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Employee ownership – a role in the Baltic economies?

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Abstract

Purpose: This paper gives an overview over some theory and empirical evidence on employee ownership and other forms of employee financial participation and answers the following questions:
What is employee ownership and what is the relation to other forms of financial participation?
Why is employee ownership widespread in some developed market economies like US and in Italy, France and Spain, while it has a quite rare occurrence in the Scandinavian countries?
What are the conditions favouring and what are the barriers for employee ownership?
What are the advantages and drawbacks for employee owned companies?
The paper also gives a summary of the experience in the Baltics – with reference to the following three country articles – and gives finally some perspectives for the future.

Methodology/approach: This is a **general review** article on theory and some of the main empirical research results on employee financial participation.

Findings: It is predicted that employee ownership will be found in organizations which are small, homogenous, labor intensive, and with high emphasis on human capital. Employee ownership can have positive effects on labour productivity, but financial constraints may make a barrier for investment and restructuring. Legislation with tax incentives, rules for selling and buying employee shares, access to loans change the balance in favor of employee financial participation. In the Baltic countries there was a wave of employee ownership following early privatization. However, these firms soon were taken over by managers and often later by outside owners. Profit sharing is rare and there is no legislation promoting employee participation in the management bodies of companies.

Implications: Legislation following the trend in EU could promote a revival of employee financial participation and strengthen motivation and productivity especially in knowledge based companies.

Value of the paper: A short overview over the main theoretical predictions and empirical findings on employee financial participation and on the development in the Baltic countries.

Keywords: employee participation, employee ownership, profit sharing, labour motivation, labour productivity.

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1. Introduction

Employee ownership has been quite widespread in all the three Baltic economies in connection with the privatization process. But the experience has been rather short-lived since in most of the employee owned companies the majority of shares have been transferred to managers and in some cases to core outside investors or foreign investors. The experience has shown that the conditions were not ready for this type of ownership and the potential of high employee motivation and increased productivity have not yet been exploited. However, in the most developed economies in EU and in US different forms of employee financial participation has a quite strong presence as part of the business model for using the high potential of human capital.

In this article I will first give a short introduction to the different forms of employee participation. Then the conditions favoring or hampering the spread of employee participation will be discussed both from a theoretical side and from empirical evidence from the West. This leads to an analysis of the possible effect of employee participation, again supplemented by a discussion of the evidence, here, from both East and West. Finally, the experience from the transition countries in Eastern Europe will be discussed. The focus will be on the three Baltic countries and with most weight on employee ownership since this type of employee participation has by far been the most important in these countries.

Different types of employee participation

Employee participation can take several forms which all related to the ownership rights of the company. There are three fundamental ownership rights: the right to control, the right to the surplus from the activities of the company and the right to the accumulated net assets of the company. The shareholders get typically a share of all these three rights. However, there could be limitations on some shares bearing only little or no right to voting at the general assembly, and sometimes the power of minority shareholders are so limited that the right to control is negligible. There can also be some rights to control without financial rights. In countries such as Denmark, Sweden, Germany and Holland the employees are by law eligible to some of the seats in the boards of joint stock companies of a certain size. They can cote in the company board, but have no other ownership rights. There are also examples of profit-sharing, where employees get a certain share of the profits, but have no shares and no votes at the general assembly. Sometimes, profit-sharing is connected to buying/transferring shares of the company and then gradually increasing the ownership of the employees. In this way there are many possible combinations and types. Table I gives an overview over the main forms of employee participation.

Table I. Different forms of employee participation.

Type **right to:**	**Control**	**surplus**	**Wealth**
Majority employee ownership	+	+	+
Minority employee ownership	**Limited**	+	+
Profit sharing	**0**	+	**0**
Non controlling ESOP	**0**	+	+
Worker cooperatives	+	+	**limited**
Representation in the company board	+	**0**	**0**

In some countries there are special employee ownership schemes giving support through taxes, subsidies or other advantages with incentives to transfer ownership to employees, e.g. the US legislation for ESOPs (Employee Stock Ownership Plans) or the French support of profit sharing in combination with accumulation of employee shares (Uvalic, 2006). In the US ESOP a thrust fund, often leveraged by loans, takes over shares (often majority) of the company and these are gradually transferred to the workers through profit sharing. The system has benefited from tax advantages and covers now 8.8 millions or about 6% of the workforce in US. In most cases the votes are not directly controlled by the workers, but by trustees of the fund - marked by zero control in table I. However, there are several thousand companies with majority employee control (Rosen et al, 2005).

