descriptive statistics and estimation procedures allowed us to generate stylized findings concerning (a) the use of OTB versus formal loans, (b) the characteristics of employee recipients, and (c) the impact of the OTB loan on profitability. Below, we position these findings as extensions of and contributions to resource dependence theory. Logistic and ordinary least squares (OLS) estimation procedures would allow us to supplement inferences from descriptive statistics with results found in Tables A.1 and A.2 in Appendix A.

## Stylized Findings and Theoretical Implications

### Patterns of OTB Loan Issuance

Of the 459 loans in our sample, 57% (262) were OTB loans (see Table 1). Among the 187 loans greater than $1,000, 69% (128) were OTB, reflecting a strong

**Table 2.** Descriptive Statistics

| | *N* | Minimum | Maximum | Mean | SD |
|---|---|---|---|---|---|
| Transaction data | | | | | |
| *Total Loans* | 459 | $25 | $11,500 | $1,102 | $1,500 |
| *Formal* | 197 | $50 | $10,000 | $822 | $1,013 |
| *OTB* | 262 | $25 | $11,500 | $1,309 | $1,754 |
| *Large Loans* (>$1,000) | 187 | $1,000 | $11,500 | $2,136 | $1,908 |
| *Formal* | 59 | $1,000 | $10,000 | $1,741 | $1,475 |
| *OTB* | 128 | $1,000 | $11,500 | $2,313 | $2,054 |
| *Loan-Related Employer Profit* | 459 | $0 | $136,334 | $14,901 | $8,544 |
| *Formal* | 197 | $0 | $2,288 | $312 | $178 |
| *OTB* | 262 | $0 | $136,334 | $25,870 | $14,834 |
| *Reason for Loan* (see Table 1) | 459 | 1 | 10 | 5.48 | 2.87 |
| *Length of Service—Preloan* (years) | 459 | 0 | 13 | 2.26 | 1.99 |
| *Length of Service—Postloan* (years) | 459 | 0 | 10 | 1.96 | 1.53 |
| Employee data | | | | | |
| *Ethnicity* (1 = minorities) | 459 | 0 | 1 | 0.73 | 0.44 |
| *Age* | 459 | 19 | 54 | 31.05 | 7.92 |
| *Gender* (1 = male) | 459 | 0 | 1 | 0.86 | 0.35 |
| *Length of Service* (years) | 459 | 1 | 17 | 4.28 | 2.97 |
| *Role* (1 = supervisor) | 459 | 0 | 1 | 0.90 | 0.30 |
| *Performance Rating* (1–5) | 459 | 2 | 5 | 3.41 | 0.97 |
| Firm data | | | | | |
| *Employer Ethnicity* (1 = minorities) | 83 | 0 | 1 | 0.09 | 0.28 |
| *Firm Age* (years) | 83 | 1 | 42 | 9.65 | 6.09 |
| *Employees* | 83 | 4 | 96 | 22.59 | 20.58 |
| *Revenue* | 83 | $150,000 | $12,000,000 | $2,734,318 | $2,567,741 |
| *Tangible Assets* | 83 | $40,000 | $3,250,000 | $446,390 | $492,212 |

willingness by employers to issue relatively large employee loans without formal documentation. Overall, the loans ranged from $25 to $11,500, and averaged $1,102, with 20 of the loans issued in an amount of $5,000 or greater. The average OTB loan size was 59% higher than the average formal loan.

Patterns in the descriptive statistics provided in Table 2 were statistically and financially significant, providing a platform to address Framing Questions 1 and 2.

**Stylized Finding 1.** *SME owner-lenders are more likely to issue OTB loans than formal loans.*

The 83 businesses included in the study issued an average of 5.5 employee loans, with a low of 1 loan to a high of 16 loans. Twenty-seven businesses issued only OTB loans, 17 issued only formal loans, and 39 issued both kinds of loans; that is, the OTB loan was a much more popular choice versus the formal loan. Also, it was commonplace for employers to switch between informal and formal loans relative to making one kind of loan versus the other, indicating an active decision choice among intuitive employers based largely on worker characteristics.

**Stylized Finding 2.** *Many employers issue both OTB and formal loans to employees.*

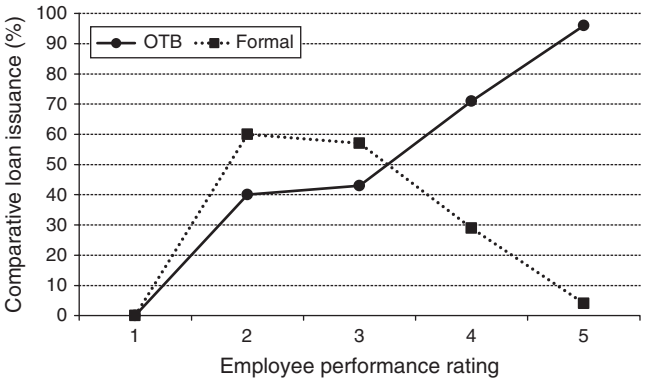
By contrast, scholars of resource dependence and social exchange theories posit that employers exercise power over employees through formal, structural mechanisms, often consisting of more detailed contracts aimed at reducing ex ante uncertainty (Cook and Emerson 1978, Pfeffer and Salancik 1978). We contribute to this literature by showing that owners of labor-intensive SMEs appear to willingly forsake some measure of control by entering informal agreements, specifically OTB loans, in order to multiply the avenues through which employee obligations can be discharged. Furthermore, we found that employers tended to issue both OTB loans and formal loans, indicating that employers actively engaged in strategic loan selection, and employers were prepared to increase financial and operational risks through informal arrangements as a means of building long-term goodwill with key employees.

## OTB Loan Issuance to Better-Performing Workers

Loan issuance rates by employee performance reveal important patterns, as well (see Figure 1).

