

# Financial Participation of Employees in Estonia

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## Financial Participation of Employees in Estonia<sup>1</sup>

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## **1. Background**

Presently, legal regulation of participation of employees – financial participation as well as participation in decision-making – is not well developed in Estonia. On the one hand, it is due to the fact that no tradition of employee participation could have been formed after Estonia became independent because different, contrary political aims, e.g. development of the free-market economy and promotion of national elites, were given priority. Although employee ownership emerged during the early stage of privatization, it was a temporary phenomenon. Earlier experience with employee participation in decision-making was considered to be a relict from the time under Soviet rule and, therefore, to be discredited and not worth following. On the other hand, the solution of current employment and social problems is not associated with a higher level of participation of employees.

### **a) History**

Historically, participation of employees was related to co-operative movement and, later, to privatization procedures, especially at the early stage in the end of the 80ies.

Co-operative movement started at the beginning of the last century with agricultural co-operatives and reached its peak during the first independence period (1,156 co-operatives in 1927) with co-operatives in different branches such as fishing, insurance, crafts, agriculture and consumer co-operatives.<sup>2</sup> However, these co-operatives were not owned by employees. Under socialist rule, Estonia had a large consumer co-operative sector. After the beginning of privatization, consumer and supply co-operatives mostly remained in the hands of their members, although some related firms became subsidiary companies to central co-operatives.

The early start of the economic and political transition in Estonia was closely connected to the fight for independence. In the aftermath of the August coup, the national question played an important role. The majority of industrial workers were Russian-speaking. In the early years most of them did not get Estonian citizenship. They had no voting rights for parliament. Therefore, they had very limited political power. In this way the group of workers was split and their political influence was quite small. At the same time the political debate in the first years of transition was not focused on economic problems, but rather on the national question. This is a main explanation why the support for employee ownership which was inherited from the Soviet legislation was abolished during the early years of transition (Mygind, 1994).

In the first stages of transition the workers could use some of their power connected to the Workers' Councils. Especially, in Estonia, these councils did have some influence, but they were split in a pro-Russian and a pro-Estonian organization quite early in the process (Terk, 1996). During the transition especially the Russian-speaking

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<sup>2</sup> See Krinal, V. (2001): 100 aastat eestlaste ühistegevust, Ühistegelised uudised, Okt., Nov.

part of the employees lost influence. This is probably an appropriate explanation behind the decreasing importance of employee-ownership at the beginning of the 1990s.

The development of participation concept in connection with privatization started under the Soviet rule when such new forms as small state enterprises (Order of the Soviet Government on Small State Enterprises 43/1986 and 91/1987), private co-operatives (Soviet Law on Co-operatives from 26 May 1988) and enterprises leased by the workers' collectives (Decree of the Supreme Soviet on Leasing and Leasing Relations from April 1989 and Decree of the President of the Soviet Union on the Basic Principles of Leasing from November 1989) were introduced according to Soviet legislation. Whereas co-operatives became a popular form in Estonia from the beginning and did not disappear after Estonia became independent (Mygind, 1995, p. 239),<sup>3</sup> only few leased enterprises (12) were founded under Soviet law (Terk, 1996, p. 112). Enterprises could be leased on the initiative of 2/3 of the employees; the enterprise remained in state ownership, but it was managed by the management board elected at the general meeting of employees and ownership could be transferred after depreciation of assets or through buy-out. Small state enterprises, as their name shows, also remained in state ownership, but could control profits, prices and salaries and were granted tax allowances. At the early stage of privatization, additional forms of semi-private enterprises, people's enterprises (Estonian Charter of People's Enterprises from 11 December 1989) and leased enterprises (Estonian Law on Leasing from 26 September 1990 and Estonian Government Order on Leasing Relations from January 1991), were introduced also according to Estonian law.<sup>4</sup> People's enterprises could be established on the initiative of at least 3/4 of the workers' collective. The enterprise remained in state ownership, but authority of the owner concerning management and partly concerning revenue was transferred to the enterprise on the basis of a trust concept. This form, although introduced under Estonian legislation, was considered to be a relict of the socialist economy and, therefore, not wide-spread (only 7 enterprises) (Mygind, 1995, p. 240). More popular was the leasing model according to Estonian law. Although the Estonian legal acts as compared to the Soviet law did not limit the group of persons authorized to apply for leasing to the workers' collective, it granted the workers' collective preferential treatment, since employees were not obliged to invest 20 per cent of the book value of the enterprise to be allowed to lease the enterprise. All these semi-private forms provided employees with decision-making rights (management election), but financial participation of employees was limited. Nevertheless, as proto-forms they constituted a convenient platform for takeover by employees and/or management during privatization. E.g., it is assumed that leased enterprises were major source of employee ownership in Estonia (Jones et al., 2003, p. 10). These forms might still exist and have to be considered since the Commercial Law

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<sup>3</sup> Further details on co-operatives see II. 1. b) bb).

<sup>4</sup> Since Estonia declared its independence from the Soviet Union on 16 November 1988 and the Soviet Union / Russian Federation recognized it only in 1991, there was a period of conflicting jurisdictions.

addresses leased enterprises, collective enterprises and state small enterprises in § 509 (6) as being transformable to limited liability companies and joint-stock companies.

The first stage of actual privatization was privatization of small and middle-sized enterprises according to the Law on Privatization of State-Owned Service, Trade and Catering Enterprises from 29 December 1990 which granted employees pre-emptive right to buy the enterprise at the initial price. It must be noted that also 7 large enterprises were privatized under the above law in June 1991 and were taken over by employees. According to amendment of May 1992, the scope of the law was extended to all small and middle-sized enterprises, but rights of employees were reduced to purchasing the enterprise at the highest price (limited by law) at an auction. After adoption of the Privatization Law in 1993 regulating all privatization procedures including small privatization, all privileges of employees in the course of small privatization were abolished, but, at this stage, small privatization was almost completed and 80% of enterprises as estimated were taken over by insiders (Mygind, 1995, p. 240).

Large privatization started relatively late because there was no consensus of main political forces on basic principles of privatization, but already early conceptions contained plans to reduce the rights of employees. The Government concept from September 1990 indicated that the number of shares to be sold to employees should be reduced to 20% and discounts for employees should be limited. In the draft of Privatization Law submitted by the Popular Front in May 1991 discounts for employees were abolished, but pre-emptive rights remained. This draft law was rejected by a narrow margin. The PL finally adopted in 1993 followed the German Treuhand model and contained no preferential rights of employees. Reasons given for this concept were, on the one hand, political tensions with Russian-speaking employees and, on the other hand, analyses of privatization practice in other transition countries, e.g. in Poland (Terk, 1996, p. 108).

Privatization vouchers, which were introduced in 1993 to all permanent residents of Estonia according to the length of employment, could be used as substitute for cash in auctions and tenders of enterprises. They could also be used for public offerings of shares in the 39 large companies where the majority of shares were sold to a core investor (Mygind, 2000, p. 60). However, they were mostly used for privatization of land and housing; only 39% were used by the population to purchase shares of enterprises (Terk, 2000, p. 172). Privatization vouchers could have been used for payment in privatization until 1 December 2000 (§ 29 (2) PL).

Unlike privatization in the industrial sector, employees were granted more rights in privatization in agriculture. Collective farms were privatized according to the Law on Agricultural Reform from March 1992, whereby former owners entitled to restitution (§ 14 LOR) and employees according to their working shares (based on length of employment in agriculture and job description) became co-owners and were entitled to vote at the general meeting. Owners and users of 'structures in agriculture' and domestic physical persons and legal entities engaged in agricultural production were

granted pre-emptive rights in privatization of land (§ 22 LRL). If application for privatization on the basis of pre-emptive right was submitted before 1 January 2002, the selling price corresponded to the assessed value in 1993 or 1996 if then the value was lower than in 1993 (§ 22/3 (1) LRL) and it could be fully paid in vouchers (§ 22/3 (4) LRL). According to these regulations and by founding co-operatives, many employees in agriculture became co-owners and thus obtained participation rights.

### **b) Social Partners**

Currently, the social partners are represented by the Confederation of Estonian Trade Unions (Eesti Ametiühingute Keskliit) and the Estonian Employers' Confederation (Eesti Tööandjate Keskliit). The power relation between social partners in Estonia is asymmetric, the trade unions being traditionally the weaker party.

First trade unions were formed in Tallinn 1905, first central organization of trade unions in 1927. However, a government-friendly workers' union which did not effectively protect the interests of employees was formed instead of trade unions in 1936. Under Soviet rule, union membership was obligatory and the trade unions functioned as an instrument of the Communist party to control workers and managers. Therefore, the traditional unions had lost their credibility, and their role and membership diminished after the independence in 1991. The central trade union had 700000 members in 1991, only half of this number in 1993 and only 50000 in 2001. Union membership as percentage of all employees fell from 87% in 1991 to 15% in 2001 (Eamets et al., 2003).