Worker cooperatives are often defined in relation to traditional cooperative principles of one vote per member and open membership. In the case of a worker cooperative it means that only workers are members and they have equal say at the general meeting. There are mechanisms for enrolling new employees as members and for exiting members transferring their ownership back to the cooperative. The value, a member gets, when leaving is in most cases restricted - they only have ownership right to a limited part of the accumulated wealth in the company. This is often referred to as *collective* ownership (Mygind, 1987) in contrast to the most widespread situation of employee ownership in Eastern Europe where employees own *individual* shares which can be sold in principle for the market value. This distinction has some important consequences for the theoretical predictions about the behavior of the two types of ownership.

Conditions favoring and hampering employee ownership

In Western industrialized countries employee ownership is not widespread although there are some exceptions like the Mondragon cooperatives in Spain, the worker cooperatives connected to the Lega in Northern Italy, or ESOPs in US. It may surprise that employee owned enterprises are rare in the Scandinavian welfare states shaped by strong unions and Social Democratic parties. The agenda from the 1970s of development of Economic Democracy has not evolved into employee ownership. Instead wage-earners' pension funds like in all developed economies play an increasing role as owners of enterprises. Why is employee ownership most widespread in some developed market economies like US and in Italy, France and Spain, while it is quite rare in Scandinavia? What are the conditions favouring and what are the barriers for employee ownership? In which sectors of the economy are they expected to develop?

The rarity of employee ownership is not because of inferior incentives. On the contrary most studies show that employee owned enterprises mean higher motivation and productivity (Blinder, 1990). However, they have often problems in relation to attracting capital and the functioning of a market for individual employee shares. Dow (2003) finds the basic difference in comparison with the dominant capitalist firm in relation to the inalienability of labor in contrast to the situation for capital. Employee owned firms have a *commitment problem* in relation to external capital inputs, a *composition problem* in relation to the collective decision making by the employee owners and a *commodification problem* in relation to trading employee shares.

The conditions favoring or hampering employee financial participation are related to a broad specter of factors: institutions, culture, technology and socio-economic conditions. These conditions will in the following be presented on three levels: individual, company and society.

At the *individual level* cultural and socio-economic conditions play a decisive role: Are the employees motivated to take over their companies and do they have the necessary capital to do this?
It is important that the employees have a desire for self-governance – a desire to participate in decisions. At the same time some collective culture may ease the process of decision making in the group of employees. A collective culture dominated by a collective wage-earner attitude accepting that control resides at the capitalist owner will, however, not give any push for employee ownership. It is not enough with a desire for being part of decision making. The employees must have the

necessary skills, the education and the ability to go into this process. They must also be willing to offer the effort and time for going into the decision processes, which in a democratic employee owned company may be quite demanding. Employee owners can thus be expected to be found, especially among the higher educated and more experienced employees. In knowledge based companies the highly educated employees often have better access to the necessary information to monitor the managers than it is the case for external capital investors.

Personal wealth of the employees plays an important role when a considerable down-payment is needed for ownership. Wealthy employees can afford this contribution without concentrating a high proportion of their wealth in the same venture where they have also invested their human capital. This concentration of risk must be seen in combination with the individual preferences, the degree of risk-aversion, and the capital problem discussed below in relation to the company level. Risking both the job and a high proportion of personal wealth is like putting all the eggs in one basket as pointed out by Meade (1972) and Putterman (1993). The risk connected to losing the job and losing specific human capital is an important element determining the value of employee ownership (Blair, 1995). The costs of lost specific human capital will be included with extra weight in the decision process in the employee owned firm compared to the situation in the traditional firm.

The cost of losing the job also depends on the individual mobility. The cost is very high for a well established employee with family, house etc. who could not move to another location without considerable costs. This can be contrasted to young mobile employees who frequently shift between different enterprises to collect experience and who are not bonded by family obligations and high investments in the local area. Therefore, macro variables such as alternative local employment possibilities play an important role for the weight an employee puts on the mobility factor. This includes also the level of unemployment benefits and the social safety at the level of society.