More than 90% of employees who were rated as 5 (on a scale of 1 to 5, with 5 being the highest rating) received an OTB loan, and about 70% of employees rated as 4 received an OTB loan. By contrast, employees with a performance rating of 3 or 2 were much more likely to receive formal loans, while no employee with a rating of 1 received a loan. This indicates a pronounced preference of OTB lending to more valued employees versus a preference for formal loans for less valued employees. Logistic regression results in

**Figure 1.** Loan Issuance Rates by Employee Performance Rating ($N = 459$)




Model 1 of Table A.1 support these findings and show that employers were 4.7 times more likely to make OTB loans to their most valued employees ($p < 0.001$).

**Stylized Finding 3.** *Better-performing workers are much more likely recipients of OTB loans.*

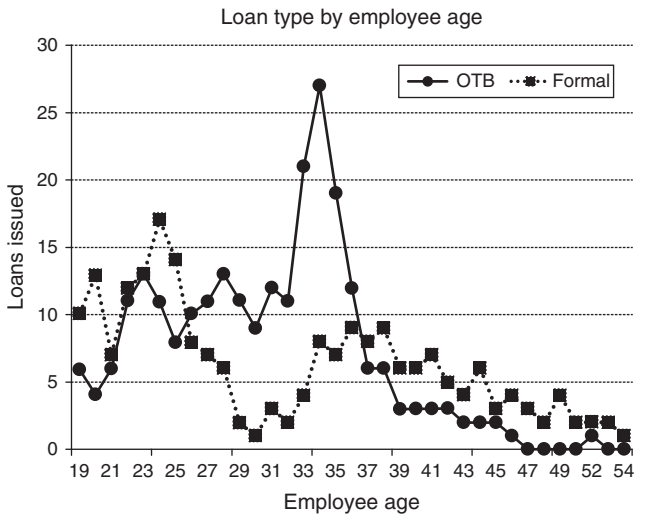
The preference of making OTB loans to better performers also seemed related to the employee's age. Figure 2 illustrates that OTB loan recipients were workers with enough experience to supervise a project and enough physical prowess to complete work.

Among the loan recipients in the 31–35 age range, 95% were supervisors, 82% received an OTB loan, and 72% received a loan for $1,000 or more—all of which significantly exceed the mean values.

**Stylized Finding 4.** *SME owner-lenders are more likely to issue OTB loans than formal loans to workers who are aged in their* 30*s.*

Resource dependence theory would suggest that better-performing workers would seek and receive preferential contractual terms (Pfeffer 1981, Pfeffer and Salancik 1978). On the other hand, evidence from this study shows that in smaller, labor-intensive firms, informal rather than formal mechanisms were instrumental in creating and sustaining goodwill or relational cohesion between employer and employee (Lawler and Yoon 1996). These tactics were particularly evident among workers in their mid-30s who possessed supervisory acumen and physical prowess.

**Figure 2.** Loan Issuance Rates by Employee Age ($N = 459$)




## Issuance of Larger OTB Loans

Prima facie, larger loans are riskier, and employers would seek greater contractual protection when making them. Yet, as the data in Table 3 indicate, OTB loans were issued far more frequently than formal loans when the loan amount exceeded $1,000. While OTB loans were issued 57% of the time overall, they constituted nearly 70% of the larger loans.

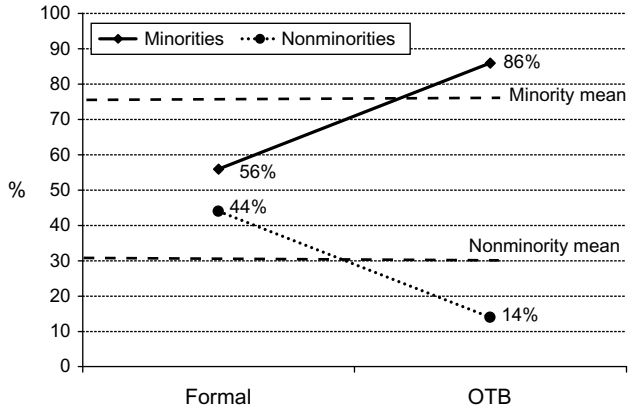
As these data suggest, smaller loans were evenly split between formal and OTB loans, but large loans were overwhelmingly informal arrangements, especially among higher-performing employees.

**Stylized Finding 5.** *SME employers are more likely to issue larger OTB loans to higher-performing workers.*

**Table 3.** Loan Issuance Practices Among Employers Issuing Both Formal and OTB Loans

| | Formal | % | OTB | % |
|---|---|---|---|---|
| All loans | 111 | 40 | 165 | 60 |
| Loans by size | | | | |
| <$1,000 | 75 | 51 | 72 | 49 |
| ≥$1,000 | 36 | 28 | 93 | 72 |
| Loans by gender | | | | |
| Male | 92 | 39 | 146 | 61 |
| Female | 19 | 50 | 19 | 50 |
| All loans by race/ethnicity | | | | |
| Minority employees | 52 | 27 | 143 | 73 |
| All other employees | 59 | 73 | 22 | 27 |
| Small loans by race/ethnicity | | | | |
| Minority employees | 45 | 44 | 58 | 56 |
| All other employees | 30 | 68 | 14 | 32 |
| Large loans by ethnicity | | | | |
| Minority employees | 7 | 8 | 85 | 92 |
| All other employees | 29 | 78 | 8 | 22 |
| Loans by performance rating | | | | |
| 1 | 0 | 0 | 0 | 0 |
| 2 | 27 | 59 | 19 | 41 |
| 3 | 63 | 57 | 48 | 43 |
| 4 | 19 | 29 | 46 | 71 |
| 5 | 2 | 4 | 52 | 96 |
| Loans by age | | | | |
| 30–35 | 13 | 16 | 70 | 84 |
| All others | 98 | 51 | 95 | 49 |
| Loans by age: ≥$1,000 | | | | |
| 30–35 | 6 | 10 | 57 | 90 |
| All others | 57 | 61 | 36 | 39 |

**Figure 3.** Loans to Minority and Nonminority Employees ($N = 459$)



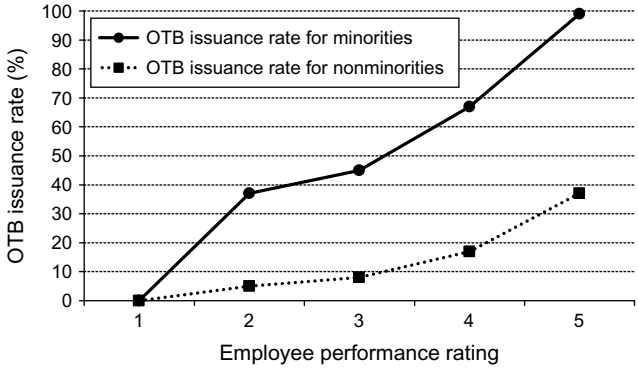

Hart and Holmstrom (2010) propose that under conditions of transactional uncertainty, parties write more detailed contracts that are ex ante incomplete but that can be further completed ex post. Whereas some studies examine how and when parties write such contracts, we present evidence on conditions when employers would forgo ex ante contracting entirely, and especially when they face greater risk.

