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Financial Participation of Employees in Latvia[1]

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Contents

1. Background

This report outlines main trends in employees' financial participation in Latvia including historical, socioeconomic and legal background. A special emphasis is placed on privatization during the transition period which shaped an environment for employees' financial participation and influenced the current state of employee share ownership and profit-sharing. Attitudes of social partners and the government will be addressed. The report will show why the transition process lead to a low level of employees' financial participation and the indifference and ignorance of policy makers concerning the development of financial participation.

a) History

Financial participation has had a relatively short history in Latvia. In 1930s, during the first independence of the Republic of Latvia, the co-operative movement was strong in agriculture including co-operatives for farming and for processing agricultural products. There were also so called crafts co-operatives in rural areas and in cities (Aizsilnieks, 1968, p. 56-58). In the Soviet period, consumer and housing co-operatives prevailed. However, co-operatives did not, at any time, play an important role in the economic development of the country.

The process of privatization began before independence in all three Baltic countries. The first private enterprises were established during the period of liberalization that followed Gorbatchev's policy of 'perestroika'. In this period, small state enterprises, new co-operatives, leased enterprises and joint ventures were introduced. The Soviet law on enterprises from 1987 granted the general meeting of employees' rights concerning future production plans and the right to elect the enterprise's director. Latvia was the first Soviet Republic that implemented this law. The government soon realized that the application of Soviet legislation lead to dissipation of state assets at rather less than fair value. As a result, they introduced legislation to stem the flow (OECD, 2000, pp. 121-123). All Latvian co-operatives had to restructure and re-register before March 1992, and the activities open to co-operatives were restricted, forcing the dissolution of many of them. Latvians could continue to lease state companies, but the legal status remained unclear until February 1993 when new legislation made it possible for groups of employees to make a new leasing contract. The legislation also allowed companies to issue shares worth up to 10% of the authorized capital and to sell them to employees at a discount, or to transfer them free of charge, but value had to be paid in full when the employees left the company. These shares had full voting right.

Except for some early experiments, small privatization started in November 1991 according to the Law on Privatization of Objects of Trade, Catering and Services. These objects were transferred to municipalities which implemented small privatization. The initiative for privatization could come from the employees or other

potential buyers. The decision about privatization, method, initial price etc. was made by local privatization commissions consisting of representatives of the state, municipality, trade unions and specialists. Possible privatization methods were sale to employees, auctions to a selected group, open auctions and sale to a selected buyer. Especially the latter method made dubious dealings possible (Vojevoda and Rumpis, 1993, p. 8). Employees who had been working in the enterprise at least 5 years had a pre-emptive right to buy shares at the initial price. Purchasers had to be Latvian citizens or have been living in Latvia for at least 16 years, so that foreigners played no role in the first years of small privatization. The legislation was changed in February 1992, whereby the pre-emptive right for employees was abolished. Some size restrictions were also removed and the number of branches included in municipal governed privatization was gradually extended.

A list of medium and large enterprises to be privatized was passed with the decrees of August 1992 and of February 1993. The list consisted of 579 enterprises proposed by the sector ministries. 400 of these enterprises were to be privatized by public offerings of shares, but 147 were to be leased with the option to buy. Later this list was extended to 712 enterprises (Jemeljanovs, 1996, p. 205). However, except for the leasing option the privatization proceeded very slowly and before the privatization agency took over, only around 50 large- and medium-sized enterprises were privatized and 78 companies transformed into statutory companies as a preparatory step for privatization.

In 1992-1994, the privatization process was decentralized whereby sector ministries became key privatization institutions, so that the existing networks could be used to the advantage of insiders. This was mainly done using the legislation on leasing with an option to buy. Former owners had the first right to make a leasing contract, the insiders of the company came in the second place. For that reason, especially managers had good opportunities to take their enterprises over (Shteinbuka, 1996, p. 187). In 1994, the possibility of making new leasing contracts was removed by the new privatization law. In the period between 1992 and 1994 privatization was rather slow and only 234 firms were privatized using leasing. Of 234 leased enterprises 204 were bought out in most cases by the leaseholder, 16 leasing contracts were annulled (LPA, 1998). The average price for leasing buy-outs was on the same level as for tender privatization.

In 1994, the legislation was changed following the Treuhand model and the Latvian Privatization Agency (LPA) was established in May 1994. LPA organised the first international tender at the end of 1994. In 1995 and 1996 the process gained some speed to peak in 1997 with privatization of 313 enterprises. From 17 April 1994 till 1 October 2004, privatization rules have been approved in the statutory procedure for 2,126 state property units (except land), and 1,989 units (93.5% of state property units to be privatized) have been sold (purchase agreements signed with new owners), organised into statutory enterprises or liquidated. The tenders usually resulted in a purchase agreement with a single unit or a consortium most often acquiring a majority of shares. Most of these sales were to domestic outsiders, but some of the largest went to foreign owners; insiders played a minor role.

b) Social Partners

The interests of employees in Latvia are represented by the trade unions. Trade unions started their activities in 1905 and at that time united 25,000 workers. The role of trade unions has been increasing until 1919 with support provided mainly by social democrats. The activities of trade unions peaked in 1933 when 40 organisations and units operated in different industries and different regions and the total number of unionised workers was 50,000. In the period from 1934 until 1940 trade unions were not active due to the political regime. After Latvia regained its independence in 1990, the Law on Trade Unions was adopted on 13 December 1990. The Free Trade Union Confederation of Latvia (FTUC) is the biggest non-governmental organisation in Latvia, which protects the interests of employees who are trade union members at the branch and inter-branch level and represents 25 organisations.[2] Trade unions are quite weak and the current rate of unionisation in Latvia is 18% according to the calculation of the authors. On the one hand, it is due to discredit of trade unions in connection with their role under Soviet rule. On the other hand, present economic problems such as job uncertainty and high unemployment[3] lead to inactivity[4] of employees concerning their rights. The interests of employers are represented by Latvian Employer's Confederation (LEC). With regard to financial participation of employees, Director General of the LEC, Ms. Elina Egle, declared in the interview that the Confederation's activities are in line with the government legislation and that financial participation of employees is outside the area of competence of the Confederation.