At the *company level* the problem of collective decision making and the free rider problem increase with bigger firm size, with increasing heterogeneity of the labor force and in general with higher complexity of the employee-owned organization. This is what Dow (2003) calls the *composition* problem of the controlling owner group. He compares with the capitalist firm where the group of owners often is smaller and owners often have parallel interests. Hansmann (1988 and 1996) emphasizes the problem of decision making in a heterogeneous group of employees where e.g. unskilled workers may have conflicting interests with the group of highly skilled professional workers. This type of conflict was found in a case study at the Danish employee owned newspaper Information (Westenholz and Mygind, 1982). Here, conflicts between printing workers and journalists were behind the demise of employee ownership. Thus, the typical employee owned company will be relatively small with a quite homogenous labor-force. If the labor force is heterogeneous ownership may be limited to a smaller homogeneous group of managers and specialists. In the West we find a high frequency of partnerships where key employees are the dominant owners in sectors such as IT, consultants, lawyer companies and other professional services.

Knowledge based companies have a high dependency on human capital. Some of this human capital may be firm-specific and can not be used in another company. The employees need extra incentives to invest time for training and developing these specific skills. They run the risk of losing this human capital if they have to change to another company. There is mutual dependence between the employees and the company – a dependency which makes employee ownership an obvious solution. However, in a heterogeneous group with varying human capital between the employees only some of them may become owners.

Teamwork, empowerment of employees, modern HRM-techniques etc. are ways to involve the employees for higher effort and investing specific human capital into the firm. It may involve part of the package of employee ownership in the form of different forms of financial participation, profit sharing, stock options etc, or in the form of participation in some decisions (Kaarsemaker and Poutsma, 2006). It could be an advantageous strategy for the capital owners to introduce some elements of employee participation and ripping some of the benefits of employee ownership without giving up the ultimate control. According to Dow (2003), however, without full employee ownership there would be a commitment problem now in disfavor of capital ownership. Still, it could be assumed that a management style with a high degree of employee participation like in the typical Scandinavian company may decrease the pressure for real employee ownership.

The finance problem connected to high capital intensity is a classical problem in the literature on employee owned firms (Vanek, 1971; Meade, 1972; Putterman, 1988). High capital intensity, high assets per worker, means that the capital cost per employee is very high and in most cases beyond the possibilities of the average employee. At the same time there is a commitment problem (Dow,

2003) for attracting external capital both as bank loans and as non-controlling equity because there may be conflict of goals between the employee owners and the external capital. Thus, the theory predicts low capital intensity in employee owned enterprises. Evidence both for Western and Eastern Europe shows that banks are reluctant to lend money to employee owned companies. This is confirmed by most Western experience except for Mondragon (Dow, 2003). Mondragon is also the exception in relation to financial constraints on bank loans: By having a strong bank as the financial center of the group Mondragon companies have been able to overcome the important financial constraint barrier for employee owned companies. Combined with accumulating individual employee-accounts this had made it possible for the Mondragon cooperatives to expand in sectors with high capital intensity (Thomas and Logan, 1982; Whyte and Whyte, 1991).

The conditions at the individual and at the company level interact with the conditions at the s*ociety level.* The individual choice of employee ownership depends on the possibilities for finding satisfactory working conditions on the labor market. These conditions are determined by the economic development in the given country, legislation and the role and strength of the unions. In economic downturns with high unemployment the job alternatives are few and unsatisfactory giving pressure for more employee ownership including defensive takeovers of companies about to close down.

There is a substitution effect between favorable market conditions for labor with good employment possibilities and a security system in case of unemployment on one side and the need of employee ownership on the other side as an alternative if the labor market shows high uncertainty and few opportunities for employees. Therefore, strong unions and a high support level for employees can limit the pressure for employee ownership. Codetermination with obligatory seats for employee in the boards of stock companies and in general a participatory management style can have the same effect – the employees have influence, so why bother with direct ownership?