## Loan Issuance to Minorities

Minority employees were much more likely to receive OTB loans than nonminorities. While about three-quarters of minority workers received OTB loans, roughly three-quarters of nonminorities received formal loans. The effects of an employee's minority status on employer loan choices, including those taking into account employee performance, can be seen in Figures 3 and 4.

It is evident from these figures that minorities with higher performance ratings were even more likely to receive OTB loans. While minority employees in our study outnumbered nonminorities by a large margin (i.e., 73% versus 27%), the OTB lending rate to minorities was six times greater (i.e., 86% versus 14%) among employers who issued both OTB and formal loans (see Figure 3). By contrast, we would note that in other settings, ethnic and racial minorities are disadvantaged in receiving loans (Cohen-Cole 2011, Weller 2007). Thus, it would seem that in this setting, employers perceive greater potential in using the OTB loan (not the formal loan) in gaining goodwill with minorities, perhaps because there is a mutual sense that those who could not

**Figure 4.** Minority vs. Nonminority OTB Loan Issuance Rate ($N = 459$)




otherwise obtain credit and loans experience a heightened sense of obligation and goodwill. In this sense, loans are less a form of bondage or even peonage that lead to onerous compliance terms and more an instrument of helping workers repay employers in kind.

**Stylized Finding 6.** *SME employers are more likely to issue OTB loans than formal loans to minority workers.*

**Stylized Finding 7.** *SME employers issue large OTB loans at a greater rate to higher-performing minorities than to higher-performing nonminorities.*

These results suggest that employers did not see employer vulnerability as a means to exploit minority employers, but rather as a better opportunity to build goodwill with them.

## Prosocial vs. Opportunistic Loan Requests

In undertaking this study, we wondered whether an employee's reason for requesting a loan played a role in the decision to issue an OTB or formal loan. On the one hand, employers might be indifferent, focusing instead on a workers' ability to repay the loan. On the other hand, prosocial requests might help employers screen worthy loan recipients. Unequivocally, employers perceived loans as a way to strengthen goodwill with conscientious workers and particularly those who needed the money to support their families versus loans that we labeled opportunistic/transactional (see Table 4). Nearly 80% of all prosocial requests received OTB loans, versus just 46% for all other loan requests.

Moreover, employees received significantly more money for prosocial requests relative to opportunistic/

**Table 4.** Prosocial vs. Opportunistic/Transactional Loan Requests

| Reason for loan | Min ($) | Max ($) | Mean amount ($) | Overall frequency (no. and overall %) | OTB frequency (no. and % OTB) |
|---|---|---|---|---|---|
| Prosocial requests | 50 | 11,500 | 1,337 | 146 (32%) | 117 (80%) |
| Opportunistic/transactional requests | 25 | 7,500 | 1,014 | 313 (68%) | 145 (46%) |

transactional requests (mean loan size of $1,337 versus $1,014, respectively).

**Stylized Finding 8.** *SME employers are more likely to issue OTB loans to conscientious workers seeking funds for prosocial reasons.*

## OTB Loans Are Conducive to Longer Service and Higher Profitability for Employers

In analyzing retention rates among recipients of employer loans, we found that OTB loans led to longer postloan service, relative to formal loans (see Figure 5). On average, workers who received OTB loans remained nearly twice as long as formal loan recipients, even after taking into account age and job performance (see Table A.2, Model 5(b)).

Figure 5 shows the effect of formal loan issuance on employee retention as a baseline and then highlights the differential impact of OTB issuance, and the evidence is that retention increased from 1.36 years for formal loan recipients to 2.47 years for OTB recipients. Interestingly, for the population of employers who issued both formal and informal loans (versus one or the other), postloan retention averaged 1.95 years for formal loan recipients and 3.52 years for OTB recipients. Overall, these results show that issuing any kind of loan increases employee retention, and informal loan issuance significantly increases retention relative to formal loans. For robustness, we tested these results by using length of service as the outcome variable in Table A.2. The results revealed that the type of loan is the single largest source of explanatory power in predicting postloan length of service ($p < 0.001$).

**Stylized Finding 9.** *Recipients of OTB loans remain at firms longer than recipients of formal loans.*

**Figure 5.** Mean Values for Length of Service After Loan ($N = 459$)

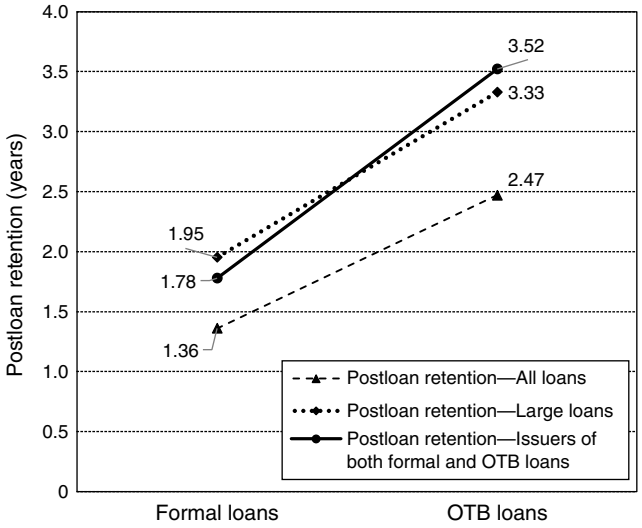



**Table 5.** Annual Retention Value by Performance Level

| Performance rating | Employer estimates of annual retention value | | | |
|---|---|---|---|---|
| | Low ($) | High ($) | Mean ($) | SD ($) |
| 1 | (1,500) | 2,500 | 220 | 510 |
| 2 | 0 | 15,000 | 1,220 | 1,647 |
| 3 | 1,500 | 25,000 | 6,760 | 3,809 |
| 4 | 1,500 | 60,000 | 21,850 | 10,325 |
| 5 | 5,000 | 120,000 | 29,480 | 13,942 |

*Note.* $n = 83$ business owners.