Recent debates on participation of employees between the social partners arose due to the necessity to transform the *acquis communautaire* into Estonian law. At the beginning of 2004, the social partners were involved in preparation of the draft law on social dialogue by which the EC Directive 94/45/EC on European Workers' Councils; the EC Directive 2002/14/EC on national consultation rules and the EC Directive 2001/86/EC supplementing the statute for a European company with regard to employee involvement required in the case of establishing a European company were to be transformed into Estonian law. The Confederation of Estonian Trade Unions demanded that the law should establish conditions for effective social dialogue by regulating the information and consultation procedures and delimitation of powers of state authorities, extend control power of employees by stipulating representation of employees on the board of public enterprises and private enterprises with more than 300 employees and ensure implementation by introducing stricter rules for state control. The Estonian Employers' Confederation argued that the draft law contained more obligations for employers than the respective EC directives and that strict rules will hinder rather than help to develop the social dialogue. Further, the Confederation opposed the idea of employees' representatives becoming members of management bodies. Since the government was not willing to play the role of the arbitrator and the social partners could not find a compromise solution, bipartite consultations ended in March 2004 with the recommendation to withdraw the draft law and to prepare a new

draft law on collective labour relations incorporating Law on Collective Agreements, Law on Settlement of Collective Labour Disputes and Law on Employees Representatives.

Another controversial debate between the social partners took place in connection with the draft law on Involvement of Employees in the Activities of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies, and also in this case no result was achieved.<sup>5</sup> However, the Parliament adopted this law on 12 January 2005.

Generally, the idea of participation of employees could not be successfully promoted until now. The legal secretary at the Confederation of Estonian Trade Union Ms Tiia Tammeleht declared in an interview that the question of financial participation of employees is currently not on the agenda of the Confederation.<sup>6</sup> The Estonian Employers' Confederation is strongly opposed to any extension of employee participation rights.

However, it must be noted that recent discussions concerned only employee participation in decision-making, which is generally contrary to the interests of employers, and not financial participation of employees, which could, under certain circumstances, have advantages for both employees and employers.

### **c) Current National Policy**

Current unemployment, especially of young and elder persons, and high costs connected with employment makes the government consider other employment and social problems, e.g. participation rights of employees, as being secondary. Mr Tiit Kaadu from the Ministry of Social Affairs affirmed in an interview that the ministry acknowledged lack of legislation concerning employee participation, but has other priorities so far. According to Mr Kaadu, the initiative to improve the situation would have to come from the trade unions (Eamets et al., 2003), whereas, as stated above, the trade unions are not planning to address this issue either.

Participation of employees has not been on the political agenda of the Parliament. The only political party which addressed this issue is the Social Democratic party. Social democrats have been in opposition for the last five years and currently hold only 6 of 101 seats. They proposed amendments to the Commercial Code regarding representation of employees in management bodies of corporations several times, but these initiatives were rejected by other political forces.

Under such circumstances, it is unlikely that new legal regulations on employee participation in Estonia will be adopted on the initiative of Estonian social partners or other political forces in the foreseeable future.

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<sup>5</sup> For further details see II.1.b) aa) (3).

<sup>6</sup> Interviews with Mr Kaadu and Ms Tammeleht were conducted by Ms Johanna Korhonen in January 2005.



### **2. Types of Schemes and their Legal Foundations**

Notwithstanding the lack of special legal regulation of financial participation of employees, the economic research shows that individual Estonian enterprises use different financial participation schemes (employee shares, stock options and profit-sharing) on the basis of articles of association or internal rules. Obviously, overall legal regulation does not - at least purposefully - create incentives, but also does not inhibit the development of some forms of financial participation, excluding such complicated forms as ESOP for which state legal regulation and tax incentives are needed. Therefore, this paper will focus on general provisions of privatization, company, tax and labour law and on their potential role for development of financial participation.

#### **a) Employee Share Ownership and its Legal Foundations**

The most common form of employee participation in Estonia is employee share ownership which had been obtained mostly during privatization and to which the provisions of company, securities and tax law currently in force are applicable.

##### *(1) Privatization Issues*

Although privatization in Estonia can be considered virtually completed, since the overwhelming majority of enterprises have been privatized and the Estonian Privatization Agency was closed on 1 November 2001 (§ 11 (1) PL) after completing the last big privatization deal selling AS Eesti Raudtee (Estonian Railways), enterprises of the energy sector and public utilities are still partly owned by the state and could be sold in the future. For that reason, the laws regulating privatization (Privatization Law from 17 June 1993 (hereinafter referred to as PL); Law on Ownership Reform from 13 June 1991 (hereinafter referred to as LOR); Law on Land Reform from 17 October 1991 (hereinafter referred to as LLR)) are still effective, but substantially amended. Employee ownership in Estonia could emerge only at a very early stage of privatization because all privileges of employees in connection with privatization were abolished after the consolidated concept of privatization was laid down in the Privatization Law adopted on 17 June 1993. Since the Estonian legislation did not differentiate between employees and management when regulating preferential rights of the staff of enterprises in the privatization process, the term 'employees' shall be used as a generic term for employees and management for the purposes of presentation of legal regulation.

The basic concept of privatization in Estonia which is fundamental for PL and LOR and still effective is direct sale to the highest bidder at a public tender supplemented by restitution (see § 36 (1) LOR).

Thus, the effective PL (as amended on 14 November 2001) contains no privileges for employees nor for other groups of potential buyers which is understandable as the

effective law is based on the provision on termination of activities of the Privatization Agency (§ 1 (1) PL) and thus on termination of main privatization proceedings, although further smaller privatization proceedings are anticipated and therefore a new 'government agency organising privatization' (§ 4 (1) PL) is established. The only pre-emptive right contained in the PL concerns private shareholders who hold shares in partly state-owned enterprises: they have pre-emptive right to purchase shares from the state at a price determined by the organiser of privatization, ie the respective state or municipal agency (§ 2 (4) PL). This might apply to employees if they are minority shareholders in their own enterprise still partly owned by the state.

Since the privatization process is almost completed, the few privileges of employees in Estonian legislation have been abolished. Initially, pre-emptive rights, which often also lead to the possibility to buy assets or shares under value, were the most popular mechanism. In privatization in the industrial sector, most influential political forces were opposed to buy-outs by employees, so that all preferential rights of employees were abolished as early as 1993. Other political preferences determined privatization in the agricultural sector, so that preferential treatment, both in privatization of enterprises and of land, was granted to employees of agricultural enterprises, but these rights were also terminated due to the completion of main privatization procedures.

Pursuant to the effective PL, employees are not entitled to participate in the decision-making process during privatization procedure. However, rights to participate in decision-making in the new company, e.g. voting right at the general meeting, right to call the general meeting etc., are attached to the shares if they were acquired by employees in the course of privatization.

### *(2) Company and Securities Law*

Although employee ownership on shares of their enterprises purchased during privatization is decreasing, some employees still hold shares and thus have the rights attached to these securities according to company and securities law. In Estonia, company law is primarily laid down in the Commercial Code from 15 February 1995<sup>7</sup> (hereinafter referred to as CC) and securities law in the Securities Market Law from 17 October 2001 (hereinafter referred to as SML). Estonian company law is strongly influenced by German law, so that even rulings of German courts can be used for interpretation of provisions of the Estonian CC (Klauberg, 2004, p. 1). However, special rules on participation of employees in management and decision-making which are contained in a special German law (Betriebsverfassungsgesetz) were not considered by the Estonian law-maker.

According to CC, there are the following five kinds of undertakings: sole proprietor (§§ 3, 75 ff. CC), general partnership, limited partnership, limited liability company (osaühing, §§ 135 ff. CC) and joint-stock company (aktiaselts, §§ 221 ff. CC). For

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<sup>7</sup> An important part of commercial law also constitutes the Law on Commercial Associations from 19 December 2001, which will be addressed under II.1.b) bb).

neither of these forms, there are special rules on employee share ownership concerning acquisition, limitation of the number of shares or issuing employee stock, so that general rules apply. The quantitative distribution of different business forms shows which forms are more popular, and this might have an impact on development of specific employee participation forms now and in the future.

**Table 1. Business forms, non-profit associations and foundations**

	2001	2002	2003	2004
Sole proprietor	19,443	20,563	21,464	21,830
General partnership	305	318	342	365
Limited partnership	468	601	630	660
Limited liability company	43,266	49,060	54,387	59,767
Joint-stock company	7,862	7,412	6,743	6,241
Commercial association	933	910	855	775
Branch of foreign company	331	356	365	388
Non-profit association	15,886	17,774	19,369	21,293
Foundation	436	502	570	638
Total	88,930	97,496	104,725	111,957

Source: Statistical Office of Estonia

**(a) Corporations**

As the above table shows, most legal entities are corporations, whereby limited liability companies are the most popular business form. Since the most wide-spread form of financial participation of employees in Estonia is share ownership, legal regulation of the rights of shareholders directly influences financial participation. All shareholders have voting rights at the general meeting (for LLC § 174, for JSC § 226), with the exception of holders of preferred shares in a JSC who have no or restricted voting rights (§ 237 CC), right to initiate calling the general meeting (for LLC § 171 (2) 3 CC, for JSC § 296 CC), right to elect and remove members of the management board or of the supervisory council (for LLC § 184 (1), (3), for JSC § 298 (1) 4 CC), to receive dividends (for LLC § 148 (5), for JSC § 226), to transfer shares (for LLC § 149 (1), if articles of association do not provide otherwise; for JSC § 229 (1) CC) and to receive assets in the case of liquidation (for LLC § 148 (2), for JSC § 226 CC). All shareholders have a pre-emptive right to purchase shares which other shareholders of their company are going to sell (for LLC § 149 (2), (3), for JSC § 229 (2) CC). In the case of capital increase, a share increasing the size of the share can be set off against a claim of the shareholder to the company upon the resolution of the general meeting provided that this does not harm the interests of the company and its creditors (for LLC § 194 (1), for JSC § 346 CC).

