

**RIGA TECHNICAL UNIVERSITY**  
Faculty of Engineering Economics and Management  
Institute of National and Regional Economy

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**DEVELOPMENT OF EMPLOYEE SHARE OWNERSHIP IN  
LATVIA**

**Summary of Doctoral Dissertation**

Scientific Advisor:  
Dr. oec., Professor  
**Inna DOVLADBKOVA**

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## DOCTORAL DISSERTATION

### PROPOSED TO THE RIGA TECHNICAL UNIVERSITY FOR THE PROMOTION TO THE SCIENTIFIC DEGREE OF DOCTOR OF ECONOMICS (Dr.oec.)

The Doctoral Dissertation has been developed at the Institute of National and Regional Economy, Faculty of Engineering Economics and Management of Riga Technical University. The defence of the Doctoral Dissertation will take place at the open meeting of the Promotion Council "P-09", RTU Faculty of Engineering Economics and Management on the 26<sup>th</sup> of November, 2013, Kalnciema Street 6, Riga at 14:00 p.m., room 119.

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#### CONFIRMATION

I hereby confirm that I have written this Doctoral Dissertation which has been submitted for review to Riga Technical University for the promotion to the degree of Doctor of Economics (Dr.oec.). This Dissertation has not been submitted to any other university in order to receive any scientific degree.

Anželika Berķe-Berga \_\_\_\_\_

The Doctoral Dissertation has been written in English. The Dissertation, without appendixes, is presented on 189 pages. The Dissertation consists of the introduction, 3 chapters, conclusions, proposals and the list of references; it contains 14 appendixes, 17 figures and 15 tables. The list of references contains 114 sources of information used to complete the Doctoral Dissertation.

The Doctoral Dissertation and its Summary are available at the Scientific Library of Riga Technical University, Ķīpsalas Street 10, Riga.

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## **GENERAL REVIEW**

During the past decade the economy of Latvia has experienced both rapid growth and deep recession. The cyclical nature has reflected highly in employment. During the time we were going to join the European Union and after obtaining the membership employers faced with a disproportionate increase in wages, problems of attracting skilled and highly qualified workers, as well as frequent staff turnover. According to the data of Latvian Central Statistical Bureau (CSB), the average salary in Latvia from year 2004 until the end of 2008 increased on average by 21% per year. Thus issues of employment and wage stabilization were topical. And after 2008, when the global financial crisis began, the situation in Latvia changed rapidly. Most of Latvian businesses were forced to make redundancies - the unemployment rate from 2009 till 2011 increased on average by 8.4% per year, leading to an increase in social tension and pressure on the public welfare budgets. Many Latvian residents, forced by circumstances, had to leave the country because they began actively searching for sources of livelihood abroad. As the situation stabilized, since 2012 businesses in certain sectors (for example, information and communication services, etc.) again faced with lack of skilled workers.

This reflects the fact that the Latvian current issues are related to the regulation of wages and salaries, employee turnover, loyalty, retention of specialists in a company, etc. One of the possibilities for improvement are employee share ownership (hereinafter - ESO). World practice has shown that ESO can contribute to employee motivation and the resulting factors. Employee share ownership has the potential to contribute to multiple objectives: to increase employee motivation, competitiveness of the company, product and service quality, to regulate and normalize unreasonably high employee migration, to promote the formation of long-term savings, public welfare, equal distribution of income, to reduce the effects of the economic cycle as well as improve staff knowledge of the business. ESO means making employees co-owners of the company, by giving them shares of the company. Thus, the employees may self-identify with the company, be more interested in its activities, and suggest their ideas, share experiences, participate in the monitoring process to be more motivated to perform their work with maximum efforts and quality.

Nowadays, ESO plays an important place in scientific research of human resource management (HRM). Enterprises in the world's developed countries (e.g. USA, UK, France, Ireland, Japan, etc.) have used ESO for decades. In strategic management one of the most

effective long-term employee incentive financial instruments is ESO. If the type of ESO is properly selected, meets business objectives and HRM policies, all stakeholders can derive the benefits from it - employees, contractors, and the state. An important prerequisite for existence and development of employee share ownership is creating the environment for it, including legislation and public awareness.

World studies on employee financial participation are widely spread. Issues of employee financial participation, including the employee share ownership, have been studied by several researchers. The most prominent of these are J. Blasi, D.Kruse, A. Pendleton, E. Poutsma, W. Nijs, A. A. Alchian, M. Jensen, etc.