Employers were motivated to make OTB loans that would lengthen the service of better performers because such workers underpin firm profitability. For example, one employer calculated that the annual retention value of an employee receiving a performance rating of 5 to be $100,000, meaning that even a very large OTB loan would pay for itself in just a few months of incremental retention. Retention values are displayed in Table 5, as classified by job performance.

This table shows that employers who issued an informal loan to an employee with a rating of 5 believed that they gained, on average, nearly $30,000 of firm value per year, per employee. Of course, this gain declined markedly at lower levels of employee performance. The laddered effect of performance on firm value finds strong support in the regression analyses (see Table A.2, Model 6).

**Stylized Finding 10.** *SME employers increase profitability through OTB issuance.*

Findings thus support the notion that the OTB loan instrument creates firm value by fostering open-ended and multifaceted avenues through which employee obligations can be discharged. Whereas formal loans invoke a legalistic sense of reciprocity, informal loans create options for generalized reciprocity, including a greater sense of partnership in building and sustaining the business through prosocial workplace behaviors. Employees receiving OTB loans are more likely to relate the OTB issuance to trusting intentions and an act of goodwill. This, in turn, strengthens relational cohesion (Lawler and Yoon 1996) and generates wealth for employers (Lawler and Yoon 1996).

We proposed that OTB loans (relative to formal ones) confer goodwill to valued workers and that employers will be prepared to forgo loan repayment when they witness workers repay loans in kind. Overwhelmingly, OTB loans are issued to better-performing employees (Figure 1) as a means of retaining them (Figure 5). Since OTB loans are strongly associated with employee longevity relative to formal loans (3.52 years for OTB loans versus 1.78 years for formal loans), employers are motivated to issue OTB loans to better performers. For the smallest firms, extending the tenure of top employees through OTB issuance enhances annual firm-level

operating profits by more than 35%, and this can mean the difference between the success or failure of the small, labor-intensive firm (Hunt 2013).

## Limitations

The research design limited our ability to make strong causal claims, and it involved trade-offs that require further elaboration. In particular, the study did not allow us to investigate cases when a loan request was refused. Without these data, it is not possible to make representations about whether the dynamics that we observed were also explanatory of when employees requested but did not receive loans. In light of this limitation, interest was limited to the kind of loan that was extended. We should also emphasize that we distributed the survey to employers and not employees. While this, too, has limitations, it reflects the realities that employers were reticent to allow us unfettered access to their employees on sensitive matters; some employees who had received loans had departed their firms by the time employers completed the survey. With employee data, we would have gained a stronger sense of why employees did not leave their firms after receiving OTB loans. Through this, we could have established whether trust was built as a result of employer loan choices. We would also have preferred for the survey to be issued at the time each loan was made. We recognize that sensemaking that does not necessarily reflect employer and employee circumstances at the time the loan was made can lead to biases. Despite the significant challenges and limitations we faced in even collecting data from the relevant actors ex post, we elected to pursue the rich and unusual insights afforded by the context rather than abandon interest in the topic.

Regarding measurement issues, there was no straightforward way to calculate profits associated with the loans (as indicated by the value of post-loan retention of loan recipients). Nevertheless, with the assistance of the survey participants, we developed and validated an equation that provided a conservative estimate of the financial impact. As such, the equation remains only an estimate, since it relies on each employers' personal assessment of the additional retention value for workers at each level of job performance. For comparison across firms, this calculation is made at the level of the employer rather than the individual recipient of the loan.

Reverse causality also loomed large for this study insofar as employers could provide higher evaluations of employees after issuing OTB loans as a matter of retrospective sensemaking or self-validation. We sought to address this concern through the interview process in which employers reflected on employee performance prior to the issuance of the loan, and both employers and employees reflected on changes in the nature of their relationships after the loan issuance. Appendix B elaborates more thoroughly how we sought to deal with reverse causality and endogeneity concerns in the estimation procedures.

In light of these limitations, we opened this article by emphasizing key boundary conditions that frame the present contributions—namely, that the results pertain to smaller, labor-intensive firms. Employers featured in our sample owned sufficiently small firms that they possessed detailed knowledge of employee needs and vulnerabilities. One would imagine by virtue of sheer size that the dynamics between owners and workers in larger firms between are very different. A further limitation pertains to research design, particularly as it relates to method variance. Unavoidably, data were gathered through monomethod, self-report surveys, completed during interviews that may reflect employer biases (Sacket and Larson 1990, Schmitt 1994, Schwarz 1999). Although significant measures were taken to mitigate these biases, we ultimately relied extensively on employers to provide the data.

## Discussion

In any context, the act of lending money offers an intriguing portal to human relations because it involves the lender exchanging cash in return for obligations that lenders usually seek to contractually secure and enforce. The finance literature is replete with studies that examine when and how individuals fail to perform on those obligations, such that loans are instruments for moral hazard or adverse selection. Rarely, if ever, have we encountered evidence that loans serve as instruments of goodwill; in this study we discovered that they can be beneficial to workplace relations and employer profitability when they can be repaid in kind. Whereas one may perceive OTB loans as invitations for transaction costs and moral hazard, we discovered and explicated conditions in which informal, open-ended loans overcome opportunism, skepticism, and cynicism that could otherwise loom large in the workplace (Ghoshal and Moran 1996). An employer of an asbestos abatement company told us, "When one of my workers asks for a loan, I know I could get stuck [due to nonpayment], but if I lose a top hand, then I lose jobs; and, if I lose good jobs, then I'm dead." Through our exploration of this mutual lifeline, we contribute understanding about the many small firms that rely heavily on their employees for reliable, faithful labor and about the ways in which employer intuition guides lending practice.