## 2. Types of Schemes and their Legal Foundations

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Since employees who became shareholders acquired often minority shares in newly founded LLC and JSC during privatization, especially provisions concerning shares acquired before 1 September 1995 and rights of minority shareholders are of special importance. Pursuant to § 515 (1) and (2) CC, rights attached to shares issued before 1 September 1995 which do not comply with the provisions of the Commercial Code remain valid, whereas rights not attached to shares are void. Minority shareholders of a JSC can be bought out by the majority shareholder holding at least 9/10 of the shares upon resolution of the general meeting with at least 95% of the votes represented by all shares; a fair compensation to minority shareholders in this case is secured by the provisions regarding takeover bids (§§ 363 2 (2), 363 7 (1) CC) and the right to lodge a claim with a court (§ 363 8 (2), (3) CC). Minority shareholders have no corresponding sell-out right.

In the SML, employees and management are mentioned in connection with the prospectus if securities are offered to employees and requirements concerning an investment firm. If securities issued by a company are offered solely to employees or managers of this company the prospectus need not be made public and registered (§ 17 (1) 2) SML), which means that employees and management are not entitled to compensation pursuant to § 25 SML if they suffer losses as a result of volatility of acquired securities. It seems to be justified since management and employees might have insider knowledge, but it could be argued that employees, unlike managers, not necessarily have full information on the financial situation of the company. Notably, employees are not deemed insiders, but third persons, who could receive information from insiders, under the same law (§ 191 (1), (3) SML). If a company provides investment services only to its employees and management, it has not to be registered as an investment firm (§ 42 1) SML). The consequence is that this company can conduct investment activities without licence (§ 48 ff. SML), is not obliged to notify about transactions (§ 91 SML) and to have additional reserve and risk funds (§§ 93 ff. SML) and there are no additional requirements for managers (§ 79 SML).

As there are no special rules concerning employees, there are apparently no incentives for companies, apart from facilitation of share sales and providing investment services within the company of employees, but the consequence of these rules is lack of control and limitation of liability for the company. If employees are also shareholders, they have voting rights in each company form, although they generally have weak influence on resolutions of the general meeting being minority shareholders in most cases. Minority shareholders who represent at least 10 % of the share capital are entitled to demand to call a general meeting (for LLC § 171 (2) 3 CC, for JSC § 296 CC) and to lodge a claim with a court for removal of the members of the management board or supervisory board with good reason (for LLC § 184 (5) CC, for JSC § 319 (5) CC).

Additional rights were granted to employees of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies according to the Law on Involvement of Employees in the Activities of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies which was adopted on 12 January 2005 after a long controversial debate between the social partners. The law

transformed EC directives 94/45/EC and 2001/86/EC on employee involvement required in the case of establishing of a European company requiring nomination of employees' representatives into the Special Commission for Negotiations, the European Work Council, the SE Special Commission for Negotiations as well as the SE Council or Administrative Council. According to Mr Tiit Kaadu from the Ministry of Social Affairs, there are 20 to 25 enterprises in Estonia presently to which this law shall be applied. The crucial question in the Estonian debate was participation of trade unions in working councils of European companies. The Employers' Confederation argued that representatives of trade unions should not have preferential treatment as compared to employee representatives elected at the general meeting of employees. Trade unions claimed that the general meeting of employees, but not the trade union is usually influenced by the employer. It appears not adequate that the debate was so heated considering the fact that the number of European companies in Estonia is quite small. However, this debate must be understood as a start of a broader debate on lack of participation rights of employees in Estonia which becomes evident if compared with neighbouring European states.<sup>8</sup> Although the law has been adopted, implementation might present difficulties, since, as the Deputy Secretary on Labour Policy from the Ministry of Social Affairs Mr Piret Lilleväli stated, these issues are new for Estonia and social partners are not strong enough to support the implementation.

### (b) Co-operatives

Co-operatives have been a popular company form in Estonia beginning with the first period of independence, during the socialist rule and first experiments under Gorbachev and also after Estonia gained independence, but only a small percentage are commercial associations. The Estonian law on co-operatives was adopted in 1992 and did not differ significantly from the preceding Soviet law from 1988. It was applicable to both commercial and non-profit co-operatives. Compared to other parts of the Soviet Union, co-operatives developed quite early and rapidly. By January 1990, there were more than 2000 co-operatives with about 7% of employment (Arkadie et al., 1991, p. 258). The number of co-operatives peaked in 1993. According to the Statistical Office of Estonia, there were 2,943 co-operatives in August 1993. Since then many co-operatives have been transformed to other legal forms. In July 1998 there were 2,124 co-operatives in the enterprise register, but only 769 of them were registered as profit earning co-operatives (Publication of the Statistical Office of Estonia 1998). The development of commercial and non-profit co-operatives showed that these two forms are substantially different and it would be appropriate to adopt new special laws on each form. For that reason, the structure of statistics was changed in 2001, so that the figures before and after 2001 are not comparable. In 2003, there were 19,369 non-profit associations (including former housing co-operatives) and 855 commercial associations.

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<sup>8</sup> For further details on participation of employees in decision-making in Estonia in a European context see Tavits (2004).

## 2. Types of Schemes and their Legal Foundations

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In the context of employee participation, commercial association regulated by the Law on Commercial Associations from 19 December 2001 (hereinafter referred to as LCA) is relevant. According to the new law, commercial association is a flexible form for associations of physical persons or legal entities not owned by the state, whereby each member has one vote (§ 1 LCA). Generally, members are not personally liable, but personal or additional liability can be stipulated in the articles of association during foundation or by amendment of the articles of association for which over  $\frac{3}{4}$  votes of members is necessary (§§ 1 (2), 13 (1) LCA). The profit is generally transferred to the reserve, but it can also be distributed among members according to the participation of members in the activities of association or in proportion to contribution if it is stipulated in the articles of association and if at least  $\frac{1}{20}$  of the net profit is transferred to the reserve (§§ 29, 30 LCA). Majorities in voting and management structure are similar to the LLC.

The new law seems to be an administrative challenge for small agricultural co-operatives, so that the state considers it necessary to provide financial support to agricultural commercial associations for foundation and administrative expenses. The legal foundation for such subsidies constitute §§ 59-61 of the Law on Rural Development and Agricultural Market Regulation from 11 October 2000. The subsidies are granted if at least five of members of the commercial association are agricultural producers and if one of the areas of activity of the association is connected to agriculture (§ 60) at a certain rate for maximally five years (§ 61).

Theoretically, co-operative is an appropriate business form for employee-owned enterprises. New legislation on commercial associations seems to bring advantages, since – which is not typical for co-operative as a business form – liability can be limited and profit can be distributed. However, if the liability is limited, the association capital must be at least 40,000 EEK (§ 1 (3) LCA) as the minimal share capital of a LLC (§ 136 LLC). Co-operatives were owned by employees in Estonia only at the early stage of transition in the end of the 1980s-at the beginning of the 1990s. The number of commercial associations is quite small and decreasing over time. The reason seems to be higher administrative expenses and higher requirements concerning management.

Under LCA, each member has one vote at the general meeting, but the regulation on delimitation of power between the general meeting and the management board is not detailed. Thus, LLC could be preferred to a commercial association because the legal regulation is explicit and unambiguous.

### (c) Partnerships

Partnerships are a traditional business form for small enterprises owned by employees from human capital intensive firms as IT and law firms to small family enterprises e.g. in trade and catering. Interestingly, human capital intensive firms in Estonia do not choose this business form, preferring LLC. For that reason, the number of partnerships in Estonia, especially general partnerships, is very small. Partnerships in Estonia are divided in general partnerships (täisühing) and limited partnerships

(usaldusühing) under CC. The most important disadvantage of partnerships is personal liability of partners (for general partnership § 125 CC, for limited partnership concerning general partner § 125 CC, concerning limited partners § 132 CC). In a limited partnership, liability is limited for limited partners, but they are not entitled to represent the company and to participate in management unless the articles of association provide otherwise (§ 128 (1), 131 (1) CC).

In partnerships, partners are usually co-owners and managers at the same time. However, joint personal liability of partners makes both sole proprietorship and LLC more attractive alternatives. A specific form of partnership where it is possible that only one partner is liable if the damage is caused by him personally as in German law firms does not exist in Estonia. Although at least general partners dominate the decision making proceedings in partnerships, it is difficult to find a solution if partners disagree. The liability and succession are additional risk factors.

### **b) Profit-Sharing**

Special legislation concerning profit-sharing with regard to employees does not exist, so that there are neither direct incentives nor direct restrictions. Although it is preferable for employees to receive dividends instead of wages/salary since they do not have to pay income tax on dividends, the company has to pay income tax on dividends. Due to this interest conflict and to the fact that shareholders among employees are not numerous such scheme of profit-sharing is not wide-spread. More popular are monetary incentive schemes where the bonus is not dependent on profit (Mygind, 2002, p. 19). For taxation reasons, it is more profitable for employees to be employed as self-employed persons rather than as wage-earners (better possibilities for tax deductions). For employees in higher positions and with management experience, the combination of self-employment with LLC is most profitable. The substantial advantage of LLC is the fact that no corporate income tax is imposed in Estonia, the disadvantage is additional administrative work and possibly administrative costs which can be minimized if the employee has corresponding experience.