Most empirical studies of ESO (M. Conte, S. Estrin, etc.) point to its positive effects. From studies of the practical examples of ESO models in companies, it is known that about 67% of the models have been effective in 22% - the result is neutral, and in 11% of cases, the result has been negative. The main economic arguments in favour of employee share ownership are based on increase of the motivational level of employees. This - more flexible - pay system promotes higher level of employee loyalty the company, more awareness of their work, as well as prevents employee turnover. ESO model in a company could also benefit from highly qualified staff retention, improve teamwork, work organization and workers' desire to advance them.

The positive impact of ESO is impugned by American scientists Cory Rosen, John Case and Martin Staubus. In their view, the introduction of ESO alone does not automatically mean the change in attitudes and outcomes of employees. It depends on the formation of owner's psychology in the employees. Owner's attitudes may be established if in the ESO model employees have: appropriate amount of shares (which the employee considers sufficient); the company creates the internal culture that helps employees to feel as co-owners; and there is a shared understanding of the business and common target.

In Latvia ESO is not widespread. There is lack of legal framework of the different forms of employee financial participation, and the existing tax provisions discourage entrepreneurs to use ESO. It is approved also by the local researchers and international experts. The situation is complicated by the fact that there is no legislation regulating modern legal framework for ESO in Latvia. Laws, which refer to any of the ESO form, are limited to the shares of employees. In tax laws personnel securities are not distinguished or included in the wage, so that they are applicable to these taxes: personal income, business income, income from capital gains tax and social

insurance contributions. It is not possible to apply the equivalent tax advantages for ESO as there are for life insurance savings or private pension funds. Consequently, the entrepreneurs use ESO very rarely, they prefer the above mentioned bonuses because they are easier to be administered and they are tax-advantageous. But these bonuses do not give employees ownership and voting rights. For the development of ESO in Latvia there have been discussions between the Latvian government and the social partners (employers' representatives, trade unions), but the matter was postponed for an indefinite period.

The issue of employee share ownership has been studied relatively little. Mostly, the studies have been done about the privatization period and the experience during that time. These studies and the major results are discussed and analysed in this thesis. This thesis will examine the implementation of personnel security concept in theory and in practice, and it will be applied for Latvian economic conditions.

In this dissertation ESO is being analysed in the context of employee motivation. Employee motivation, increase of competitiveness and promoting the firm's resources to make best use is in connection with the management sciences. Consequently, the study is related to science: management, the sub-sector: business management<sup>1</sup>.

The main research question of this thesis is: *what are the opportunities of ESO use in Latvia?* This issue is divided into three sub-questions which are research questions:

- 1) What is the theoretical background of ESO and its impact on employees, business owners and the state?
- 2) What is the experience regarding ESO and its models in the European Union countries?
  - a. What is EU best practice in the field of ESO?
  - b. What is the Latvian historical experience of employee share ownership and the current situation?
- 3) What should be the ESO model in Latvia?
  - a. Basic conditions of the model.

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<sup>1</sup> According to the classification No.41.1 of The Council of Sciences of Latvia

- b. How ESO would influence employee motivation and the related factors in Latvia?
- c. What is the business owners' view on the ESO model and its implementation possibilities in Latvian companies?

These research questions form the basis of the thesis structure, which is divided into 3 parts. The research design of this dissertation is presented in Figure 1.

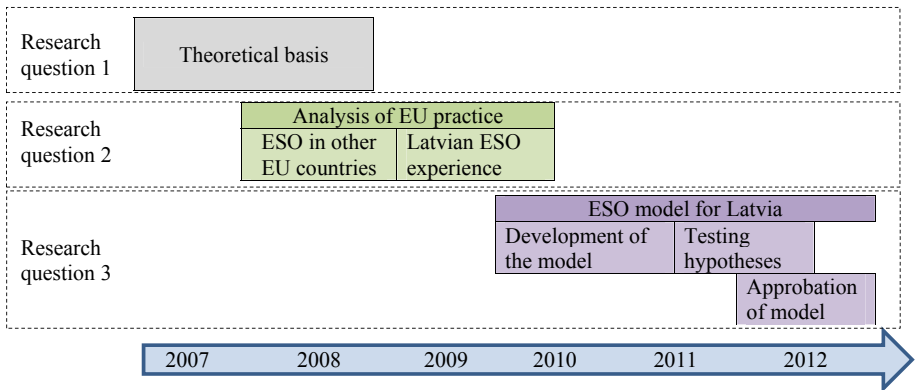


Figure 1 **Research design of the Doctoral dissertation**

The main **goal** of the thesis is based on a comprehensive analysis of theoretical and practical issues of employee share ownership, identifying the ESO problems in Latvia and development of ESO model which would be relevant and useable in Latvian companies.