To our knowledge, there is no other research on OTB lending, and therefore, the first steps in this study were to learn about the context from employers and their workers. The second step involved hand collection of data, with loans as the unit of analysis. As we addressed the seven framing questions, we discovered

underexplored facets to the employment-organization nexus (Arthur and Rousseau 2001, Barley and Kunda 2001) that extend, refresh, and, in some cases, challenge existing conceptions of employer–employee relations in SMEs. As our analysis demonstrated, these answers have been distilled into 10 stylized findings, each of which has implications for scholars and practitioners well beyond the rich context that has birthed them. Table 6 summarizes these research findings in terms of how each contrasts with received wisdom, especially theoretical precepts drawn from extant studies focusing on large, well-resourced firms.

The results presented here show that better-performing and more conscientious recipients of OTB loans

**Table 6.** Summary of Stylized Findings and Theoretical Implications

| Stylized findings | Received wisdom | Comparison between stylized finding and received wisdom | Novel theoretical implications |
|---|---|---|---|
| 1. *SME owner-lenders are more likely to issue OTB loans than formal loans.* | Employers exercise power over employees through formal structural mechanisms including contracts and peonage that reduce uncertainty (Cook and Emerson 1978, Pfeffer and Salancik 1978). | In smaller firms, employers forsake control and peonage for informal agreements that expand ways employee obligations can be discharged. | Informal mechanisms, including loans, are a pervasive and attractive means of extracting goodwill from critical resource dependencies. |
| 2. *Many employers issue both OTB loans and formal loans.* | More complete contracts that specify contingencies reduce uncertainty for employers (Hart and Moore 1988). | In smaller firms, employers are willing to forsake contractual protections in lending money to workers. | Strong patterns of employer loan choice indicate that employers utilize complex heuristics in the issuance of formal and informal loans. |
| | | Employers face an active decision choice as to whether to issue loans informally or informally, subject to employees' circumstances. | Employers increase financial and operational risks through informal arrangements with employees as a means of making long-term investments in human resources. |
| 3. *Better-performing workers are much more likely recipients of OTB loans.* | Better-performing workers are better positioned to gain binding, contractual benefits from employers (Cook and Emerson 1978, Pfeffer and Salancik 1978). | In smaller firms, where access to high-performing labor is costly and challenging, informal loans are issued to better-performing workers in order to manage a firm's critical resource dependencies. | In smaller firms, informal mechanisms are instrumental toward creating and maintaining relational cohesion (Lawler and Yoon 1996). |
| 4. *SME owner-lenders are more likely to issue OTB loans versus formal loans to workers of optimal working age.* | Employers will offer special arrangements to retain the most desirable workers (Rousseau et al. 2006), based on critical employability factors (Clarke 2008). | Incomplete markets exist for SME labor and for individual creditworthiness. | Incomplete markets for labor and credit can be assuaged through symbiotic needs and informal actions. |
| | | | Even employees confronting incomplete and discriminatory markets for personal credit possess important sources of leverage based on age and performance, especially when they are aged between 32 and 35. |
| 5. *SME owner-lenders are more likely to issue larger OTB loans to higher-performing workers.* | Larger loans attract greater contract specificity (Chinyio and Olomolaiye 2009, Leung and Liu 2003, Mooi and Ghosh 2010) to mitigate employer risk (Van Praag 2003). | In smaller firms, larger loans signify greater employee vulnerability and thus greater scope for employers to help deserving employees. | Cash-strapped and resource-constrained SMEs can and will increase financial and operational risk factors to make calculated investments for key resources. |
| | Workers' expression of vulnerability diminishes their standing and power within the firm (Frone et al. 1995, Rousseau 2000). | Employers may actually take steps to consciously increase risk factors. | |

**Table 6.** (Continued)

| Stylized findings | Received wisdom | Comparison between stylized finding and received wisdom | Novel theoretical implications |
|---|---|---|---|
| 6. *SME owner-lenders are more likely to issue OTB loans than formal loans to minority workers.* | More vulnerable workers are more susceptible to forms of employer exploitation and control (Danna and Griffin 1999, Frone et al. 1995). | In smaller firms, greater workers vulnerability offers greater scope for employers' help to extract employees' goodwill. | More vulnerable minorities are more likely recipients of OTB loans. |
| 7. *SME owner-lenders issue large OTB loans at a greater rate to higher-performing minorities than to higher-performing nonminorities.* | Minority and ethnic sameness is a strong predictor of who receives preferential treatment from employers and other powerful actors (Aboud 1984, Ghorashi and Sabelis 2013, Nagel 2002). | Minority workers were issued OTB loans at a significantly higher rate than nonminorities, indicating that they are more indebted recipients of OTB loans. | "Sameness" in race and ethnicity is inversely related to OTB loan issuance. Employers, who were virtually all nonminorities, showed a decisive preference for issuing OTB loans to minorities in far greater numbers than to nonminorities. |
| 8. *SME owner-lenders are much more likely to issue OTB loans conscientious workers seeking funds for prosocial reasons.* | Employers would be indifferent between reasons for loans and seek to mitigate risk of nonrepayment of loans via contracts (Abowd et al. 2004, Kalleberg et al. 2000, Williamson et al. 1975). | In smaller firms, an employee's inability to discharge prosocial obligations is an occasion for the employer to build goodwill with the coveted worker. | Financial exigency is sorted and rationalized by individuals making lending decisions. The reason for requesting the loan is a key determinant of how aid is given because employers gain goodwill by making OTB loans that meet employees' prosocial obligations. |
| 9. *Recipients of OTB loans remain at firms longer than recipients of formal loans.* | Firms engage in formal "structural" arrangements (including contracts) to elicit commitments of better-performing workers (Arthur and Rousseau 2001, Cook and Emerson 1978). | In smaller firms, idiosyncratic arrangements are frequently deployed to attend to employees' exigent needs. | Informal mechanisms in social exchange invoke greater gratitude and loyalty among recipients. Employer loans and especially OTB loans emerge as instrument for idiosyncratic arrangements. |
| 10. *SME owner-lenders increase profitability through OTB issuance.* | Issuing OTB loans increases the risk of employee default and exposes the employer to greater risk (Fugate et al. 2004, Robinson and Rousseau 1994). | Lending money to employees is a zero-sum game for employers unless it can promote goodwill. | Informal mechanisms create firm value by providing open-ended and ambiguous ways in which obligations can be fruitfully discharged.<br>Whereas formal loans invoke direct reciprocity, informal loans create options for generalized reciprocity by recipients and "paying it forward." |

stayed at their firms. Employers and employees often told us that the issuance of an OTB loan represented a crucial point in their relationship: the transaction merged personal and professional imperatives, providing clear evidence that the employer would help the employee in his or her hour of need (Lawler and Yoon 1996).