Recently, a dialogue between social partners has been promoted by the government. The LEC, FTUC and the government signed the Tripartite Agreement on Social and Economic Partnership on 1 October 2004 on the initiative of the Prime Minister Mr. Indulis Emsis. However, the issue of financial participation has not yet been addressed in this context.

c) Current National Policy

The government is not concerned with the financial participation of employees, since the reduction of employment is considered to have priority. The Ministry of Social Affairs concentrates its activities on solving problems related to increase of minimum wages and allowances for the unemployed.

Participation of employees has not been on the political agenda of the Parliament. Political parties and other policy makers do not pay attention to the issue of employees'

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2 Latvijas Republikas Likums par arodbiedribam, Ziņotajs, No. 3/4, 31 January 1991 as amended.

3 The unemployment rate was 10.6% in 2003.

4 An important factor influencing the behaviour of employees is the psychological factor which is determined by the age, lack of experience in defending their rights in a market economy and lack of relevant education of many elder employees. The psychological factor leads to the lack of interest in obtaining additional rights and value by purchasing shares.

financial participation. Financial participation as a component of social model development was not included in economic parts of parties' programmes. As individual interviews with policy makers have shown, there is no knowledge of the concept and no awareness of possible positive economic impact of financial participation and no dialogue between those representing interests of employees and employers about the idea of financial participation.

2. Types of Schemes and their Legal Foundations

Employee share ownership as well as profit-sharing are used in Latvian companies and are directly or indirectly regulated by legal acts affecting the effectiveness of such forms of financial participation. Whereas no special legal regulation on profit-sharing exists, there are several legal acts which touch upon employee share ownership and should be interpreted in correlation with each other. However, regulation of employee share ownership has not been developed systematically, so that it partly creates incentives and partly inhibits the development of such schemes.

a) Employee Share Ownership and its Legal Foundations

The main form of financial participation of employees in Latvia is employee share ownership.

(1) Privatization Issues

Although the privatization is advanced it is not completed yet, so that it is still possible for employees to acquire shares in special procedures as prescribed by law. The Law on Privatization of Objects Owned by the State or a Municipality, hereinafter referred to as PL, is the main regulatory act on privatization of enterprises. The PL was adopted on 17 February 1994 and, although amended, is still in force. It shall be interpreted in line with the Law on Reorganisation of State and Municipal Enterprises in Statute Corporations from 8 July 1996, hereinafter referred to as RL.

The PL provides for various methods of privatization such as sale, investments in share capital, increasing of share capital by attracting private investors, sale of shares to the management of the company (Art. 2). Shares of state-owned corporates can be sold to the employees in the course of privatization even below the nominal value of such shares, however, the shares to be privatized to the employees cannot amount to more than 20% of the share capital of the particular company (Art. 57 RL). If municipal objects are privatized by restructuring, the plan of such privatization shall contain a clause stating how many shares will be sold to employees as well as the discount, if such is applicable according to law (Art. 40 (2.5) RL). Management buy-out can be

applied if the company has no tax debts, no salary debts to employees, no other debts or encumbrances amounting to more than 10% of the equity capital, and the company's business activities comply with the articles of association (Art. 2 (6) PL). By using such a method of privatization, up to 25% of the shares can be sold to the management (Art. 2 (2.6) RL).

As can be seen from the legal acts directly regulating the issue of privatization of state-owned shares of enterprises, an important difference exists between employee ownership and management ownership, the latter being even subject to a special privatization method, which can be used as a reward for successful managers of state- or municipality-owned corporations. However, the 20% limit of employees share privatization appears as a limitation of rights rather than a privilege, due to the fact that there is no clear obligation in the law to offer any shares to the employees at all in a particular privatization case.

There are no special rules for participation of employees in decision-making concerning privatization matters. The general rules of the Commercial Law apply stating that the right to take part in the administration of the company, to receive dividends and, in the case of the liquidation of the company, to a liquidation quota are attached to the share (Art. 226 of the Commercial Law from 13 April 2000). However, it should be noted that the limit of 20% regarding employees' shares and 2% regarding management shares in most cases cannot provide for a genuine influential participation in decision making, due to the fact that in most cases a two-third majority will be required for important resolutions, therefore, employees or managers can be outvoted even in very essential decisions (e.g. a change of statutes or increase of share capital).

(2) Company and Securities Law

General issues on commercial activities, i.e. activities by merchants, are regulated by the Commercial Law from 13 April 2000, hereinafter referred to as CL. According to CL, a merchant is a physical person (an individual merchant) or a business (partnerships and corporations) registered with the Commercial Register (Art. 134 (1) CL).

(a) Corporations

There are two forms of corporations with important differences in respect of the regulation of the share ownership of employees: limited liability company (hereinafter referred to as LLC), a private company, the shares of which are not publicly tradable objects, and joint-stock company (hereinafter referred to as JSC), a company the stocks of which can be publicly tradable objects (Art. 134 (3), (4) CL). For LLC, there are no special legal regulations on employee share ownership so that general rules apply. By contrast, JSC can issue special employee stock which can be acquired by employees in the broad sense, ie including managers (Art. 255 (1) CL). Employee stock shall be issued only on account of the net profit of the company, and the total value of employee stock should not exceed 10% of the registered equity capital of the company

(Art. 255 (4) CL). Another limitation concerning employee stock is the requirement that the company's own capital should not become less than the registered capital (Art. 255 (5) CL). No voting right and right to liquidation quota are attached to employee stock issued according to Art. 255 CL.[5] Such stocks can be freely sold if the articles of association do not provide otherwise (Art. 255 (7) CL). It must, however, be noted that in the event that an employment contract is terminated, or a member of the board of directors leaves office, the company has a pre-emptive right to acquire employee stock (Art. 255 (8) CL). There is no provision in capital market regulations that issuing of employee stocks shall be considered to be a public offering. For the purposes of the respective rules, an offer shall not be a public offer, where it regards transferable securities offered as a bonus to the current or former employees or members of the executive board by the issuer or a capital company that together with the issuer belongs to the same concern (connected corporation) (Art. 14 (2), 11 of the Law on the Financial Market from 20 November 2003, hereinafter referred to as LFM). It is the only provision to be found on employee share ownership in the legislation on securities.