According to the main goal there are following **tasks**:

- 1) In depth analysis of theoretical aspects of employee share ownership;
- 2) Analysis of ESO related theories, benefits and risks for employees, business owners and the national economy;
- 3) The evaluation of ESO usage and specifics in different European Union countries;
- 4) Identification of studies and problems related to ESO in Latvia;
- 5) Conduct of studies and analysis of the results about opportunities of employee share ownership in the Latvian economy;

- 6) Development of recommendations concerning changes to Latvian law and taxation to promote employee share ownership in Latvia;
- 7) Development of ESO methodological principles and methodical guidelines, which would be applicable for medium and large companies in Latvia;
- 8) Finding out the opinion of employees of Latvian medium and large joint stock companies regarding ESO and its potential impact on improvement of employee motivation and the related factors;
- 9) Practical approbation of the developed ESO model and the development of proposals for its practical application in Latvian enterprises.

### **Research object and subject**

The *object* of research is the employee share ownership as an improvement factor for employee motivation.

The research *subject* is the development of employee share ownership model implementation conditions for Latvia.

### **The theoretical and practical methodological basis of the research**

The theoretical and methodological background of this research is theoretical literature on economic and management issues, works of foreign researchers and scientists concerning employee share ownership concerns. The ESO is viewed in context with employment, motivation, productivity, economic benefit and other related issues.

The researchers who have done research about ESO in different contexts are:

- 1) Motivation theories context – M. Armstrong, H. Murlis, R. M. Steers, L. W. Porter, G. A. Bigley;
- 2) Human resource management context – S. P. Robbins, T. A. Judge, C. Rosen, J. Case, M. Staubus, P. Milgrom, J. Roberts, R. E. Walton, P. R. Lawrence;
- 3) Strategic management context – R. E. Freeman, M. Hamberg;
- 4) As principal – agent problem solving tool – M. C. Jensen, W. H. Meckling, J. B. Wolf;
- 5) Corporate governance context – D. H. Chew, S. L. Gillan, K. A. Kim, J. R. Nofsinger;
- 6) As instrument for rewarding company's top management – J. M. Fried, J. Newmann, et.al.



The information base of this thesis consists of literature, international publications, legislation, international studies and some unpublished materials according to the research subject.

The methods used in development of this thesis are – deduction, induction, analysis, synthesis, system analysis method, and special methods of quantitative and qualitative research.

### **The scientific novelty of the Doctoral Dissertation**

The research results of this thesis provide the following major scientific novelty to support the scientific importance of the thesis:

1. The author has specified the economic concepts of employee participation, employee involvement, employee financial participation, employee share ownership; the complete concept of employee financial participation is defined and classified. The concept of employee share ownership is formulated.
2. ESO has been viewed with in-depth scientific and theoretical research from points of view of stakeholders - employees, employers and the society. This is the original context of the study. This view is important to understand the benefits and risks of involved stakeholders, and development of recommendations for the national ESO model.
3. The author has done deep situation analysis regarding ESO experience in Latvia, based on available research and the results of author's qualitative research (expert interview). The found shortcomings and problems form the basis for the development of recommendations for harmonization of changes in legislation regarding ESO in Latvia.
4. The author has developed an ESO implementation model for Latvia, which contains:
  - a. Methodological principles and methodical guidelines for employee share ownership (share based profit sharing, share purchase plan and stock options) for the practical implementation in the company;
  - b. Proposals for the improvement of the legal basis and tax incentives for creating environment for development of employee share ownership in Latvia. These proposals are intended for these laws: the Commercial Law, the Law on state and municipality shares and companies, the Law on personal income tax, the Law on state social insurance, and the Law on corporate income tax.

The model has been approbated by a separate study – in-depth interviews with executive representatives of large and medium joint stock companies.