### **c) Taxation Issues**

General provisions on taxation are contained in the Taxation Law and imposing of special taxes is regulated by the Income Tax Law from 15 December 1999 (hereinafter referred to as ITL), Value Added Tax Law and Social Tax Law. In connection with financial participation of employees, the ITL is relevant. If income tax on wages is higher than income tax on dividends, it would be an advantage for introduction of schemes of financial participation of employees.

There is no corporate income tax. Personal income tax on wages is paid as a withholding tax with a rate of 24% in 2005 (§ 4 (1) ITL) (the rate will decrease to 22% in 2006 and 20% in 2007). In addition, the employee shall pay a social tax of 33% and a

pension fund payment of 2% which is withheld by the company from the gross salary. The third payment besides income tax affecting the salary is an unemployment insurance payment of which 1% is withheld from the gross salary and 0,5% from the gross salary is paid by the company. However, the employee is not obliged to pay income tax on received dividends, unless dividends are paid by a foreign legal entity or by an association or from a pool of assets which does not have the status of a legal entity (§ 18 (1), (4) ITL).

Instead, the resident company pays income tax on distributed profits despite the fact whether the distribution is monetary or non-monetary (§ 50 ITL). Only if profits are distributed as a so called bonus issue no income tax is paid. The company shall pay income tax of the net sum of the distributed sum according to the formula set in § 4 (1) ITL. This means 18.24%, i.e.  $24/76 \times$  distributed amount.

Thus it can be concluded that financial participation as dividends on shares or other forms of profit-sharing is preferable to the wage-earner position for the employee, but less advantageous for the company.

### 3. Incidence Now and Over Time

In this section, it will be shown how employee ownership and profit-sharing emerged and what development lead to the current situation regarding employee participation.

#### a) Small Privatization

While the initial legislation on small privatization introduced in spring 1991 favoured insiders, after May 1992 most of these preferences were taken away. In the early version of PL employees had the right to buy the enterprise at the initial price, in most cases much below the market value of the assets. It is estimated that around 80% of the first wave of 450 small enterprises were taken over by insiders before the change in policy (Kein et al., 1995, p. 146). Subsequently, the importance of insider ownership in privatization process declined. Insiders were merely entitled to match the final bid whereas the amount was limited by law. According to the amendment of May 1992 the circle of participants in privatization was widened to include foreigners. In the PL from June 1993, the last privileges of insiders were taken away. The control of the privatization process including small privatization was transferred to the Estonian Privatization Agency. The development in sales can be found in Table 2. At this stage of small privatization, the method of sale by auction included relatively small objects, often spin-offs from larger companies. However, the price per object increased considerably during the period, and since June 1993 no formal limit of the asset value for sale on auctions has existed.



**Table 2. Small privatization in Estonia (objects sold by auction)**

	1991	1992	1993	1994	1995	1996	1997	1998	total
Objects	211*	556*	252	126	120	84	64	20	1,433
Price million EEK	1.7*	42*	128	68	80	149	161	287	917
Av. price 1,000 EEK	8*	76*	508	540	666	1,774	2,516	14,350	678
Av. price 1,000 1995 EEK	312	276	970	697	666	1,442	1,838	3,689	659

\*1991 and 1992 data from Purju (1996), other years from EPA. 1991 price was 18 million Rubles. Estonian Privatization Agency estimates the total number of object 1991-1998 to 1,367 for a total price of 893 million EEK.

It is shown in Table 2 that small privatization proceeded very rapidly in the first years, when the assets were sold at very low prices. Note, however, that the increase in average price especially in the early years was also due to inflation. Compare data in Table 2 with the average price 1995 EEK deflated by CPI. In the later years, the increase is caused by the fact that another type of objects, spin-offs of fixed assets from enterprises in large privatization, was sold. The small privatization was very fast in the early years. In 1991 more than 90% of the enterprises in the service and trade sector belonged to the state or municipalities. In 1994 83% of the activities in the service sector, 90% of whole sale and 94% of retail sale were private (Purju, 1996).

At the individual level employee ownership seems to be most stable in small enterprises, and more small enterprises have a fairly equal distribution between the employee owners compared to the situation in larger enterprises. Based on the sample the estimate for the whole economy shows that 29% of the employees were owners in 1995 falling to around 25% in January 1997 (Jones et al., 1998).

### **b) Large Privatization**

From 1993, the strategy for large privatization was changed according to the German Treuhandanstalt model. The Estonian Privatization Agency put out large enterprises to open tender often announced internationally. The offered price was only one of the criteria for choosing the buyer. The proposed business plan and guarantees for investments and employment also played an important role. In this model the main idea was to find a core investor. Since substantial capital was needed, foreign capital had an advantage in this process. Also at this stage, since the managerial group often had accumulated some capital, it was possible for them to begin to secure loans in the rapidly developing system of private banks. Furthermore, domestic capital suppliers were allowed to buy on instalment and it was also possible for domestic buyers to use vouchers as part of the payment from summer 1994. Hence, at this stage, alliances between managers and a broad group of employees were no longer necessary. In addition, foreign capital gained increasing access during this stage of large privatization. From spring 1996 they were also allowed to buy on instalment and to use vouchers as payment. The consequence was that broad groups of employees only seldom had the

opportunity to take over their enterprises in this type of privatization (Mygind, 2000, p. 30).

The Treuhandanstalt model gained speed during 1993, and the largest number of privatization contracts for large enterprises was made in 1994, see Table 3. By the end of 1995 most large enterprises had been privatized and by 1999 only a few though quite large enterprises remained. At the end of 1998, 483 large enterprises had been sold through EPA by direct sale at a total price of around 4.7 billion EEK or 400 million USD. The investment guarantees amounted to 4.6 billion EEK and the owners took over liabilities of 2.2 billion EEK. The table shows a tendency for fewer, but larger and more expensive enterprise privatizations, 1994-1997.

**Table 3. Overview over large privatization**

	1993	1994	1995	1996	1997	1998	Total
Enterprises	54	215	142	43	17	12	483
Price million EEK	353	1,329	937	474	1,295	318	4,707
Average price 1,000 EEK	6.5	6.2	6.6	11.0	76.2	26.5	9.7
Total paid by vouchers	0	294	443	134	298*	76	1,245
% paid by vouchers	0%	22%	47%	28%	23%	24%	26%
Debt taken over million EEK	196	700	618	230	416	8	2,168
Average debt 1,000 EEK	3.6	3.3	4.4	5.3	24.5	0.7	4.5
Invest.guarantees million EEK	237	858	1,021	489	1,715	281	4,601
Average 1,000 EEK	4.4	4.0	7.2	11.3	100.9	23.4	9.5
Job guarantees	9,099	25,573	17,279	12,742	2,929	72	56,226
Average	169	119	122	30	172	6	116

\* 50% paid by vouchers, except the shipping comp. sold for 700 million EEK to Norwegian company. Source: Mygind (2000), based on the material of EPA.

Two types of vouchers have been distributed in Estonia. Capital vouchers were distributed to all residents depending on years of work. Compensation vouchers were distributed to owners of property nationalized in the early Soviet period (or their heirs) if they did not want this property back, or if it was not possible to return this property. By the end of 1998, 8.3 billion EEK and 7.1 EEK billion compensation vouchers have been distributed (Ministry of Finance). The two types of vouchers were used both for privatization of real estate and enterprises.

In March 1995 the biggest investment fund crashed. The resulting losses of investors exceeded the losses caused by the banking crisis in 1992-1993. This was an important reason why investment funds did not develop like in other countries with voucher schemes. Investment funds accumulating vouchers did not have any formulated role in the legislation. By June 1996, there were 6 privatization investment funds accumulating vouchers whose value constituted only 1% of the total value of the distributed vouchers (Kein et al., 1995).

**Table 4. Use of vouchers**

Nominal value million. EEK	1994	1995	1996	1997	1998	total
Housing	500	1,979	660	283	120	3,542
Real estate	0	30	204	470	1,342	2,046
Small enterprises auctions	14	25	75	80	142	336
Large enterprises tenders	16	726	218	490	243	1,693
Public offerings	0	704	666	940	0	2,310
Compensation fund	26	513	528	252	183	1,502
Total	556	3,977	2,351	2,515	2,030	11,429
Market/nominal voucher value	0.20	0.17	0.18	0.35	0.28	

Source: Mygind (2000), based on Ministry of Finance.