In addition to identifying and investigating an underresearched yet organizationally fertile context, we sought fresh insights into resource dependence theory by explaining and predicting which high-performing workers are most likely to be OTB recipients. When we interviewed employers and employees, we noted that full-time workers with pressing family needs struggled to fulfill their family's basic financial needs. Rather than borrowing from predatory credit card issuers, payday lenders, or loan sharks, these workers requested loans from employers. Interestingly, each of these loan requests could have been duly addressed through the issuance of a formal, tax-compliant loan, yet over half the loans were issued off the books at the instigation of the employer. Virtually without exception, cash-strapped workers expressed gratitude toward the employer, but OTB issuance was far from an altruistic choice by the employer. Rather, employers sensed that making OTB loans in these circumstances would generate goodwill on the part of needy workers that would elicit stronger commitment to the business in the form of ongoing labor services. For specialty contractors, replacing high-performing workers is time consuming and expensive, and it involves uncertain outcomes. Thus, employers of small labor-intensive businesses have developed approaches to manage critical resource dependencies involving high-performing workers. Selectively making OTB loans is an ingenious employer tactic that has passed unrecognized in the literatures on resource dependence and strategic human resource management.

Relatedly, we provide nuance and texture to the notion that informal arrangements may enable firms to

manage resource dependencies by allowing parties to solve unexpected contingencies. In this study, informal loans seemed to promote goodwill among employers and tended to mitigate any tendency for employees to be opportunistic—say, by taking the loan and leaving the firm. Whereas formal contracting establishes rights and entitlements leading to transactional resolution, OTB loans, similar to other informal arrangements, are conducive to goodwill between the parties that in turn can produce stronger and more varied commitments between the parties predicated on mutual understanding and trust (Uzzi 1997). In our view, what is unique about OTB loans is that they leave open-ended the infinite number of ways that the worker can discharge his or her obligation to repay a cash advance. Whereas contracts create expectations regarding ex post performance relative to the specific obligations set forth in a formal, legally binding agreement, informal understandings enable open-ended, ongoing relationships between parties that reduce the likelihood that they will feel shortchanged or otherwise disappointed (Azoulay et al. 2010). When advising employers, Hart and Holmstrom (2010) called for more detailed contracts that are ex ante incomplete but that can be further completed ex post. It would appear, however, that trying to write more detailed contracts ex post can prevent open-ended arrangements from realizing their value-creating potential, defeating the purpose of the informal loan.

This study enumerated conditions that enable such potential. First, we found that larger obligations are more likely to elicit informal loans, despite the added risks to the employer, because they create greater obligations that can be honored by goodwill. Second, we found that employers were only partly motivated by the ability of the employee recipient to repay the loan and were much more mindful of the scope for the loan to build loyalty and gratitude among their best workers. Employers used OTB loans to create value-creating obligations with selected recipients who were conscientious and would use the loan prosocially. Employers intuitively understood that value that could be captured by loan repayment and the associated interest was dwarfed by the value created from eliciting labor services. Along these lines employers in our sample, who were overwhelmingly Caucasian, were much more likely to provide OTB loans to minority employees than to nonminorities—OTB loans were not some kind of concession or favor granted on the basis of demographic homophily (McPherson et al. 2001). For their part, workers were shielded from the exorbitant rates and crippling fees accompanying payday loans and predatory credit cards.

## Conclusion

Felix Veloz, who featured in the frontispiece of this article, believed that he benefited from receiving an OTB loan. After all, he received money to pay down his mother's costly medical treatment while sidestepping predatory third-party credit terms that failed to account for his demonstrable employability. After a number of years, Tom Dolan even told Felix to "forget about needing to repay the [OTB] loan." Tom's perceived act of goodwill strengthened the bonds between Felix and TD Roofing and of course Felix's tenure with the firm. Today, Felix is confident that if he ever faces such a cash crisis again, Tom would step in to help him. We learned that this scenario plays out inexorably at small firms that rely on high-performing labor services. The informal arrangements that led to Felix's trust and confidence were well placed because they helped him address the specter of incomplete markets for credit to deserving minority workers—and helped Tom secure reliable labor. While the OTB loan was not the only factor in eliciting Felix's loyalty, both Felix and Tom remember it as a "defining moment" in their relationship—a scenario replicated across countless other SMEs.

## Acknowledgments

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## Appendix A

**Table A.1.** Logistic Regression Results

| | Likelihood of issuing an OTB loan | | | |
|---|---|---|---|---|
| | Model 1 | Model 2 | Model 3 | Model 4 |
| Independent variables | | | | |
| *Macroeconomic Effects* | −0.10* | −0.10* | −0.10* | −0.08* |
| | (0.03) | (0.03) | (0.03) | (0.03) |
| *Industry Effects* | −0.10* | −0.08 | −0.08 | −0.07 |
| | (0.04) | (0.02) | (0.02) | (0.02) |
| *Firm Effects* | 0.09 | 0.07 | 0.09 | 0.05 |
| | (0.07) | (0.05) | (0.06) | (0.3) |