There is special regulation concerning employee shares in state- or municipality-owned companies. According to the Law on State and Municipality Corporations the government of Latvia or the respective municipal authority decides in which state or municipal company employees' shares can be issued (Art. 68 (1), (2)). Employee shares can belong only to employees and board members and cannot be alienated to other persons, even to other employees (Art. 68 (4), (5)). If the employment is terminated, or the member of the board leaves office, employee's share is transferred back to the company (Art. 68 (6)). This is one of the exceptions when a company is allowed to acquire its own stock (Art. 70). In the case the company has acquired its employee stock, it is to be transferred to the employees within six months from the moment. If the shares are not transferred within the mentioned time period, the shares will be deleted and the share capital will be decreased respectively (Art. 71 (1), (2)).

The major share owner owning at least 95% of all shares can make a final share buyout offer and, in such case, the minority, which on some occasions may be employees of the company who acquired shares during the privatization, would have an obligation to sell the shares to the major shareholder (Art. 81 LFM). Therefore on some occasions employees holding minority shares can be forced to sell their shares to the majority shareholder.

In order to facilitate the acquisition of stocks of the employees the legislator has provided the possibility that a company may fully pay up stock, which can belong only to the employees of the company (employee stock) (Art. 237 (1) CL). The case where the company acquires employee stock is the exemption from the general rule

[5] Employee stock issued by a private JSC according to Art. 255 CL should be differentiated from the stock acquired by employees in the course of privatization. Limitations attached to employee stock according to Art. 255 CL, in particular lack of voting rights, do not apply to privatization stock.

prohibiting the company to acquire its own stock which can belong only to employees (Art. 240 (1), (3) CL) provided for that it is transferred within 6 months (Art. 242 CL). The equity capital of JSC can only be increased if the stock is to be utilised for special purposes, one of them being distribution of the newly issued stock among employees (Art. 254 (2), (6) CL). These provisions create incentives for the company to issue employee stock.

As far as participation rights arising from share ownership are concerned, shares/stock acquired by employees in the course of privatization, shares of employees in LLC and employee stock issued according to Art. 255 CL by JSC should be distinguished. Whereas voting right is attached to the shares/stock acquired by employees in the course of privatization and shares of employees in LLC, employee stock issued according to Art. 255 CL by JSC is non-voting stock. Therefore, share ownership in general provides for a possibility of participating in decision-making, with the exception of employee stock. However, the influence would not be strong also in cases where employees possess voting shares, since employees would be minority shareholders in most cases.

Further, the Labour Law from 1 June 2002 as amended contains provisions on establishing work councils in enterprises in accordance with the respective EC regulations. Employees can protect their rights through trade unions or by electing their representatives to the work council (Art. 10, 11 of the Labour Law). In enterprises with more than five employees, employees are entitled to appoint their representatives for representing the interests of the employees of the respective enterprise, where their interests can collide with those of an employer. Employees' representatives are elected by at least half of employees by a majority vote.

Like German regulations concerning the establishment of a similar institution, the *Betriebsrat,* the Latvian Labour Law contains provisions concerning such rights of employees as the right to vote and the right to be elected. Moreover, it is not required that the employees' representative should be an employee in the respective enterprise. The law provides no legal instruments for the employer to restrict the right of employees to elect their representatives. Thus, the employer cannot legally prevent the elections and determine or impose the candidates for the position of a representative. The Labour Law grants the representatives the right to demand information about economic and social conditions as well as about decisions that could influence the interests of employees.

The Labour Law provides a legal tool for influencing the activities of the representatives only after they have been chosen. Performance of the duties of an employee representative may not serve as a basis for refusal to enter into an employment contract, for termination of an employment contract, or for otherwise restricting the rights of an employee. However, the employer is entitled to require that the rights of the employees' representatives shall be exercised so that the efficiency of the operations of the undertaking is not reduced (Art. 11 (2) of the Labour Law). Employee representatives have also the duty not to disclose information brought to their

attention that is a commercial secret of the employer. The employer has the duty to indicate in writing what information is to be regarded as a commercial secret.

Since 7 April 2005 special provisions on work councils in European Companies, hereinafter referred to as SE, contained in the Latvian law on European Company, hereinafter referred to as LEC, are in force. The law applies if the SE is registered in Latvia, company registered in Latvia participates in the foundation of the SE or founding company of the SE registered in another EU state registers an affiliated company in Latvia. Where the management or administrative organs of the participating companies draw up a plan for the establishment of a SE, they shall negotiate with the representatives of the companies' employees on arrangements for the involvement of employees in the SE (Art. 16 (1) LEC). The employees of companies participating in the establishing of a SE may elect already appointed employees' representative to negotiate the involvement of employees in the SE (Art. 19 (1) LEC). A special negotiating group should be elected if the amount of employees in the company participating in the establishment of a SE is not sufficient in order to elect employees representatives (Art. 19 (2) LEC). The level of involvement of employees in the SE depends on the level of their involvement in the companies establishing the SE. The SE must inform and consult the representatives of employees of the SE about the development of the business and of production and sales, the situation and probable trend of employment, investments, and substantial changes concerning organization, introduction of new working methods or production processes, transfers of production, mergers, cut-backs or closures of undertakings, establishments or important parts thereof, and collective layoffs. In the case a SE is established by transformation and the rules of a Member State relating to employees' participation in the administrative or supervisory body applied before registration of a SE, all aspects of employees' participation shall continue to apply to the SE. If none of the participating companies was governed by participation rules before registration of the SE, the latter shall not be required to establish provisions for employees' participation (Art. 33 LEC). Thus, if the Latvian JSC participated in the establishing of a SE together with the JSC registered in another EU Member State, which provides no rules on participation of the employees, these rules should not be implemented.

(b) Co-operatives

The number of co-operatives is relatively small, but it is a persistent business form which is still used, especially in agriculture. Co-operatives are outside the scope of application of the Commercial Law and are regulated by the Law on Co-operatives from 5 February 1998 (hereinafter referred to as CoopL) with later amendments. The law defines a co-operative as a voluntary association of physical persons or legal entities created with the purpose to provide services to increase the efficiency of the economical activities of its members (Art. 1 (5), 3 (1), 17 CoopL). The members are not responsible for liabilities of the co-operative. Unlike the right to vote in corporations, the right to vote in co-operatives depends not upon the amount of the

contribution invested; each member is entitled to one vote only (Art. 22 (2) CoopL). A co-operative is a legal entity and each member of a co-operative is entitled to participation in the management, to dividends of profits, which will be divided according to the investment of the respective member and according to the statutes of the co-operative (Art. 1, 3, 34 CoopL).