Table 5 gives an overview over the distribution of ownership in an Estonian sample of 666 enterprises at the time of privatization before January 1995 (Jones et al., 1998, p. 18). 83 firms privatized during 1995 and 1996 were included in the 255 state- and municipality-owned enterprises. 6 firms did not give information about their ownership at the time of privatization. Among the 405 responding private enterprises (666-255-6) slightly more were outside-owned than insider-owned. Enterprises with outside majority dominated by domestic owners constitute 31% of the private enterprises or 19% of the total. Outside majority with foreign dominance were at the same level as inside majority with employee dominance – 22% of the private enterprises or 13% of the total. Inside majority dominated by managers made up 16% of the private enterprises and 10% of the total. 6% had no majority for either state, outsiders or insiders. Employee ownership was most widespread in agriculture (39%) and lowest in transport (3%) in January 1995. Manager ownership was most widespread in fishing, mining and wood production (27%) and lowest in trade (6%). However, by January 1997 the share of manager ownership for the whole economy increased to 26%, and in trade to 13% (not reported in the table).

**Table 5. Ownership January 1995 and 1997 size and capital intensity, Jan. 1995**

Frequency  Row percent	Majority					No ma- jority	No answer	Total
	State	Outsiders		Insiders				
		foreign > domestic	domestic > fo-reign	manager> employee	employee> manager			
TOTAL								
Sample at priv.	255(38)	89 (13)	125 (19)	65 (10)	88 (13)	38 (6)	6 (1)	666 (100)
Sample Jan. 95	243(36)	96 (14)	144 (22)	83 (12)	74 (11)	26 (4)	0 (0)	666 (100)
Whole economy	4,383(39)	2,204(20)	1,861(17)	1,064(10)	1,232(11)	415 (4)	-	11,158(100)
Sample Jan. 97	110(17)	86 (13)	145 (22)	106 (16)	52 (8)	17 (3)	150(23)	666 (100)
Whole economy	621 (5)	3,621(31)	2208(19)	2,947(26)	1,185(10)	974 (8)	-	11,556(100)
EMPLOYEES	normaliz	whole	economy					
5-19	3,315(41)	1,823(23)	1,226(15)	570 (7)	790 (10)	292 (4)	-	8,017(100)
20-99	902(33)	346(13)	500(18)	466(17)	368 (14)	122 (5)	-	2,705(100)
100-	166(38)	34 (8)	135(31)	28 (6)	73 (17)	0 (0)	-	436(100)
Average	205	66	118	59	137	26	-	133

### 3. Incidence Now and Over Time

Frequency  Row percent	Majority					No ma- jority	No answer	Total
	State	Outsiders		Insiders				
		foreign > domestic	domestic > fo-reign	manager> employee	employee> manager			
25% quartile	13	10	21	20	26	10	-	14
50% median	47	22	59	32	60	22	-	42
75% quartile	128	68	146	62	138	38	-	110
BRANCHES	normalize	whole	economy					
Agricult.	285(28)	0 (0)	338 (33)	0 (0)	390 (39)	0 (0)	-	1,013(100)
Fish,mine,wood	179(31)	28 (5)	144 (25)	154 (27)	67 (12)	3 (1)	-	576(100)
Manu. food etc.	126(20)	54 (8)	227 (35)	81 (13)	109 (17)	46 (7)	-	642(100)
Manu. paper etc.	239(22)	173(16)	361 (34)	121 (11)	94 (9)	80 (7)	-	1,068(100)
Construction	696(57)	61 (5)	223 (18)	86 (7)	115 (9)	41 (3)	-	1,222(100)
Trade	1,748(43)	1,404(35)	255 (6)	255 (6)	343 (9)	29 (1)	-	4,035(100)
Transport	132(26)	99 (20)	116 (23)	75 (15)	17 (3)	64(13)	-	504(100)
Service	977(47)	383(18)	197 (9)	293 (14)	96 (5)	153 (7)	-	2,098(100)
Nom. capital/ employee 1000 EEK								
Average	35	299	34	6	4	13	-	66
25% quartile	2	5	2	1	0	0	-	0,7
50% median	10	49	8	2	1	1	-	4
75% quartile	28	141	29	7	5	7	-	22
Total assets/ employee 1000 EEK								
Average	412	398	154	44	42	179	-	258
25% quartile	19	71	30	15	16	20	-	24
50% median	56	161	57	34	35	60	-	54
75% quartile	122	437	125	61	52	99	-	123

Source: Mygind (2000).

At the time of privatization there were 28 employee dominated enterprises with more than 100 employees in the sample. By January 1997 this number had fallen to 9. For similar enterprises with less than 100 employees the numbers fell from 60 at the time of privatization to 42 in January 1997. Normalized for the whole economy, employee ownership had in 1995 a higher proportion in large enterprises (17%) than in small (10%), but in 1997 the proportion of employee ownership in large enterprises fell to 7% (not reported). For management dominated enterprises especially the number of small enterprises in the sample increased. Domestic-outside-majority-owned enterprises increased their share especially for large enterprises. In a multivariate analysis, Jones and Mygind (1999) find that if the labour force were to be doubled this would lower the probability of a firm remaining insider-owned by more than 25%, but raise the probability of a firm remaining outsider-owned by a little more than 32%. As shown in Table 6, employee ownership had the highest proportion of privatized enterprises in the early privatization up to 1992 (38% of the enterprises in the sample).

Then manager ownership took the leading position 1992-93. Finally, outside-domestic-owned-firms constituted the main part for the privatization from 1994. An even smaller part of the new firms were employee-owned.

**Table 6. The relation between time of privatization/start and initial ownership**

<b>Estonia</b>		<b>Foreign</b>		<b>Domestic</b>		<b>Manager</b>		<b>Employee</b>		<b>Total</b>	
<b>Privatized</b>	to 1992	9	19%	10	21%	10	21%	18	38%	47	100%
	1992 - 1993	9	25%	7	19%	13	36%	7	19%	36	100%
	1994 - 1999	33	13%	144	56%	66	25%	16	6%	259	100%
	Total	51	15%	161	47%	89	26%	41	12%	342	100%
<b>New firms</b>	to 1992	8*	20%	13	32%	17	42%	3	7%	41	100%
	1992 - 1993	9	12%	27	35%	29	38%	12	16%	77	100%
	1994 - 1999	5	11%	17	39%	17	39%	5	11%	44	100%
	Total	22*	15%	57	35%	63	38%	20	13%	162	100%
<b>Total</b>		73	15%	218	43%	152	30%	61	12%	504	100%

Only private companies included. We do not have the timing-information for all companies. Therefore, the number of enterprises is lower than in the total datasets. \*25 foreign new enterprises established before 1992 are not included in the table because they were later added to the initial random sample.

After the initial survey in 1995 subsequent ownership surveys on the Estonia sample of enterprises were conducted annually. During this process some firms exited the panel because of closure or denial of response. Other groups were added later to give a broad coverage of later stages of the privatization process. The total group of companies included in this unbalanced panel is 800 companies for the analysis referred below for the period 1995-2002.<sup>9</sup> The information about the concentration of ownership for the largest single owner was used to define ownership of former employees as diversified domestic ownership with the largest single owner having less than 20% of ownership. This definition can be justified because practically no enterprises were privatized to diversified external owners. It is important to distinguish between the groups of domestic external investors and former employees because there are basic differences between the process behind the ownership change to external investors and to employee-owners leaving the firm but keeping their ownership.

The transition matrix for Estonia in Table 7 (Jones et al., 2005, p. 272) shows the change between the first known ownership type after privatization (or when the firm

<sup>9</sup> The information about the concentration of ownership for the largest single owner was used to define ownership of former employees as diversified domestic ownership with the largest single owner having less than 20 per cent of ownership. This definition can be justified because practically no enterprises were privatized to diversified external owners. It is important to distinguish between the groups of domestic external investors and former employees because there are basic differences between the process behind the ownership change to external investors and to employee-owners leaving the firm but keeping their ownership.

### 3. Incidence Now and Over Time

started as a new entity) and the last year with available information.<sup>10</sup> The first line in the matrix shows that 114 enterprises, which were foreign-owned at the start of privatization (or when they were set up as new firms), also were foreign-owned at the last year of record. From the relevant row, it can be seen that 10 changed to domestic dominant ownership and 9 to manager ownership while none changed to employee ownership. This means that foreign-owned enterprises have a quite stable ownership structure with a total 'ownership-change' rate of only 14%. Firms with external domestic ownership had a higher rate of 'ownership change' (26.7%) from the start. 19.1% have changed into management ownership. Of firms that were initially management-owned, 23.6% have changed ownership type and most of these to outside ownership (15.7% to domestic and 5.7% to foreign).

**Table 7. Privatization/start - 2002 ownership transition matrix: first year as private by last year recorded**

#### Total

\last year first year	foreign	domestic	manager	employee	former employee	total	change
foreign	114	10	9	0	0	133	14,3%
domestic	11	132	37	0	0	180	26,7%
manager	8	22	107	3	0	140	23,6%
employee	6	22	35	28	8	99	71,7%
former emp.	0	4	3	2	15	24	37,5%
total	139	190	191	33	23	576	

#### Privatized

\last year first year	foreign	domestic	manager	employee	former employee	total	change
foreign	45	4	1	0	0	50	10,0%
domestic	8	106	15	0	0	129	17,8%
manager	2	11	56	2	0	71	21,1%
employee	1	12	15	11	3	42	73,8%
former emp.	0	4	2	2	12	20	40,0%
total	56	137	89	15	15	312	

#### New

\last year first year	foreign	domestic	manager	employee	former employee	total	change
foreign	69	6	8	0	0	83	16,9%
domestic	3	26	22	0	0	51	49,0%
manager	6	11	51	1	0	69	26,1%
employee	5	10	20	17	5	57	70,2%
former emp.	0	0	1	0	3	4	25,0%
total	83	53	102	18	8	264	

1. Former employee ownership defined as domestic dominant with concentration <20% 1999.

<sup>10</sup> The person or entity owing the biggest share is considered as the owner. The results follow the same pattern as the not reported matrix without estimates of former employee ownership.