The situation in Denmark gives an interesting illustration of how different legislative element and a strong labor movement have improved mobility and the protection of labor so the wage-earner situation is favorable. Therefore, employees have not sought the alternative as employee-owners to improve their situation. The Danish social security system with high and long lasting unemployment benefits have made redundancy less threatening. At the same time there are very few thresholds for firing workers. This high degree of flexibility combined with high social security is thus named “flexicurity”. The organization of work is characterized by a flat organizational structure with high degree of participation and empowerment of employees. Unions are strong and workers have a high union-membership rate. Even in periods of high unemployment as in the 1980s there was no movement for establishing employee owned companies in Denmark. By law employees have one third of the seats in the company board of joint stock companies with more than 50 employees. Except for this and some tax-advantages for minority employee shares there are no legislative support for employee participation. Majority employee ownership is only found in professional partnerships, legal firms, architects, IT-companies etc., but here it is typically only leading and core employees who are owners. On the other hand some of the larger companies have minority employee ownership, and although the employee shares only make up a few percentages of the total share capital the value of the shares sometimes make up a considerable amount for the individual employee and in this way it can contribute to the incentives for these employees giving high identification with the company.

In contrast to Scandinavia much more employee ownership is found in Southern Europe and US with higher uncertainty for the workers on the labor market. The explanation for the different types of employee ownership in countries such as Italy, Spain and France mostly in the form of worker cooperatives are also connected to special treatment in legislation related to cooperatives or in US in relation to ESOPs with important tax advantages and institutional structures that helps the sustainability of these types of employee ownership. In Scandinavia such favorable institutional rules are only found in a few specific sectors such as some social services in Sweden (Pestoff, 2000).

Effects of employee participation - advantages and drawbacks of employee ownership

There are many theories and comprehensive analyses of evidence of the effects of different forms of employee financial participation. Still, in many areas there are no clear conclusions because the analysis is very complex with many different elements playing a role for company performance.

Most authors agree on the positive alignment and incentive effects of different forms of employee participation. In the traditional capitalist firm there is a commitment problem between labor and capital. Although different human resource management tools can be exploited to increase the incentives of employees the ultimate tool is to overcome the distinction between owner and employee (Dow, 2003). Closely related to the productivity effects the theory predicts a lower turnover of the employees because of the higher motivation and because employee ownership is more likely to be found in firms with high investment in specific human capital. In a meta-study combining the results of 26 econometric empirical studies Kruse (1993) finds strong support for a positive relation between productivity and profit-sharing. These results are also confirmed by Perotin and Robinson (2003). They stress that studies from more than 20 countries covering several tens of thousands of enterprises agree that financial participation has a positive or neutral effect on productivity, and schemes that offer a larger financial involvement have higher productivity effects. They find that cash profit-sharing schemes seem to have a short-term effect, whereas share schemes, which are more long-term oriented, seem to have a more sustained effect. Many studies point in the direction that the combination of financial participation in the company results and well informed employees active participating in decision making give the highest effect on labor productivity (Kruse and Blasi, 1997). Conte and Svejnar (1990) finds mixed results for ESOPs and concludes that they do not mean lower productivity. For cooperatives they find increasing productivity. In a review of the empirical evidence for transition economies Jones (2004) finds that employee ownership either have a neutral or positive effect on productivity.

The direct connection to the company results e.g. in the form of profit sharing (Weitzman, 1984) or the form of employee ownership is predicted to give more flexibility in wage settlements. Employees are willing to accept lower wages because they get a share in the results of the company. This also leads to the prediction that employment will be more stable and income for the employees more volatile in companies with employee financial participation. In their review Perotin and Robinson (2003) find little evidence for the stability of employment, however they find some indication that profit-sharing firms may respond less to downward demand shocks and more to upward shocks than other firms.

The classical theory of labor management in the form of “Illyrian firm” based on the Yugoslav model (Ward, 1958), and further developed by Vanek (1970), states that this type of collectively employee owned firm maximizing the average income per labor has some “perverse” short run adjustment in the form of a negatively sloped supply curve. This theory, however, has quite restrictive assumptions including collective ownership where employee owners cannot recuperate capital gains. By relaxing these assumptions and/or by assuming individual ownership the goal of the employees align with maximizing profits. Furthermore, this Illyrian theory has been contradicted by the empirical results (Sertel, 1982; Mygind, 1987).