All co-operatives can be divided into commercial and non-commercial co-operatives. The purpose of forming commercial co-operatives is profit-making, whereas non-commercial co-operatives are aimed at improving the management of property belonging to co-operative members. The organs of the co-operative are the Members' meeting, the Board and the Supervisory Council (Art. 37 CoopL). The members' meeting is entitled to elect and revoke the Board, the Supervisory Council, the Auditor and the Liquidation Commission, to determine the remuneration of the board members and to make decisions on important issues (Art. 39 CoopL). Other decisions are made by the board. The member of the board are jointly and severally liable for board decisions and have the burden of proof for the actions of the board. The Supervisory Council can be elected to control the board between the meetings.

There are no limitations on distribution of profit of the co-operatives. However, the Law on Co-operatives provides for an order of distribution of profit. Firstly, profit is distributed to make reserve capital in accordance with the articles of association, secondly, to pay out dividends and, thirdly, to repay profit. The remaining part of profit can be distributed in accordance with the decision of the members' meeting.

There are special rules on agricultural co-operatives (Regulation of the Cabinet of Ministers No. 328). Agricultural co-operatives do not produce agricultural products, but provide services for farmers. Agricultural co-operatives have to be registered in the company register and be recognised by the committee consisting of representatives of the State Revenue Service, the Ministry of Agriculture, the Rural Support Service and the Latvian Association of the Agricultural co-operatives.

Liability of members of co-operatives is limited and profit can be distributed, but there are limitations on distribution of profit, so that LLC would be a more convenient business form. Each member of a co-operative has one vote, but this advantageous rule is relevant for employees only in workers co-operatives that are not numerous in Latvia.

(c) Partnerships

Partnerships usually are established in order to implement specific projects, e.g. construction companies, establish a partnership to join their resources and means for a big construction project. However, this business form is not used by small human capital intensive firms like law firms which prefer LLC due to limitation of liability. This means that partnerships are not relevant for financial participation of employees presently. Partnerships in Latvia are divided in general partnerships (pilnsabiedrība) and limited partnerships (komandītsabiedrība) under the Commercial law. However, only general partnerships might become relevant for employee participation, and they

should be presented below. The Civil Law provisions regarding partnership contracts shall be applied to a general partnership, in so far as the Commercial law does not provide otherwise. Partnerships are not deemed legal entities under Latvian law. They are not to be registered, unless they are achieved for a specific project. A general partnership is a company in which two or more partners operate under a common business name. A physical person or legal entity can be partner in a general partnership. All partners are jointly and personally liable for the obligations of the general partnership with all of their assets and personal property. Agreements that contradict this rule are void in relation to third parties (Art. 94 CL). A general partnership operates on the basis of a partnership contract concluded by the partners, which may be amended only with the consent of all partners. Each partner can represent the general partnership in all legal transactions unless the partnership contract prescribes otherwise.

On the one hand, the establishment of a partnership is easier and cheaper than of the LLC. The founders have to conclude a partnership contract. The law does not require a written form of this contract. It can be an oral agreement and it should generally not be submitted it to the Commercial Register. For partnerships the law does not require a minimal statute capital, establishment of management bodies and preparation of the articles of association. Relations between partners are regulated only by a partnership contract. If a partnership contract does not contain any provisions on this issue the commercial law and civil law regulate the relations between partners. On the other hand, the law provides for joint liability of partners. A specific form of partnership where it is possible that only one partner is liable if the damage which is caused by him personally as in German law firms does not exist in Latvia.

In partnerships, the consent of all partners shall be necessary to take a decision. However, a partnership contract can provide that a decision shall be taken by majority vote.

b) Profit-Sharing

There are no limitations in the law with regard to profit-sharing of companies with their employees; however, there are also no exact regulations with regard to such profit-sharing. It is possible to determine the amount of salary to be dependent on the profit of the company and it is possible to provide benefits in the form of premiums as well as other benefits directly connected with the profit of a particular company. However, all those benefits will be subject to personal income tax amounting to 25%. In such a way the incentive to provide additional benefits is decreased since the benefits of profit-sharing are 25% less than they would be in the case of share ownership by paying out dividends to the shareholders, because dividend payments on the contrary are not taxed.

In addition, there is a tendency to use other alternatives to paying salaries to the employees, not by offering shareholdings in the company but rather to register employees as self-employed persons and to conclude service contracts with these persons.

c) Taxation Issues

The most important regulatory acts on taxation are the Law on Personal Income Tax from 11 May 1993 as amended (hereinafter referred to as LPT) and Law on Corporate Income Tax from 9 February 1995 as amended (hereinafter referred to as LCT). Since there are no taxes on dividends distributed when establishing a new company there is a strong incentive to get the profit out of the company not by way of salary to an employee, but rather by paying out dividends and finding other ways to get to the profit which is primarily connected with the differences in the taxation: general personal income tax 25% flat (Art. 15, 2 LPT); corporate income tax 15% flat (Art. 3 (1) LCT); exception from general personal income tax: there is no tax on dividends either for companies nor for physical persons who receive the dividends (Art. 9, 2 LPT).

Tax legislation does not expressly regulate compensatory forms of profit-sharing. The Law on Taxes and Duties states that personal and corporate income taxes compose a uniform income tax system (Art. 4 (1)) and that the same income cannot be subject to both income taxes - corporate and personal - unless explicitly required by law (Art. 4 (4)). Furthermore, the Law on Personal Income Tax states that income tax can be imposed only as a tax on income from economic activity where it is not subject to the corporate income tax, and tax on other sources of income (Art. 1 (3) LPT). Thus, it is indicated that the net income after taxes is subject to the procedure of utilization of company profit according to Art. 189 CL.

3. Incidence Now and Over Time

Financial participation of employees, especially employee share ownership, emerged in the course of privatization, but was not sufficiently supported after 1994 and was steadily decreasing over time.

a) Small Privatization

In 1992, only in 8% of all cases an auction was the chosen method of small privatization because the municipal authorities were against favoring the richest purchasers, and auctions usually resulted in prices much higher than the initial price. The auction price was on average 5 times higher than the initial price while the average final price was 3.7 times higher than the initial price (Vojevoda and Rumpis, 1993, p. 10). Direct sale to employees or to another selected buyer was by far the most frequent method and more than the half of enterprises in small privatization were sold by instalments (see Table 1).