2. Only those firms with domestic dominant ownership and with information on concentration in 1999 are included; their number fell from 649 to 568. Companies included, for which we have data only for some years, e.g. 1997-2000.

Only 3 firms (2.1%) have changed into employee ownership. By contrast, movement away from employee ownership proceeds at a very high rate with more than seven in ten cases switching ownership type. In about half of these 71.7% the move is to ownership by management. This includes 35.4% of the initial group, compared to 28.3% to outside ownership and 8.1% to former employees. It might seem surprising that ownership by former employees is more stable than employee ownership. Actually, the continuation of ownership by employees leaving the firm can be taken as an indicator of inertia which also functions as a barrier for further ownership changes.

Surprisingly, the results are quite robust to dividing the groups into privatized and start-ups. Because of the initial disequilibrium in ownership caused by privatization one might expect a higher rate of change for privatized companies. However, the initial years of transition are very volatile both for privatized and new companies both because of rapidly changing markets and institutional environment. In a more stable institutional environment one might expect a higher change-rate for new companies as compared to more mature companies.

Jones, Kalmi and Mygind (2005) find in a multivariate analysis that firms owned by insiders are less capitalized. This supports the hypothesis that insufficient wealth to invest in equity limits the possibilities to establish employee-owned firms, and points out that the unusual circumstances created by the privatization process have helped employees to temporarily overcome this obstacle. A second major finding is related to risk. The results show that employee ownership is most durable in less volatile firms.

The survey evidence reported in Kalmi (2003) as well as the case study evidence reported in Kalmi and Mygind (2003) points out that Estonian firms often apply by-laws that limit the group of potential shareholders. This reduces outsider take-overs. On the other hand, outsider-owned firms also place similar restrictions. There is evidence concerning the tendency for the number of employee-owners to decline over time (Kalmi, 2002, 2003). This is a result of restrictions on share trading - it is not possible for outsiders to buy shares and new employees face similar difficulties. By contrast, retiring employees often keep their shares, or they sell them to managers. As a result, we observe less employee ownership, fewer employee owners, increased ownership by former employees (which is typically transitory), more managerial ownership, and more concentrated ownership. A key finding is that it is often the inactivity in the share market – or indeed the absence of any market – more than active trading of shares that shapes the ownership relations. The process is biased in ways promoting managerial ownership and discouraging employee ownership and ownership changes in general.

Under the direction of Kalmi and Mygind 12 case studies of employee-owned firms have been performed in Estonia. The studies cover the period from before privatization to around 2000. The results are published in Kalmi and Mygind (2003), see Table 8. Ten of the enterprises in case studies were privatized in the early period

when the privatization process remained in a political deadlock resolved only in June 1993 with the introduction of the new privatization law. The cases show the variation in privatization methods leading to employee ownership.

**Table 8. Determinants behind initial employee ownership at time of privatization**

Time around privatization	Product	Privatization method	Motivation/ economic situation	Size empl.	Capital/ labour
<i>Estre</i>	Agro machines	1991 leasing 1998 takeover public offering	Participation, economy bad from 1992	512 (1991)	probably quite low
<i>Printing House</i>	Printing books	1991 leasing 1993 coll.-> individual 1997 full privatization	quality assets good results cream	177 (1995)	quite high
<i>Ramsi</i>	Peat products	1991 leasing 96-99 full privatization	defensive save jobs	250 (1991)	quite low
<i>Ester</i>	furniture for shops	1986 new co-operative 1991 joint stock	quite bad 1991	111 (1991)	quite low
<i>Ke Va</i>	Transport	1991 leasing 1993 full privatization	participation economy quite good, cream?	356 (1991)	quite high
<i>Kommunal-projekt</i>	City planning	1997 public tender privatization	economy quite bad 1997	111 (1997)	low
<i>EKE Ariko</i>	Consulting	1991 privatization with retained profits	quite good not cream	30 (1991)	low
<i>Puurmani</i>	agro milk etc.	1993 from agricultural to worker co-operative green vouchers	defensive bad economy save jobs	305 (1993)	quite low
<i>Sektoron</i>	fuel, petro resale	1992 privatization by comp. auction	defensive, but assets OK	8 (1992)	quite high
<i>SH Tamp</i>	Metal precision instruments	1991 small state enterprise 1994 EPA privatization	defensive, but assets OK	110 (1991)	quite high
<i>Viru Ölu</i>	beer softdrinks	1991 spin off agro privatization	defensive, but assets OK	130 (1991)	quite high
<i>Norma</i>	safety belts	1991 people's enterprise 1994 EPA privatization	participation cream good assets	2,781 (1991)	quite high

Source: Kalmi and Mygind (2003).

We find only few examples of cream-skimming, where insiders took over valuable assets at a relatively low price. To this group belong *Printing House* and *Norma*. *Norma* was a well-known company with a good reputation and profit margin around 40% in



1991-92. Norma employees could take over the assets for a low leasing fee in the first round as a people's enterprise. However, in the second round of privatization through the Privatization Agency the price went up and especially some managers made a good deal. *Printing House* benefited from better technology than its competitors had and a quite stable market. However, the price paid in the final privatization of 1997 was quite high.

In many cases the new firms were spin-offs of larger firms (*Ramsi, Sektoron, Viru Ölu, SH Tamp*). The spin-offs often represented the more promising business lines of former state firms or collective farms. However, with the exception of *Viru Ölu*, the main motive of these firms was to save jobs, so these privatizations were rather defensive. Another example of defensive privatizations is *Puurmani*. *Ester* is a special case since it had already been operating for five years at the beginning of transition.

In the West employee ownership is concentrated in enterprises with low capital intensity because problems of risk concentration and lack of capital discourage employees from owning firms with high capital intensity. However, specific opportunities in the privatization process may help to overcome these barriers. This happened in the cases of *Printing House, KeVa, Sektoron, SH Tamp, Viru Ölu* and *Norma*. However, in the cases of *Printing House* and *Sektoron* the employees actually paid a rather high price for the assets, whereas special opportunities of leasing, vouchers and the legislation on people's enterprise made it possible for the employees to take over the assets at low cost in the other mentioned cases. However, in the second round of privatization by the Privatization Agency the price increased considerably in the case of *Norma* and *SH Tamp* and this was the main reason why the managers increased their stakes considerably through new share issues.

Newly started companies with high financial participation of employees can be expected to be found in industries with high input of human capital – because here the motivation, recruitment and retention of the knowledge workers are often decisive for the success of the companies (Mygind, 2001, p. 325). Therefore, research has been done on employee participation in the IT sector in Estonia.

In an interview with one of the leading Estonian IT specialist, Linnar Viik, he mentioned that workers participation is not an issue in the Estonian IT sector, with very few exceptions. In big IT companies, like *Microlink, Abobase, Helmes, Ordi, Starman*, the motivation system is based on share-options. Key workers can buy options and feel themselves as a part of firm. The majority of IT companies are small. One or a few of the employees are usually the owners. Functions like bookkeeping are outsourced or done by hired employees. In many cases IT students work on a contract base as programmers. Labour turnover is often high among the programmers.

*Helmes*<sup>11</sup> is a typical small IT consulting and systems integration company which was established in 1991 in Tallinn and presently employs 50 consultants with a solid background of building business critical IT systems. In order to motivate the

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<sup>11</sup> See <http://www.helmes.ee>.

employees, *Helmes* has decided to use partnership scheme. According to internal rules of *Helmes* partnership shares of employees should cover at least 50% of private assets of employees. A partner is not just a shareholder; he or she must work in company.

**Table 9. Governance cycles: employee-management-outside in 12 Estonian cases**

Ownership	Broad employee	Employee management	Management	Management former empl.	Foreign
<i>Estre</i>	1991/1998 leasing/full			employee minority	
<i>Printing House</i>	1991/1997 leasing/full			employee minority	
<i>Ramsi</i>	1991/1996 leasing/full			employee minority	
<i>Ester</i>	1986 co-operative	1991 joint stock	1993 by share issue	1998 liquidated and split	
<i>KeVa</i>	1991 leasing	gradual change	1995 management majority		
<i>Kommunal-projekt</i>		1997 tender privatization	1999 nearly 100% man.		
<i>EKE Ariko</i>	1988 small SE			chief consult + former empl.	
<i>Puurmani</i>	1992 agri coop			gradually former empl.	
<i>Sektoron</i>	1992 spin off			gradually former empl.	
<i>SH Tamp</i>	1991 small SE		small part Prede		foreign tunneling
<i>Viru Ölu</i>	1989 spin-off from kolhoz				1992 Danish
<i>Norma</i>	1991 peoples' e.		1994		1999 Swedish

Source: Kalmi and Mygind (2003).