**Table A.1.** (Continued)

| | Likelihood of issuing an OTB loan | | | |
|---|---|---|---|---|
| | Model 1 | Model 2 | Model 3 | Model 4 |
| Independent variables | | | | |
| *Firm Size—Revenues* | −0.08 | −0.06 | −0.08 | −0.05 |
| | (0.03) | (0.02) | (0.03) | (0.02) |
| *Firm Size—Employees* | −0.18** | −0.12* | −0.14* | −0.12* |
| | (0.05) | (0.04) | (0.05) | (0.04) |
| *Firm Size—Assets* | −0.12* | −0.09 | −0.10 | −0.09 |
| | (0.04) | (0.03) | (0.03) | (0.03) |
| *Employer Ethnicity* (1 = minority) | 0.07 | 0.05 | 0.05 | 0.04 |
| | (0.06) | (0.04) | (0.04) | (0.03) |
| *Employee Ethnicity* (1 = minority) | 1.42*** | 1.31*** | 1.17*** | 0.62** |
| | (0.28) | (0.23) | (0.21) | (0.15) |
| *Employee Performance Rating* | 1.55*** | 1.43*** | 1.44*** | 0.84** |
| | (0.48) | (0.43) | (0.40) | (0.22) |
| *Employee Age* | −0.03 | −0.04 | −0.03 | −0.04 |
| | (0.02) | (0.02) | (0.02) | (0.02) |
| *Employee Age*$^2$ | −1.03*** | −1.00*** | −0.71** | −0.34* |
| | (0.35) | (0.31) | (0.16) | (0.12) |
| *Preloan Length of Service* | 0.14* | 0.14* | 0.09 | 0.09 |
| | (0.04) | (0.05) | (0.03) | (0.03) |
| *Loan Size* | 0.22** | 0.21** | 0.14* | 0.11 |
| | (0.13) | (0.13) | (0.08) | (0.07) |
| *Firm Age* | −0.12* | −0.10* | −0.12* | −0.10* |
| | (0.03) | (0.03) | (0.04) | (0.02) |
| *Reason for Loan* (1 = relation enhancing) | | 1.88*** | 0.55** | 1.03*** |
| | | (0.37) | (0.26) | (0.27) |
| *Reason for Loan* × *Performance Rating* | | | 1.28*** | |
| | | | (0.49) | |
| *Minority* × *Performance Rating* | | | | 1.12*** |
| | | | | (0.34) |
| Constant | −1.78*** | −2.16*** | −1.52** | −1.98*** |
| | (0.54) | (0.61) | (0.70) | (0.51) |
| Log likelihood | 419.2 | 433.5 | 421.6 | 452.2 |
| $\chi^2$ | 207.7 | 209.2 | 203.3 | 241.7 |
| Generalized $R^2$ | 0.364 | 0.386 | 0.407 | 0.483 |
| Predictive accuracy (%) | 66.8 | 72.8 | 74.1 | 88.2 |

*Notes.* $N = 459$. Standard deviations are in parentheses.
$^{***}p < 0.001$; $^{**}p < 0.01$; $^{*}p < 0.05$.

**Table A.2.** Linear Regression Results

| | Model 5 Postloan Length of Service | | Model 6 Incremental employer profit | |
|---|---|---|---|---|
| | (a) | (b) | (a) | (b) |
| Constant | −1.38** | −1.04* | −2.31*** | −2.08** |
| | (0.72) | (0.51) | (1.04) | (0.95) |
| Independent variables | | | | |
| *Macroeconomic Effects* | −0.18* | −0.12* | 0.16* | 0.07 |
| | (0.03) | (0.02) | (0.07) | (0.03) |
| *Industry Effects* | 0.15* | 0.12* | 0.15* | 0.05 |
| | (0.04) | (0.04) | (0.06) | (0.02) |
| *Firm Effects* | 0.11 | 0.04 | 0.08 | 0.06 |
| | (0.07) | (0.01) | (0.05) | (0.03) |
| *Firm Size—Revenues* | −0.10 | −0.08 | 0.20 | 0.11 |
| | (0.03) | (0.04) | (0.05) | (0.03) |

**Table A.2.** (Continued)

| | Model 5 Postloan Length of Service | | Model 6 Incremental employer profit | |
|---|---|---|---|---|
| | (a) | (b) | (a) | (b) |
| Independent variables | | | | |
| *Firm Size—Employees* | −0.17* | −0.12* | −0.16* | −0.14* |
| | (0.07) | (0.05) | (0.04) | (0.03) |
| *Firm Size—Assets* | 0.09 | −0.05 | −0.33** | −0.30** |
| | (0.03) | (0.02) | (0.08) | (0.08) |
| *Firm Age* | −0.30** | −0.27** | 0.14* | −0.07 |
| | (0.09) | (0.07) | (0.03) | (0.01) |
| *Employer Ethnicity* (1 = minority) | 0.05 | 0.01 | 0.03 | 0.00 |
| | (0.03) | (0.00) | (0.02) | (0.00) |
| *Employee Ethnicity* (1 = minority) | 0.42** | 0.17* | 0.27*** | 0.14* |
| | (0.22) | (0.04) | (0.12) | (0.03) |
| *Employee Performance Rating* | 1.02*** | 0.29** | 0.65*** | 0.25** |
| | (0.22) | (0.13) | (0.23) | (0.11) |
| *Employee Age* | 0.05 | −0.02 | −0.04 | −0.01 |
| | (0.01) | (0.01) | (0.01) | (0.00) |
| *Employee Age*$^2$ | −0.17** | −0.10** | 0.18* | 0.17* |
| | (0.06) | (0.03) | (0.06) | (0.04) |
| *Preloan Length of Service* | 0.05 | −0.02 | 0.02 | −0.02 |
| | (0.02) | (0.01) | (0.00) | (0.01) |
| *Loan Size* | 0.31** | 0.22** | 0.30* | 0.22* |
| | (0.13) | (0.07) | (0.15) | (0.07) |
| *Reason for Loan* (1 = relation enhancing) | 0.68*** | 0.32** | 0.27* | 0.27* |
| | (0.20) | (0.12) | (0.60) | (0.22) |
| *Type of Loan* | 1.17*** | 0.91*** | 0.84*** | 0.47** |
| | (0.3) | (0.24) | (0.51) | (0.13) |
| *Minority × Perf. Rating* | | 0.37*** | | 0.54*** |
| | | (0.18) | | (0.19) |
| *Adjusted* $R^2$ | 0.588 | 0.672 | 0.513 | 0.605 |
| *F-value* | 66.4 | 71.4 | 58.6 | 64.1 |

*Notes.* $N = 459$. Standard deviations are in parentheses.
$^{***}p < 0.001$; $^{**}p < 0.01$; $^{*}p < 0.05$.