Table 1. Small privatization in Latvia (trade, catering and service)

1000 LVL (current p.)	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**total**
Enterprises	302	423	231	68	45	45	48	1162
of which sold at auctions	24 8%		88* 9%*				5 10%	122 11%
Iinitial price	361	1971	3521	1174	2242	1258	865	11392
Final price	1350	3871	4044	1188	2245	1263	874	14835
Final/initial price	3.74	1.97	1.15	1.01	1.00	1.00	1.01	1.30
Average final price	4.47	9.15	17.50	17.47	49.89	28.07	18.21	12.77
% paid by vouchers	0%	0%	2%	5%	19%	46%	58%	11%

Based on Central Statistical Bureau of Latvia. *1992-94. (Mygind 2000, p. 53)

The high price difference between auctions and direct sale indicates that there were favourable conditions for insiders buying at the initial price. These advantages for insiders prevailed in practice for some time even after the legislation had been changed in February 1992. The local privatization commissions continued to give preferences to insiders (Frydman et al., 1993, p. 223). We do not have exact data on what percentage of enterprises was taken over by insiders, but we estimate that especially in the first years this was the case for the majority of small enterprises. Most small enterprises had been privatized by 1994, so although the proportion of payment by vouchers were high in the latest years, vouchers were not important for small privatization.

b) Large Privatization

Large privatization of state-owned property and land is being carried out by the Latvian Privatization Agency (LPA) organised as a JSC under the Law on Privatization of Property Units Owned by the State and Municipalities from 17 February 1994. The main privatization method under this law was sale by tender to the highest bidder supplemented by restitution and mass privatization. Many of the largest enterprises have combined sale of a dominating block of shares to a core investor, and sale of minority share holdings in public offerings.

For mass privatization, a voucher scheme was used**.** In November 1992, the Law on Privatization Certificates (Vouchers) was passed after long political debates, but the distribution of vouchers did not start before September 1993, and the majority of persons entitled to vouchers started to invest them only in the summer of 1994. The people obtained one voucher for each year of living in Latvia after the World War II. Pre-war citizens and their descendants got additional 15 vouchers while 5 vouchers were deducted from people who settled in Latvia after the World War II. Only very few investment funds were formed. 9 licenses were given to investment funds based on vouchers, but only 5 were functioning. In 1995-98 vouchers for a nominal value of only around 9 million LVL were put into investment funds making up less than 1% of the distributed vouchers (Mygind, 2000, p. 17).

By 1 October 2004, a total of 103.9 million privatization vouchers have been issued to 2.45 million persons for the time they have lived in Latvia, including 788.3 thousand vouchers granted to 40.8 thousand politically repressed persons. A total of 7.73 million property compensation vouchers have been issued to 112.3 thousand former owners or their heirs, including 764.9 thousand vouchers for urban land, 458.5 thousand vouchers for companies and other property units, 89.9 thousand vouchers for property taken away from the politically repressed persons and 75.1 thousand vouchers for property alienated in illegal manner. In the first three quarters of 2004, a total of 116.7 thousand property compensation vouchers have been granted to 1.9 thousand former owners or their heirs. Compensations totalling 17.4 million LVL have been paid to 8,391 persons. By 1 October 2004, cash compensations amounting to 4.3 million LVL were paid to 24.6 thousand politically repressed persons as payment for privatization vouchers.[6] 100.63 million vouchers or 90.2% of the total number of issued vouchers have been used for privatization of state and local government property units by 1 October 2004 (see Table 2). As of 1 October 2004, a total of 4.12 million vouchers or 3.7% of the total number of the vouchers issued, including 0.46 million property compensation vouchers, were on accounts of 500 thousand physical persons. On the accounts of legal entities, there were 4.68 million privatization vouchers, including 0.33 million property compensation vouchers. Holders of privatization vouchers in October 2004 could use services of 23 licensed intermediary companies to make transactions on the privatization voucher market. Vouchers could be used until 1 July 2005.

Table 2. Use of privatization vouchers (as of October 1, 2004)

Type of Property	**Number**	**Number of vouchers (million)**	**incl. property compensation vouchers (thousand)**
For purchase of housing	412 thousand of privatized housing units	34.57	582.1
For purchase of an enterprise and other properties	Accurate data not available	7.07	109.6
For purchase of shares	accurate data not available	44.42	954.0
Total:		**100.63**	**6,250.0**
% of total vouchers issued		90.2%	80.8%

Report on the Economic Development of Latvia, 2004, p. 130.

On average 60% of the price was financed by vouchers. The market value of vouchers was only around 10-20% of the nominal value. The total sales price for state property units (except land) sold for lats and privatization vouchers were 1,644 billion LVL, including 1,347 billion LVL in privatization vouchers.

[6] See Report on the Economic Development of Latvia, Riga, December 2004, pp. 127-128.

Insider take-overs lost their importance after 1994. However, mainly in the companies with shares sold in public offerings the employees had the right to buy up to 20% of the shares. By the end of 1998, shares with the nominal value of 27 million LVL had been sold for vouchers to 25,611 employees and former employees of the companies comprising 13.56% of the shares (LPA 1998). Shares for 4.4 million LVL were sold for vouchers to 250 managers of 24 companies, making up 13.6% of the shares. (LPA 1998).

c) Case Studies and Survey Evidence

Case studies on 9 Latvian companies (see Table 3) described over the whole transition period from before their privatization confirm the results of the quantitative studies, while at the same time they give some important details of the development in employees' financial participation over the period (Mygind, 2002b). 7 of these companies were privatized quite early in the process. *Dzintars*, known as a supplier of cosmetics to the whole Soviet Union, was an early experiment of a large privatization to the employees. Another company, *Jaude*, producing electrical equipment, started as a new co-operative, but was later like the remaining early privatization cases, transformed to insider ownership through leasing with the option to buy. When the shares were relatively cheap for the employees the result was a quite broad and equal takeover by the employees (*Dzintars, Pionieris* and *Ausma* while in other cases we saw a higher concentration of ownership on managers and specialists combined with quite many non-owners among the employees.