The 12 Estonian cases give detailed information on the governance cycle at the firm level. There is still employee majority in *Printing House*, *Estre* and *Ramsi*, although management and former employees have increased their shares. *Estre* is exceptional because the proportion of employee-owners increased from 28% to 58%, even though shares were not offered to new employees. The reason for this is that employees who initially bought shares were much more likely to remain employed. Managers have taken over the majority in *Ester* and *KeVa* and increased their share in *Kommunalprojekt* to nearly 100%. Management has taken over *Norma* by 1994, and later it was sold to a foreign investor. In *Viru Ölu* and *SH Tamp* there was a direct change from employee to foreign ownership. In the case of *SH Tamp*, the acquired part of the company was closed down after taking out the human and physical assets. Only a small part

continued to exist as management-owned the enterprise under the name *Prede*. Finally, in *Eke Ariko*, *Puurmani* and *Sektoron* ownership followed the leaving employees out of the companies and management also increased its shares.

**Table 10. Takeover and concentration processes**

	<b>Managers increase share</b>	<b>Outsiders increase share</b>	<b>Exit</b>
<i>Estre</i>	no employee owner-rate increased	former employees (trade union )	no
<i>Printing House</i>	management increased share, but still employee majority	former employees other outsiders excluded	no
<i>Ramsi</i>	management increased share, but still employee domination	former employees other outsiders falling share	no
<i>Ester</i>	through new share issue 1993 and fully management ownership after split/liquidation in 1998	no	liq. and split in 1998
<i>KeVa</i>	through several share issues	1995 former employees get majority	no
<i>Kommunal-projekt</i>	managers majority from time of privatization, later further increase	no	no
<i>EKE Ariko</i>	concentration to core group mainly through share issues	former employees	spin off
<i>Puurmani</i>	managers some increase but still employee dominated	former employees	no
<i>Sektoron</i>	No	former employees and outsiders has got majority	no
<i>SH Tamp Prede</i>	through new share issues financing final privatization, still employee majority 1995 Successor-firm-manager-owned	former employees, 1995 foreign takeover of the most valuable part of assets, compensation to shareholders	main part closed 1995
<i>Viru Ölu</i>	1991-92 especially managers increase their share	1991-92 outside coop-members sell to insiders 1992 foreign takeover, 20% left to employees, 1996: 6%, 1999<1%	no
<i>Norma</i>	1994 managers buy 75% shares during transition to joint-stock com.	1996 34% on stock exchange => increase external ownership 1999/00 51% Swedish investor 19% owned by two banks	no

Source: Kalmi and Mygind (2003).

In cooperation with the Estonian statistical office we have done a survey in January 2005 on the ownership structure in 722 companies (a stratified random sample with overrepresentation of medium to large-sized companies). The results show a further decline of employee ownership. Table 11 shows different degrees of employee ownership distributed on the dominant owner (with the largest proportion of shares).

**Table 11. Degrees of employee ownership distributed on dominant owner, Jan. 2005**

	Percentage of shares owned by employees						
Dominant owner	0%	0.1-9.9%	10-19.9%	20-49.9%	50-99.9%	100%	Total
State	1						1
Foreign	185	7	2				199
Domestic	229	29	13	19			299
Manager	146	30	14	28			218
Employee				5	13	1	19
Total	561	66	29	52	13	1	722
% of firms	77.7%	9.1%	4.0%	7.2%	1.8%	0.1%	100.0%

Only 14 or 2% of the companies had majority ownership by employees in January 2005. (If we include companies with insider majority and other employees own more than managers the number increases to 3%). In 78% of the companies there was no employee ownership, while 20% of the enterprises had a minority employee shares. Most often these minority shares are less than 10% of total shares; however, in 7% of the enterprises employees own 20-49.9%. Only 4% of foreign dominated companies had employee minority shares, while 33% of the companies dominated by managers had employee shares.

Surprisingly, the survey shows that employee ownership is randomly spread over the different industries. There is no significant variation on size and thus no tendency for a higher percentage of employee ownership in smaller firms.

Survey and case study evidence shows that there is a general decline in employee ownership. The causes of this decline are keeping of shares by former employees, no possibility of obtaining shares by new employees, buying out of employees' shares and of newly issued shares by managers.

### c) Privatization in Agriculture

Agriculture was with 39% of the enterprises in January 1995 the sector with the highest rate of majority employee ownership after privatization. 78% of the employees in agriculture were owners (Mygind 2000, p. 30). Like in other sectors, employee ownership had a falling trend since then, but majority-employee-owned firms have been prevailing over a long period of time. Among the Estonian cases Puurmani and Viru Ölu had their origin in agricultural collectives. While the brewery Viru Ölu quite early was taken over by a foreign investor, the farm Puurmani kept the co-operative structure while ownership changed gradually away from employee dominance as the economic downturn meant that the majority of employees left the company while still being members of the co-operative. The survey from January 2005 shows that there is no significant overrepresentation of employee ownership in agriculture by 2005.

#### **d) Co-operatives**

As can be seen from Table 12, a considerable number of enterprises originated from former co-operatives. The supplier and consumer co-operatives were typically privatized to outside owners while agricultural collectives / co-operatives went to employees. Some of the new firms included in Table 6 cover new co-operatives, of which most went to employees. They changed ownership structure to LLC or JSC and have later followed the same trend as other employee-owned companies, which means that they have been taken over by managers or outside owners. One of the cases from the study, Ester, is a good example. It was established as a new co-operative in 1986 as a spin-off from a large textile company, in 1990, it was transferred to a JSC and later split up and taken over by the managers (Kalmi et al., 2003).

**Table 12. Origin and ownership at the time of privatization (private firms 1995)**

	Former state firms	Former co-operatives	Former joint ventures	New firms	Total
<b>Foreign</b>	9 (8.5%)	1 (1.5%)	30 (91.0%)	48 (30.4%)	88 (24.2%)
<b>Domestic outsiders</b>	33 (31.1%)	46 (68.7%)	3 (9.0%)	34 (21.5%)	116 (31.9%)
<b>Managers</b>	26 (24.5%)	4 (6.0%)	0	58 (36.7%)	88 (24.2%)
<b>Employees</b>	38 (35.8%)	16 (23.9%)	0	18 (11.4%)	72 (19.8%)
<b>Total</b>	106	67	33	158	364

Source: Kalmi (2003, p. 122), originally from database of Estonian enterprises CEES/CBS.

#### **e) Profit-Sharing**

Some information on profit-sharing in Estonia can be found in the Estonian management survey which was done by Mygind in cooperation with the Estonian Statistical Office (ESA) with 181 interviews in November/ December 1997 and 31 interviews in the summer of 1998. The total response was 220 including 8 of the pilot surveys, however, the total number of answers (N) to some questions is lower.

**Table 13. Forms of payment for employees - on ownership - 1997**

\majority ownership	state	fo-reign	do-mestic	mana-ger	em-ployee	no major	total	priva-tized	new	coop
profit-sharing	1	2	4	3	2	0	13	2	6	4
N	9	35	69	51	24	8	204	66	83	39
monetary incentive	3	26	36	21	14	4	108	42	39	20
scheme	N	9	35	69	50	7	203	69	80	38
non-monetary	0	8	10	2	0	0	20	6	12	4
benefits	N	9	36	64	52	9	202	67	82	37

Source: Mygind (2002).

Profit-sharing is not common in Estonia, but other forms of monetary incentive schemes are used in more than fifty percent of the cases (Mygind, 2002, p. 19). As an example of profit-sharing, a case study on the realtor firm *Pindi Kinnisvara* was conducted (Eamets et al., 2005), because this management-owned firm developed a specific employment system, see Table 14.

**Table 14. Structure of work contracts in *Pindi Kinnisvara***

Form of contract	No
Work contracts	48
Work contact plus self employment	2
Self- employed	35
Self employed plus limited liability company	7
Work contact plus limited liability company	4
Total	96

Half of the employees in the Estonia subsidiary of company have ordinary employment contracts. Contracts of service (self-employment) are used by most estate agents. 7 estate agents with a long-term experience use combination of self-employment with limited liability company for tax reasons. The combination of an employment contract and self-employment is used by heads of departments who, at the same time, work as estate agents. Estate agents have no fixed working time and their income depends directly on the turnover of their activities. The combination of employment and services contract are used by book-keepers. Only technical staff (secretaries, assistants, marketing managers etc.) has regular 8-hours working days and fixed wages.

#### **4. Empirical Evidence of Economic and Social Effects**

To assess the economic performance of different ownership structures the initial conditions - size, capital-intensity and profitability - must be taken into consideration. As is shown above, foreign-owned enterprises have a relatively high capital-intensity while the opposite is the case for insider-owned enterprises. Because insiders especially in small enterprises often had the first choice it could be expected that they had skimmed the cream. We do not have any significant results indicating that insiders took over the most profitable enterprises (Jones and Mygind 1999). However, insiders might have acquired their enterprises at a relatively low price as also indicated for the early small privatization.

Data on performance can be taken from the sample of 666 enterprises covering the period 1993-97 with detailed ownership information and financial variables and the financial survey 1997 done by ESA covering all large enterprises and a representative sample of small enterprises, with information on foreign, but without information on insider ownership.

An analysis on total factor productivity was conducted in Jones and Mygind, 2002. The analysis is based on panel-data for the period 1993-1997. Depending on the exact specification of the model, the analysis shows that private ownership has 13-15% higher factor productivity than state ownership. Majority ownership by foreigners are 19-21% higher, majority management ownership 15-31% higher, and majority ownership by a broad group of employees 13-24% higher than state ownership. These results are, noteworthy, both because of the high reliability and because standard theory would not expect so high efficiency of insider-owned enterprises.