## Appendix B. Notes About the Estimation Procedures

Post hoc analysis of stylized findings included the development of logistic and OLS regression models to assess the robustness of the relationships we discovered in our investigation. Since the stylized findings suggest a number of provocative inquiries for future research, the estimations are included in Appendices A and B to assist scholars in developing and testing new research questions stemming from our findings. To enrich the utility and reliability of these regression models, we included analyses with and without product terms for key potential interactions. We also tested models with separate dependent variables for the length of postloan service (Model 5) and incremental employer profit (Model 6) while controlling for a complete profile of established predictors that were drawn from our logistic regression models. Since our analysis explicitly sought to develop new insights from a wide spectrum of perspectives and competing explanations, our models were susceptible to a disproportionate impact from outliers due to rare events that may not be typical of the overall population of observations. Although there were no material outliers among the loans in our study, we took the precaution of isolating unusually large or small values by externally studentizing the residuals (Judd et al. 2009) and making a Bonferroni correction to mitigate any potential for the outsized influence of very high and very low values. This ensured that each stylized finding represents a common condition across the full context of informal arrangements SME employers and employees.

Without exception, the statistical analyses strongly supported the stylized findings. There were, however, risks to the reliability of predictors because of endogeneity. These arose because both outcomes and predictors were influenced by decision making on the part of the employers who took part in the study (Bascle 2008). Decision making by employers regarding loan choice obviously impacts outcomes (e.g., employee retention and incremental profits) that are related to those decisions. This creates the potential for misspecification in which our regression coefficients may not accurately reflect the true underlying relationships between dependent variables and predictors. Instead, the predictors are at risk of significantly overstating the actual relationship. As is clear from the great pains required to gather data on loan issuance form SMEs, the nature of the context we examined is closely

guarded and rarely ever discussed. The only way to gather information about the loans was to gather it retrospectively. Since all of our data were obtained after the fact, we were concerned about a self-selection bias (Heckman 1976) in the employer's accounting for their rationale and behaviors in issuing the loans.

Two forms of potential endogeneity concerned us: omitted variables and reverse causality (Angrist et al. 1996, Bascle 2008). Omitted variables are caused when the model excludes a predictor that may be key to understanding the actual relationship. By omitting a key variable, the model may overestimate the effect size and significance of the predictors contained in the model while missing the governing impact of a variable that was excluded. In constructing our models, we went to great lengths to include known predictors of wages and employment at the firm, industry, and macroeconomic levels; however, given the wide berth we sought while investigating this unusual context, we took a conservative stance toward the potential omission of explanatory variables. For instance, we had no reason to believe that an employee's education level played a role in determining whether an OTB or formal loan was issued, but if education were a key determinant, and if it held predictive value over and above related variables included in our model, then our model would be susceptible to misspecification. Instead of capturing the direct role of education, we would pick up on the effect of education through the variables included in our models, thereby overstating the importance of age, ethnicity, and performance while missing out on education. We sought to mitigate these potential confounds in several ways. First, we performed a number of endogeneity tests beginning with the Heckman two-step procedure, since it is a preferred solution for the conditions involving self-selection (Campa and Kedia 2002, Hamilton and Nickerson 2003, Heckman 1979). Applying this procedure, we generated the negative Mills ratio, which was found to not be statistically significant. Nonetheless, to be conservative, we incorporated the negative Mills ratio into the equations, producing the results in Appendices A and B. Even after taking the correction for omitted variables into account, the results regarding the choice of the OTB loan are significantly and positively related to the focal predictors, suggesting that results are robust to omitted variables.

A second concern, reverse causality, might arise, for example, if an owner routinely rated an employee higher simply because that employee had received an OTB loan. Or perhaps an employee would perform better after receiving an OTB loan. Retrospective data collection can result in these sorts of quandaries regarding what caused what. This condition also results in misspecification because the model fails to apprehend the correct magnitude and directionality of relationship between the predictors and the outcomes. To test for reverse causality, we developed instrumental variables (IVs) for use in a two-stage least squared analysis, which is a preferred approach for dealing with multiple endogenous regressors and in models containing both continuous and categorical dependent variables (Bascle 2008). Overall, a strong IV will be well correlated to the predictor that has been included in the model but should be uncorrelated to the model error. This means that the IV is only be related to the dependent variable through the predictor. In our test for reverse causality, we regressed the model predictors onto a vector containing seven instruments, which included change in the average price of oil, annual change in Central American birthrates, annual change in state tourist revenue, annual change in state university attendance, change in the state Hispanic population, change in the state unemployment rate, and change in the number of licensed payday lending establishments. Using Staiger and Stock's (1997) procedure, the correlation strength of our IV vector was well above the necessary threshold, allowing us to include it in the regression model as a test for reverse causality. When tested in the context of a complete model, the instrumental vector was found to be significant at $p < 0.001$. This means we can be relatively certain that the directionality of our models is intact. Our predictors drive the observed outcomes, rather than outcomes driving the predictors. For example, we can argue with confidence that employee performance, age, ethnicity, and reason for the loan request are each statistically significant determinants of OTB issuance, rather than OTB loan issuance determining each of these model variables.

## Endnote

[1] This is an anecdote from the experience of an author of this study, who was a small business owner. Names have been changed for confidentiality.

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**CORRECTION**

In this article, "Value Creation Through Employer Loans: Evidence of Informal Lending to Employees at Small, Labor-Intensive Firms" by Richard A. Hunt and Mathew L. A. Hayward (first published in *Articles in Advance*, March 29, 2018, *Organization Science*, DOI:10.1287/orsc.2017.1182), the spelling of the second author's name has been corrected, and a sentence is added to the Acknowledgments noting the equal contribution of both authors.