Table 3. Determinants of ownership structure at the time of privatization

	Product	**Initial ownership**	**Privatization method**	**Economic results**	**Size**	**Capital/ labour**
Dzintars	perfume	employee	leasing wotb	cream	900	low
Jauda	el.articles	employee	coop/ l. wotb	cream	422	low
Pionieris	footwear	employee	leasing wotb	defensive	500	low
Ausma	plastic	employee	leasing wotb	defensive	800	low
Arno	clothes	empl./man.	leasing wotb	defensive	350	low
Juglas	fabrics	man./empl.	leasing wotb	defensive	400	low
Mebelu	furniture	man/out/em	leasing wotb	defensive	514	low
Lode late	bricks	coreoutside	LPA-tender	cream	268	high
Valmiera late	fiberglass	core foreign	LPA-tender	cream	1,340	high

wotb = with the option to buy (Mygind, 2002a)

When shares were cheap per employee we find often quite broad and equal employee ownership like in *Dzintars, Pionieris, Ausma* and for minority shares also *Lode* and *Valmiera*.

In other cases we find higher ownership concentration around managers, specialists and at the same time quite many non-owners among the employees. In employee surveys we found that the main motives for buying shares were: good offer, employment (especially for workers), control (especially for managers and specialists).

The development in ownership structure as a result of privatization and the following changes can be analysed based on general enterprise data from the statistical department and a specific ownership survey done in 1997 of 167 companies covering 1993-1996 (Mygind 2002b) and another survey done in 2000 of 915 companies covering ownership ultimo 1997 and 1999 (Jones and Mygind 2005).

By January 1995, small enterprises with fewer than 100 employees owned by the state have mainly been taken over or are started by insiders and more than 50% of companies with fewer than 100 employees were majority-insider-owned. More than two thirds of enterprises with 1-4 employees were majority-insider-owned. For enterprises with more than 500 employees the corresponding figure was only 18%. Most of the enterprises with majority insider ownership in 1995 were 100% owned by insiders. It is striking that for enterprises with 20-199 employees there are slightly more management-owned enterprises than employee-owned. However, for large enterprises with more than 200 employees we have no enterprises with management dominance in our small sample of 167 enterprises.

We have data also for another large sample from 1997 (see Mygind, 2000). Insider ownership was highest in agriculture and fishing and lowest in transport and services. From the small sample it can be seen that the bulk of insider-owned enterprises in agriculture and fishing were broadly owned by employees, in manufacturing there is about balance, while managers were dominating in sectors such as construction, trade and transport. Enterprises with insider majority have around ten times lower capital intensity than other enterprises. The lowest percentage of non-owning employees is found in enterprises with employee majority ownership (see Table 4). Finally, the last columns show that there are more employee owners in privatized enterprises than in start-ups.

Looking at the distribution among the employee owners it is striking that the employee-owned enterprises are mainly found in the middle category while it has the lowest frequency for both the categories of 'rather equal' and 'very unequal' distribution. The explanation might be that in employee-owned enterprises there are more owners and more shares owned by employees opening up for a wide spectrum and thus higher in-equality in the distribution of shares. Employee ownership includes a broad group of employees owning quite small shareholdings.

Table 4. Distribution of ownership on employees

\ ownership average per enterprise		state majority	foreign majority	domestic majority	manager majority	employee majority	no majority	total	priva-tized	new
% nonowning employees										
	1993	82	70	52	85	41	62	58	45	70
	N	(7)	(4)	(23)	(15)	(27)	(6)	(82)	(42)	(33)
	1994	80	78	46	89	43	64	60	48	71
	N	(7)	(5)	(27)	(17)	(25)	(8)	(89)	(48)	(34)
	1995	76	79	47	84	41	67	59	46	72
	N	(8)	(5)	(27)	(18)	(26)	(9)	(93)	(50)	(35)
	1996	87	79	51	80	46	63	61	50	75
	N	(6)	(4)	(26)	(24)	(26)	(10)	(96)	(54)	(36)
response-rate	pct	30	31	74	48	81	71	59	74	51
distribution of shares on employee owners ultimo 1996										
rather equal		1	4	13	25	11	6	60	23	36
	(Pct)	(100)	(57)	(46)	(59)	(36)	(46)	(50)	(37)	(62)
unequal (more than 1:2)		0	0	8	5	14	4	31	23	8
(Pct)		(0)	(0)	(29)	(12)	(47)	(31)	(25)	(37)	(14)
very unequal (> 1:10)		0	3	7	12	5	3	30	16	14
(Pct)		(0)	(43)	(25)	(29)	(17)	(23)	(25)	(26)	(24)
	N	1	7	28	42	30	13	121	62	58
	(Pct)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

(Mygind, 2002a)

In the small sample of 167 enterprises we can distinguish between newly started and privatized enterprises. The proportion of newly started enterprises is highest among the small enterprises. The division of new and privatized on different ownership groups can be seen from Table 4. Although the sample is quite small the following strong tendencies can be assumed to have general validity. Enterprises with broad employee ownership are mostly established in the privatization process. Newly started companies with high financial participation of employees can be expected to be found in industries with high input of human capital because motivation, recruitment and retention of knowledge workers are often decisive for the success of the companies (Mygind, 2001b, p. 324).

In Jones and Mygind (2005) the dynamics of ownership for Latvia is based on responses from 915 enterprises specifying their ownership structure for 1997, 1998 and 1999. For 730 of these enterprises the statistical departments' own surveys include also ownership information for 1995 and 1996, however, without the distinction for insiders between employee and manager ownership. Table 7 shows the transition matrices for the period 1995-1999 for which we unfortunately cannot distinguish between manager and employee-ownership in 1995 and Table 8 covers the period 1997-1999 where we can make the distinction. Table 7 shows that insider ownership is

by far the least stable. The most frequent change was from insider to former employee (38 cases). If we include these cases as employee-owned from the start we end up with a high change away from employee ownership. Except for 13 cases coming from ownership by former employees we see very few cases in the direction of employee ownership. Quite many insider enterprises are moving to domestic external ownership. In the period between 1997 and 1999 (see Table 8), manager ownership is surprisingly stable, whereas both employee and former employee ownership are changing. The most frequent changes were from employee to manager and from former employee to external domestic. These changes are accompanied by steep increase in concentration on the largest single owner.