Profitability measures for the early years show that insider ownership has quite high profitability, while, especially for return on assets, they are quite low for foreign ownership. However, this might be connected with high levels of assets, which at this point in time have not started to pay off. The surprisingly high profitability measures for state-owned enterprises might be explained by the dominance of some natural monopolies, e.g. telecommunication and energy, doing quite well in 1997. There are no significant differences between domestic and foreign ownership in the private sector.

As Table 15 shows, all the 12 case companies faced considerable problems in the early stage of transition leading to declining sales. It is remarkable, that all of them did considerable reactive restructuring, except of *SH Tamp*, by cutting employment irrespective of their ownership structure. Lack of capital meant lack of strategic restructuring in the cases of *Kommunalprojekt* and *Puurmani*, but the remaining ten firms did some strategic restructuring in spite of lack of capital in many of the cases. However, in the cases of *Viru Ölu* and *Norma* we saw increased investments after the foreign takeover.

**Table 15. Governance and restructuring**

	Reactive restructuring		Strategic restructuring	
<i>Estre</i>	+	employment cut to half by 1993 later further reduction legislation cause excess labor	++	change of product, +exports increasing investments
<i>Printing House</i>	+	not necessary	++	high profitability quite high investment, but further increase needed
<i>Ramsi</i>	+	steep employment fall in early	+	focus on peat production
	+	years, many temporary workers		developing Western markets upgrade quality, low investments
<i>Ester</i>	+	employment cut 70% 1991-93	+	
	+	and in connection to split 1998		
<i>Ke Va</i>	+	employment cut to half 1991-93	++	developing new product-lines
	+	and to a quarter by 1999		+export and high investments
<i>Kommunal-projekt</i>	+	strong cuts before privatization	-	limited, lack of capital
	+			
<i>EKE Ariko</i>	+	flexible employment policy	++	new product, foreign clients
	+			high investment IT, buildings
<i>Puurmani</i>	+	strong cuts in employment, but still some excess labor	-	lack of capital
<i>Sektoron</i>	+	quite flexible adjustment	+	some investments in mid 1990's, but lack of capital
	+			
<i>SH Tamp</i>	-	stable employment up to 1995?	+	1995 sale of high tech assets to US investor => close down
<i>Viru Ölu</i>	+	some employment cuts in early years	+	some early investments
			++	high investment after takeover
<i>Norma</i>	+	1000 jobs cut 1991-1994	++	high investments whole period, intensified after foreign takeover
	+	core competence safety belts		

- no restructuring, + some restructuring, ++ strong restructuring

Source: Kalmi and Mygind (2003).

In the survey on 220 enterprises managers were asked about the different sources of finance (Mygind, 2002, p. 23). The responses show that for all companies internal savings were the most important source. However, employee-owned enterprises were clearly most dependent on internal savings. The problem of external finance and the general low capital intensity on insider-owned firms were also reflected in the results on investment showing that insider-owned enterprises were low on investment per employee, while foreign and external domestic ownership have high investment levels. Concerning another indicator of strategic restructuring, Western exports, foreign-owned enterprises are on the highest level for while insider-owned enterprises were at the lower end.



As an aspect of the social impact of employees' financial participation, the level of wages and the wage differences between different groups inside the company is relevant. The manager survey in Estonia gives some indications, see Table 16.

**Table 16. Average monthly salary on ownership - 1997**

\majority ownership wage EEK	state	foreign	do- mes- tic	mana- ger	em- ploy- ee	no ma- jority	total	priva- tized	new	coop
top manager - mean	7,187	15,462	9,744	9,984	4,477	6,670	10,370	10,526	9,975	8,686
standard deviation	6,834	18,525	9,864	15,903	3,314	4,802	13,301	14,238	14,370	8,454
N	8	35	66	52	25	8	194	68	82	37
all employees, mean	2840	5,373	3271	3,277	2451	2635	3,559	2,987	2,785	1,715
standard deviation	1,951	3,099	2,924	1,721	1,260	1,442	2,529	2,875	2,915	1,233
N	9	36	70	53	23	8	203	70	85	39
lowest paid empl.	1,049	2,153	1,179	1,441	734	795	1,456	1,368	1,549	897
standard deviation	7,19	1,721	609	985	684	1,051	1,022	604	1,458	707
N	9	36	70	53	25	8	195	70	85	39
top manager/employees	3.00	2.76	3.23	3.09	1.88	2.78	2.92	3.18	2.65	3.15
standard deviation	1.04	1.32	2.57	4.43	0.57	1.99	2.88	4.52	2.12	2.12
average/lowest paid	3.06	2.61	3.06	2.62	2.92	2.74	2.82	2.70	2.64	2.69
standard deviation	1.48	1.46	2.87	1.22	1.38	0.90	1.90	1.06	1.37	1.06

Source: Mygind (2002).

When looking at the social impact of employees' financial participation concerning the level of wages and the wage differences between different groups inside the companies the pay for the lowest employee was very low even by Estonian standards, but although the researchers asked about full time wage, the responses may cover part time employees. Both managers and other employees had a significant higher salary in foreign-owned enterprises than in other types. Employee-owned enterprises and no majority enterprises were found in the other end of the scale. State-owned enterprises were also below the average. The average wage for all employees and for the lowest paid employee was higher in new than in privatized companies. However, the lowest level was found in the co-operatives, probably because of quite low levels of pay in agricultural related production.

The difference between the salaries of managers as compared with other employees was lowest in employee-owned enterprises and high in management-owned enterprises. It seems that managers took out part of their ownership remuneration in the form of salaries.

## **5. Conclusions**

The current level of development of financial participation of employees is low. It is due to the fact that the aims of economic policy of the government since 1993 have been contrary to the idea of participation of employees, e.g. of financial participation, favouring the principles of laissez-fair doctrine and protection of national elites. Employee share ownership which emerged during the first years of privatization has been and still is on the decrease. However, there is a substantial difference between the employee ownership in the industrial sector and in agriculture, since there was more support for privatization by employees in agriculture and employees still hold a significant number of shares. Individual enterprises, especially in such branches as IT and real estate sector, introduce profit-sharing and share options schemes for employees, but their number is small. The number of co-operatives is small and decreasing, and there are nearly no workers' co-operatives left, whereas the number of self-employed is large and increasing due to advantageous taxation.

The evidence of the impact of employees' financial participation in Estonia concerns the economic performance of employee-owned enterprises. The results show that productivity of employee-owned companies does not differ significantly from the productivity of other domestic companies. Only foreign-owned companies are significantly more productive and have a higher degree of strategic restructuring. The main problem for insider-owned companies is the access to capital for investment. They have a relatively low level of bank loans and the owners usually do not have extra funds to invest in their company. Wage-levels are relatively low, but especially for the higher salaried employees, so that the difference between the highest and the lowest paid employee is typically lower in employee-owned enterprises.

The privatization opened up possibilities for employee ownership. This wave turned out to be quite short-lived because there were no political forces which were interested in strengthening employee participation. The start of the first employee-owned enterprises dates back to new co-operatives, leased enterprises and small state-owned enterprises in the last years of the Soviet Union. The small privatization was the most important method for employee takeovers in the early 1990ies. However, in most cases the managers took the initiative and often de facto controlled the enterprises. The domination of managers explains the relatively fast change away from employee ownership to management ownership, which were observed both in quantitative studies and in case studies. Managers were able to buy the shares at a relatively low price, since employees were in a situation of liquidity constraint and did not have information about the real value of their shares. Often employees kept their shares after retiring, while new employees did not have the opportunity to buy shares. In this way many employee-owned enterprises changed to enterprises owned by outsiders including former employees. Most companies including employee-owned companies experienced a steep fall in employment, so that employees are more interested in remaining employed than in promoting the rights of employees.

There is no special legal regulation of any of employees' financial participation schemes. This means that there are neither incentives nor restrictions concerning financial participation of employees in the legislation. Employees who are minority shareholders have only a limited possibility to influence the management of the company under Estonian company law. According to Estonian tax law, it is more profitable for employees to receive dividends than wages because employees pay no taxes on dividends, but the opposite is advantageous for the company because the company is obliged to pay taxes on dividends whereas it has to pay no taxes on employees' wages and no corporate income tax.

The necessity of transformation of *acquis communautaire* into national law in connection with the EU accession has recently led to debates on employee participation in decision-making. In this connection, the Law on Involvement of Employees in the Activities of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies transforming EC directives 94/45/EC and 2001/86/EC was adopted on 12 January 2005. Although the number of European Companies in Estonia is small, the parliamentary debate showed that the issue of employee participation is still controversial although it had not been addressed in the legislation. The draft of another, more general law on employee participation was rejected, but the discussion on this issue can continue.

Neither the government nor the social partners presently promote or are planning to promote financial participation schemes. Political forces which could have promoted the idea of employees' participation e.g. the Social Democratic Party and the trade unions are weak and do not have the necessary political influence. However, as the discussion on transformation of EU directives shows, the issue will be addressed and even new legislation could be adopted if an EU legal act on financial participation of employees were issued.

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