5. Significant results were obtained from quantitative research, survey of employees of large and medium joint stock companies. The main results of the study show a positive relationship between employee share ownership and motivation, as well as the other related factors. The results show that employees have a positive attitude towards the acquisition of shares in a company in which they work. This type of research study in Latvia is performed for the first time.
6. Recommendations for pan-European international organizations active in the social dialogue about employee financial participation matters. These recommendations concern ESO development start-up and promotion of ESO in Eastern European countries.

### **The theses presented for the defence**

- 1) The employee share ownership model has been approbated and is applicable for use in Latvian companies. The model contains recommendations for improvement of the legal basis, methodological principles and methodical guidelines for implementation of these ESO plans: share based profit sharing, share purchase plan and stock options. The model is applicable for large and medium enterprises. It will contribute to achieving the following objectives:
  - a. For employees – improvement of motivation, additional income, participation and ownership in the enterprise, creation of long-term savings;
  - b. For employers – improvement of employee motivation, productivity and competitiveness, employment stability, reducing the tax burden, solution of principal – agent problem;
  - c. For the state – stabilization of labour market, redistribution of income, savings promotion, adjustment of domestic demand.
- 2) For the development of employee share ownership in Latvia it is necessary to improve the local legislation by developing appropriate amendments to the laws:
  - a. In Commercial Law – provide the definitions of ESO types and plans and the procedure of granting and alienation of employee shares; provide the opportunity for entrepreneurs to decide themselves whether to give the voting rights to employees or not;

- b. In the Law on state and municipality shares and companies – include shareholding employees of enterprises of state and municipalities into the list of recipients of the dividend;
- c. In the Law on personal income tax – define equivalent tax incentives as for existing incentives for savings in private pension funds and life insurance savings;
- d. In the Law on state social insurance – define equivalent tax incentives as for existing incentives for savings in private pension funds and life insurance savings;
- e. In the Law of corporate income tax – include the deductions of ESO plans in the list of tax-free spending. The maximum amount of these deductions would be 10% of gross wage of each employee involved in the ESO plan.

### **The hypothesis of the research**

To promote the motivation of employees of Latvian companies to higher levels, it is useful to create the employee share ownership model.

### **Scientific publications**

The research results have been published in these reviewed scientific publications:

- 1) Berķe-Berga A. *Employee ownership model for Latvia*// Scientific Journal of Riga technical University. Series: Economics and Business. Vol.23 – Riga: Riga Technical University Press, 2013 – 6-12 p.;
- 2) Berķe-Berga A. *Employee share ownership as a productivity promoting factor* // Riga Stradins university, Scientific Proceedings: Social Science Field Research Publications of year 2011: Economics. Communication. Politics. Sociology. Social Policy and Social Work. Rights. - Riga: RSU, 2012. – pp. 36-41;
- 3) Berķe-Berga A. *Employee share ownership*// RSU interuniversity scientific conference proceedings „European Union: Treaty of Rome 50 years”. – Riga: RSU, 2008. – pp. 33-47;
- 4) Berķe-Berga A. *Securities as a motivating factor for employees*// Scientific proceedings of Riga Technical university. – Riga: RTU, 2007. – pp. 16 – 21;
- 5) Berķe-Berga A., Dovladbekova I. *Long term capital formation problems in Latvia*// Economic and Business Development Issues, RTU International Scientific Conference Proceedings. – Riga: RTU, 2004. – pp. 31-39;

- 6) Berķe-Berga A. *Life-insurance sector problems in Baltic States* // Scientific proceedings of Riga Technical university. Part 3, Economics and Business. Volume 9: Economy: Theory and Practice. – Riga: RTU, 2004. – pp. 32-38;
- 7) Berķe-Berga A., Dovladbekova I. *Pension funds - factor contributing to the economic development in Latvia*// Business Opportunities, Problems and Solutions Concerning Globalization. – Riga: Turība Business School, 2004. – pp. 39–45.

The author of this thesis is also the co-author of the Institute of European Studies study: A. Gaponenko, A. Berķe-Berga, I. Dovladbekova, O. Lukašina, R. Ivanovs „*European experience of employee financial participation and possibility of its implementations in Baltic countries*”<sup>2</sup>, Institute of European Studies, 2008, 103 P. VS/2007/0545 European Commission (EC). The study has been done within EC Project VS/2007/0545 „Strengthening the Social Dialogue in the Baltic Railway Companies disseminating the experience of employee involvement in employee financial participation”.