Table 7. Ownership transition matrix private firms 1995-1999

\ last year first year	foreign	domestic	manager	employee	former employee	total	change
foreign	**105**	**7**	**6**	**0**	**0**	**118**	**11,0%**
domestic	**11**	**139**	**20**	**4**	**1**	**175**	**20,6%**
manager	**1**	**9**	**308**	**2**	**1**	**321**	**4,0%**
employee	**1**	**4**	**13**	**118**	**6**	**142**	**16,9%**
former empl	**0**	**10**	**1**	**13**	**39**	**63**	**38,1%**
insider	**6**	**32**	**12**	**8**	**38**	**96**	**79,2%**
	124	**201**	**360**	**145**	**85**	**915**	

Inside ownership 1995 followed by manager (employee) ownership in 1997 is recorded as manager (employee) ownership 1995 and 1997. Firms going from insider to manager in the table had another owner type in the meantime. Former employee is domestic ownership with concentration < 20%.
(Jones and Mygind, 2005)

Table 8. Latvia 1997-1999 Ownership transition matrix private firms

\1999 1997	foreign	domestic	manager	employee	former employee	total	change
foreign	**110**	**8**	**5**	**0**	**0**	**123**	**10,6%**
domestic	**8**	**161**	**13**	**4**	**2**	**188**	**14,4%**
manager	**2**	**12**	**326**	**2**	**0**	**342**	**4,7%**
employee	**2**	**6**	**15**	**135**	**9**	**167**	**19,2%**
former empl	**0**	**16**	**0**	**6**	**73**	**95**	**23,2%**
	122	**203**	**359**	**147**	**84**	**915**	

(Jones and Mygind, 2005)

According to Latvian case studies, only in *Dzintars* there was some kind of regulation of the value of employees' shares in relation to the internal value of the company. In the other six companies, the nominal value of shares was usually the trading price. Therefore, the employee owners could see their share-values being eaten up by very high inflation in the early years of transition. No dividends were paid, so employees had no feeling of the real value and possible capital gains from their shareholdings. In this situation the managers could buy the shares at relatively low prices from other employees who were in a very tight economic situation especially in the early years of

transition with falling real wages. In some cases, managers diluted the shares of employees by increasing the nominal share capital with themselves as the main receivers of the extra capital. As shown in Table 9, some of the companies have continued the governance cycle to the next stage of outside, often foreign, takeovers. Thus, the cases confirm the typical ownership cycle from employee over management to outside domestic or foreign ownership (Mygind, 2002b). Three of the nine companies were liquidated (see Table 9).

Table 9. Takeover and concentration processes

	Managers increase share	**Outsiders increase share**	**Exit**
Dzintars	Management increase share from 1% to 5%, buy from employees	Foreign: gradual purchase from employees and from state (priv)	
Jauda	Managers and specialists purchase from other employees	Not relevant	
Pionieris	Not before liquidation	Not successful in attracting foreign capital	Liq.
Ausma	Managers increase share purchase from employees, new capital	Not successful in attracting foreign capital	Liq.
Arno	Managers increase share purchase from employees, new capital	Not relevant	
Juglas	Managers increase share by purchase from employees	Foreign participation in alliance with management	
Mebelu	Not before liquidation	foreign takeover after liquidation/ reprivatization	Liq.
Lode and Valmiera	Not relevant	purchase on exchange and capital increase	

(Mygind, 2002a)

d) Co-operatives

The co-operative principle regarding the distribution of profits was not followed. Profit is distributed to the members according to the contribution to the capital (Art. 34 (1) CoopL).

Co-operatives are still more active in agriculture, but there are also small- and medium-sized enterprises producing different products or providing services. Mr Ivars Strautins, president of the Central Co-operative Union Turiba declared that the co-operative movement in Latvia is not strong and unites presently about 8,000 people and the number of co-operatives is about 140 in 2002-2004, with the exception of workers co-operatives. Most of them operate in agriculture. There are very few workers' co-operatives.

e) Profit-Sharing

The management survey of 167 companies from 1997 gives some information about the spread of profit-sharing in Latvia (see Table 10).

Table 10. Form of payment for employees - on ownership - 1996

\majority ownership	state	foreign	dom.	mana-ger	employee	no ma-jority	total	priva-tized	new
profit-sharing	2	0	1	0	5	2	10	5	3
N	(11)	(0)	(3)	(0)	(18)	(16)	(7)	(8)	(4)
	18	11	30	49	28	12	149	66	65
monetary incentive scheme	8	2	9	5	2	2	29	9	12
	(44)	(20)	(29)	(12)	(8)	(14)	(20)	(14)	(19)
N	18	10	31	43	26	14	143	63	62

(Mygind, 2002a)

Profit-sharing is only reported in 7% of the responding enterprises, however, with 18%, 5 out of 28 of the enterprises with majority employee ownership. Monetary incentive schemes are used in 20% of the enterprises, however, the percentage is falling over time from 28% in 1993 to 20% in 1996 (Mygind, 2002a, p. 17).

Profit-sharing is likely to be used in new, human capital intensive sectors, e.g. IT, consulting and real estate companies. Currently, IT is one of the most dynamic industries in the Latvian economy. The government is promoting growth of the IT sector and announced that it is one of the priorities in the economic development programme. According to the 2004 data of the Central Statistical Bureau, 6,079 IT companies had a turnover of 207,597,530 LVL and profit of 10,519,947 LVL which means that IT is one of the most competitive and profitable sectors. There is a large number of NGOs in this industry. They influence implementation of modern technologies to develop IT industry as well as improvements in legislation and regulations regarding the positionf employees, but they do not promote financial participation as yet.[7] Despite the fact that employees' participation is presently low, there are factors that may influence the development of financial participation of employees in this sector in the near future. Most employees are young and highly qualified, have knowledge of economic issues and are not necessarily bound to one company, so that employers have to create incentives, e.g. by introducing employee ownership or profit-sharing, to keep them and, considering the high profits, employers are in the position to do so. Real estate sector is also generating high profits. It is typical of real estate companies to let realtors participate in the profit from the price of objects sold by them. In Latvia, realtors receive 3-5% of the profit. However, such participation can be considered as a means of motivation, but not as typical profit-sharing, since it usually means that basic salary of realtors is very low.

7 See Report on the Economic Development of Latvia, December 2004, p. 110.

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In several companies with foreign capital, some elements of the ESOP model as well as profit-sharing and stock options for employees are used.