If the employees cannot get capital gains there is also less incentive to invest in the company beyond the time where the employee expect to leave the company (Vanek, 1971). This can again be solved by individual ownership. However, the newer theory (Dow, 2003) related to the lack of commitment from external capital suppliers e.g. banks because they assume that employee owned companies will follow other goals than profit maximization, lead to financial constraints which again can explain lower investment levels in employee owned companies. This is actually confirmed in several studies including those for East European companies (Mygind, 2000). Lack of capital may also indicate that this type of companies will not be able to restructure so deeply. Studies on Estonian firms confirm to some extent this tendency, but the contrast to other kinds of firms is only significant in relation to foreign owned enterprises (Hobdari, 2003).

The experience of employee financial participation in the Baltics

The experience with employee financial participation has in the Baltic countries been dominated by employee ownership in relation to the privatization process. However, these often majority employee owned enterprises were in later stages often transferred to other majority owners sometimes leaving some employees with minority shares. Other forms of employee participation such as profit sharing has only limited prevalence and participation of employees in the company board without formal ownership have not been on the agenda except in a very recent discussion related to European Companies defined by EU rules, but this phenomenon has only marginal importance in the Baltic countries.

The first elements of employee ownership were related to the early Soviet reforms during the Gorbatjov period. The “new cooperatives” started up in the late 1980s were a preliminary form of employee majority ownership. Formally the entrepreneurs starting up these new businesses – restaurants, small shops, personal services etc. – had to share the ownership with the employees. Later, when it became legally possible the managers often took over the full ownership. Leasing by the worker collective was also a way to transfer smaller enterprises or a part of a larger enterprise to the employees. Later in the process employees and/or managers used the option to buy these enterprises. These early private companies had the highest frequency in the Baltic countries compared to other parts of the Soviet Union (Frydman et al, 1993).

After getting independence the Baltic countries developed their own specific forms of privatization. An important distinguishing factor was the existence of a large group of Russian speaking employees in Estonia and Latvia. Here, the national question dominated politics in the early years and was an important explanation why the early laws for small privatization with high advantages for employees quite soon was changed and the favourable treatment of employees were abolished. In Lithuania, on the contrary, the support for employee takeovers increased in the early years after independence and the first and largest wave of privatization in Lithuania gave strong advantages to the employees resulting in a quite high number of majority employee owned enterprises also in quite large and capital intensive enterprises (Mygind, 2000). The advantages for employee were taken away in 1992-93 in Estonia and Latvia while in Lithuania they endured to the summer 1995.

In most cases in Eastern Europe including the Baltic countries employee ownership was established through individual share ownership. There was no direct link between the job contract and ownership. The employees got individual shares through the privatization process at discounted prices. However, for new workers entering the firm at later stages there were no automatic offering of cheap shares. Likewise, for leaving employees there was no obligation to sell. Therefore, changes in the workforce meant strong tendencies in the direction of diluting the proportion of owners among the employees (Kalmi, 2002). In the first years of transition with inflation eating up the savings and the real wages of most employees this liquidity constraint was an important reason for fast sale of employee shares after privatization. Furthermore, there was a serious commodification problem (Dow, 2003) with no well-functioning market for employee shares and no mechanism for a fair valuation at exit. Thus, these shares were mostly sold at undervalued prices because the employees had no information about the real value and because the managers who often were the buyers controlled the process of buying and selling shares (Mygind and Kalmi, 2006).

Another exit route for an employee owned company could be related to the lack of sources for external capital. The evidence shows bank loans to be most restricted for employee owned companies (Mygind, 2000). Because of the reluctance of banks and external minority investors, especially, employee owned companies did not get the necessary funds for investments. Instead, an external investor with the necessary capital took over the majority of shares and took control with the company. Such takeovers also happened in successful employee owned companies where the employee owners because of the high value of the company got offers to good to decline (Mygind and Kalmi, 2006). Therefore, a frequent ownership cycle in the Baltics was observed to be: first employee ownership followed by management takeover and then ending up with outside external ownership often by foreigners (Jones and Mygind, 2006)

Exit of companies is frequent in a dynamic economy. The problem for employee ownership, especially, in the transitional economies, was that nearly no new employee owned enterprises were started. The development of the number of employee owned companies can be characterized by a ratchet effect with a lot of majority employee owned companies started in relation to privatization, but when they over time closed down or were taken over by other owner-groups there were no or very few new-coming employee owned companies to fill the holes.