4. Empirical Evidence of Economic and Social Effects

Production function analysis based on cross sections from 1994 and 1995 does not show any significant differences in factor productivity between ownership groups (see Jones and Mygind, 2000). A multi-variate analysis of the capital structure for the 1995 data shows that the debt ratio for insider-owned enterprises is significantly higher than for state-owned enterprises. Bank loans are, however, significantly lower the more insiders own, and bank loans per employee are relatively low for insider-owned enterprises (Mygind, 2000, p. 36). Concerning the source of financing for different owner groups the traditional finding is confirmed for employee- owned companies in relation to their dependence on internally generated capital. Extra capital injected from external owners play an important role only for foreign, managerial and no majority enterprises.

In the survey on 167 enterprises (see Mygind, 2002a) managers were asked about implementation of different forms of restructuring. It turned out that the differences between owner groups were modest concerning organisational changes of the number of departments and changes in hierarchical levels. Concerning orientation toward Western markets there was an increasing trend for all enterprises over the period of investigation 1993-96, with foreign-owned companies in a leading position.

The in-depth case studies of 9 enterprises show the connection with initial conditions. Both *Dzintars* and *Jauda* were quite promising enterprises from the start, while the remaining five early privatized enterprises can be categorized as defensive takeovers by employees, as an alternative to complete close down of the companies. Therefore, it is not surprising that these five defensive companies have gone through serious crisis and three of them were finally closed down. All seven early privatizations had quite low capital intensity, while the two large companies privatized through the Latvian Privatization Agency, *Lode* and *Valmiera*, had high capital per employee.

The relation between ownership and restructuring for the nine case companies is summarized in Table 11. We distinguish reactive restructuring where the companies adjust production and employment to the downward trend of demand especially in the early years, and strategic restructuring, where the companies develop new products,

markets, production methods etc. to adjust to the new opportunities on the market. In contrast to most theories, performance of most employee-owned case companies does not point in the direction of employee ownership as a barrier for adjustment of the labor-force - reactive restructuring. The exception is the furniture producer, *Mebelu*, where the reaction to falling demand was not cutting the labor-force, but cutting wages and labor hours. Also in the case of *Juglas* in the textile industry, low labor utilization point to some barriers for defensive restructuring. The barriers for strategic restructuring seem to be more important for the employee-owned enterprises. In three cases, *Pionieris, Ausma* and *Arno,* the general crisis of the industry meant low profits, no internal capital for investment, and in combination with no supply of external capital there was no room for strategic restructuring. However, it is worth noting that later shifts away from employee ownership did not improve the situation. *Dzintars* and *Jauda* are examples of strategic restructuring also in the period of employee ownership, although *Dzintars* strengthened restructuring in parallel with increased foreign involvement in ownership over time. This was also the case after the final takeover of *Mebelu* by foreign owners.

Table 11. Ownership, governance and restructuring

	Reactive restructuring adjust employment to demand		**Strategic restructuring** Invest in new products and processes	
Dzintars	++	EO no barrier	++	EO ok, but restructuring stronger in parallel with foreign involvement
Jauda	++	EOMC no barrier	++	EOMC ok
Pionieris	+	EOMC no barrier	-	General crisis in industry
Ausma	+	EOMC no barrier	-	No change when EO → MO
Arno	+	EOMC no barrier	-	No change when EO → MO
Juglas	(+)	Quite low labor-utilization	++	No causality with change in owners
Mebelu	-	labor stable, low wage and hours	-→+	+ after foreign takeover
Lode	+	even under state ownership	++	Strong coreowner, + bank
Valmiera	+	even under state ownership	++	Start under state ownership developed more with foreign owner

EO=employee ownership, MC=management control, MO= management ownership
++ high restructuring, + some restructuring, - no restructuring (Mygind, 2002a)

5. Conclusions

The current level of development of financial participation of employees is low. There has been no sufficient support by the government and social partners for the last ten years. However, some regulations supporting employee share ownership still exist. A small number of companies use profit-sharing as a means of motivation on the basis of internal rules. The number of co-operatives is small and decreasing whereas the number of self-employed is large and increasing due to advantageous taxation.

Employee majority enterprises have factor productivity equal to companies with other ownership forms, but lower capitalisation. Surprisingly, employee ownership does not present an obstacle for lay-offs as an element of reactive restructuring.

Employee share ownership emerged in the course of privatization. In the early years of privatization, small state enterprises, new co-operatives and leased enterprises were introduced. Leasing of enterprises with the option to buy was used until the mid-90ies, and it was one of the major methods of takeovers by insiders. During the small privatization, more than 50% of small enterprises have been privatized by insiders, partly bought at a price under the actual value. In the large privatization, up to 20% of shares can be sold to employees, under certain conditions also at a discount. This regulation is still effective. However, there is no obligation to offer any shares to employees. Employees could and still can use vouchers distributed among all long-time residents of Latvia to pay for publicly offered shares of their enterprise if it is to be privatized. Despite these supportive measures, employee share ownership usually changed to former employee or to managment and finally to outsider domestic or foreign ownership after a quite short period of time as both surveys and case studies show.

Only few regulations on employees' financial participation schemes exist. Joint-stock companies can issue special employee stock without voting right corresponding to up to 10% of the equity capital in the course of capital increase. For employee stock of state and municipal companies, there is an additional provision that employees can not alienate such stock and lose it to the company when leaving, but the company is also obliged to transfer these shares to other employees and can not use them for other purposes. Since there are no taxes on dividends distributed when establishing a new company there is a strong incentive to get the profit out of the company not by way of salary to an employee, but rather by paying out dividends. The Law on Taxes and Duties states that personal and corporate income taxes compose a uniform income tax system (Art. 4 (1)) and that the same income cannot be subject to both income taxes - corporate and personal - unless explicitly required by law (Art. 4 (4)).

The EU accession might have positive impact on the development of employee participation, including financial participation, but there is no evidence of such influence now, with the exception of the statement that practices introduced by branches of Western European firms in Latvia could be taken over by domestic companies competing with them on human capital.

Neither the government nor the social partners presently promote or are planning to promote financial participation schemes. The trade unions and other political forces which could support such schemes lack knowledge about the methods and advantages of financial participation and thus do not even address this issue. High unemployment and job uncertainty as well as psychlogically determined inactivity of large groups of employees make it still more improbable that employees themselves would promote financial participation. However, if an EU regulation on this issue were introduced, it is probable that the issue would receive more attention in the future.

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