Companies are often started up as greenfield or spin-offs by a small group of employees. If employee ownership is not part of the founding idea, but only an instrument to realize a certain business opportunity, the successful growth of the company means that the ownership stay concentrated in the hands of a few founders and does not include new-coming employees. Only in cases where such new companies are institutionally bonded by rules demanding that all employees are offered the possibility to join like in the US ESOPs it can be expected that employee ownership is sustainable. However, the favorable institutional setting for employee ownership in the Baltics was limited to the early privatization process. Later in the process the advantages for employees were abolished and there were no institutional rules to support employee ownership by facilitating entry and exit of employee owners and by developing a structure for external finance (Mygind, 2000).

Manager surveys done in all the three Baltic countries (Mygind, 2002abc) show that profit-sharing was only found in very few enterprises in the end of the 1990. Case evidence shows, however, that it has probably increased in the later years as one of the tools to try to keep the employees in the company and in the country, avoiding migration to one of the old EU countries like Denmark, UK or Ireland. Migration of some of the young highly educated workers has been an increasing problem, especially in Lithuania in the later years. Some case evidence collected in the research project behind the following country articles also point to examples of large companies where minority employee shares are used as a way to motivate employees. However, it was difficult to find professional companies, lawyers, architects etc. with ownership by the group of core employees.

Conclusion and some perspectives for the future.

Different forms of employee financial participation are now more widespread in the old EU countries than it is the case in the new member states. Also in US employee ownership play an important role as part of the explanation of highly motivated employees and strong developments in labor productivity, especially in sectors with high knowledge intensity.

In many of the new member states including the Baltic countries we have seen a boom in employee majority owned enterprises in relation to the privatization process. This was especially the case in Lithuania where the large privatization favored employee takeovers and opened for majority employee ownership also in large and capital intensive companies, while employee ownership in Estonia and Latvia was connected to the privatization of small enterprises and leasing of a group of medium sized enterprises. However, it seems that the introduction of employee ownership happened at a stage when the three Baltic countries were not ready to exploit the potential of employee financial participation. There were no institutions to value the employee shares and to facilitate trading at fair prices; there were no regulation for giving new coming employees the opportunity to buy employee shares; most employees were in strong need of extra money to cover the losses of steeply falling real wages in the first years of transition; the employees were not included actively into the decision process. Managers were in a strong position to take over the employee shares at very low prices. Thus, most majority employee-owned enterprises changed to manager ownership and often to the next stage in the governance cycle to outside domestic or foreign ownership.

Furthermore, there was a change in policy towards employee financial participation. In Estonia and Latvia the advantages for employees in privatization only covered the very first years of small privatization. In Lithuania the change came later after the end of the first big wave of privatization in the summer of 1995. Since then there were no legislation or initiatives promoting employee ownership or other forms of employee financial participation. This meant except for a few cases other forms of employee participation such as profit-sharing has never developed in the Baltic countries. Employee ownership turned out to be a temporary phenomenon. From being in the front in EU in relation to employee financial participation the three Baltic countries are now in the low ranks.

However, there are some new tendencies that may change the situation. First, after the steep fall in GDP in the first years of transition the Baltic economies are now fast catching up showing the highest growth rates in Europe. This means steeply increasing real wages and wealth of the employees. Pension systems are being built up, and it starts to be realistic to assume that employee shares can be part of the increasing savings. Secondly, foreign companies are bringing their systems for motivating employees to the Baltics. This includes minority employee shares, profit sharing and other types of employee financial participation. Thirdly, the increasing level of production, the increasing weight on knowledge based production means higher emphasis on human capital and more room for and effect of different forms of employee financial participation. Fourthly, as documented in the earlier PEPPER Reports employee financial participation are developing in many of the old EU countries and EU is recommending and promoting different schemes. Therefore, it can be expected that the three countries in the future to a much higher degree will start to exploit the potential of employee financial participation.

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