Results of the thesis are presented at international scientific conferences:

- 1) Riga Technical University 53rd International Scientific Conference dedicated to the 150th anniversary, 11-12 October 2012, *Employee ownership model for Latvia*;
- 2) Riga Stradins university Scientific conference on March 18-19, 2010, VIII Section „Transformation of the political, economic, social and legal systems in Latvia and the world: current realities and future contours”, subject: „*Employee share ownership as a productivity promoting factor in Latvia*”;
- 3) Interuniversity scientific conference “European Union: Treaty of Rome 50 years”, subject: “*Employee share ownership*”;
- 4) Riga Technical University 45th international scientific conference on October 15, 2004, subject: *Life-insurance sector problems in Baltic States*;
- 5) Turība Business School 5th international scientific conference on April 23, 2004; subject: *Pension funds - factor contributing to the economic development in Latvia*;

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<sup>2</sup> Darbinieku finansiālās līdzdalības pieredze Eiropā un tās ieviešanas iespējas Baltijas valstīs

- 6) Riga Technical University 44th international scientific conference on October 9, 2003, Section of National and Regional Economy, subject: *Long term capital formation problems in Latvia*.

The author has participated in international conferences and seminars in the discussion process on employee financial participation in the European Union:

- 1) International conference „Financial Participation in the EU-27” Berlin, October 2007
- 2) International conference "Employee financial involvement and participation" Riga, November 15, 2007.
- 3) Seminar on "Transparency and the information and consultation provided to workers who participate in financial participation schemes", Riga, Latvia, March 22-23, 2010.
- 4) Conference „Financial participation: a tool for better social dialogue and better corporate governance”, Brussels, Belgium, October 14-15, 2010.

This Doctoral Dissertation is an independent research and it has been written in Latvian. It consists of an introduction, three main chapters, conclusions and proposals, bibliography and appendices.

### **The practical approbation and application of research**

The most significant results of this thesis are presented and discussed at scientific conferences, national and international seminars and discussions, included in the syllabus of bachelor study courses developed by the author, and EU projects. The developed ESO model is piloted by qualitative research study - expert interviews - with the participation of nine experts - senior executives of the large and medium-sized Latvian joint-stock companies from different sectors. Author of the thesis has approved research results in these research projects:

- 1) „Strengthening the Social Dialogue in the Baltic Railway Companies disseminating the experience of employee involvement in employee financial participation”, Project financed by European Commission, No. VS/2007/0545;
- 2) Project of Latvian Council of Science „Development of human capital as increasing factor for Latvian economic competitiveness” Project No. 05.1897, 2005- 2008;
- 3) Participation in the project of Latvian Council of Science “Investment environment and investment policy development in the context of economic integration”, project No. 02.0937, project completion time from September 2004 till the end of 2004.

The research results and materials have been used in teaching at RSU Faculty of European Studies in the following bachelor courses: "Securities Market. The European Experience" and "International business and finance environment", as well as bachelor and study paper scientific advising for RSU bachelor's program students.

### **Research restrictions**

The paper does not include in-depth analysis about the related side issue research of employee share ownership, such as accounting, bookkeeping, tax administration, business and capital assessment, motivation or productivity calculation, the non-financial participation, profit sharing, etc.

### **Volume and content of the Doctoral Dissertation**

The total volume of this dissertation (excluding appendixes) is 189 pages. The thesis contains 17 depictions, 15 tables and 14 appendixes. The list of literature contains 114 references and sources of information.

*The first chapter* deals with the development of the concept of "employee share ownership", and the related terms and their description. The theory of employee share ownership is being viewed from the stakeholders' perspectives (employees, employers and the state) that form the social dialogue on this issue.

*The second chapter* examines and analyses the experience of employee share ownership in European Union countries. It looks at the European Commission's view and meaning and role of international employee share ownership institutions, and developed documents of these institutions - Model plan, TOBEQU<sup>3</sup> and PEPPER<sup>4</sup> reports. Another part of this chapter analyses the models of employee financial participation in several European countries: employee share ownership in Denmark, Belgium, the UK and Austria; and profit sharing in France, Finland, the Netherlands and Germany. Also in this chapter the author analyses Latvian experience of employee share ownership since year 1990 including the surveys carried out in Latvia about employee financial participation including employee share ownership.

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<sup>3</sup> Project „Towards Better Quality of Financial Participation of Workers in CEE”

<sup>4</sup> Reports of EC „Promoting Employee Participation in Profits and Enterprise Results”

*The third chapter* focuses on the analysis of the results of the author's three empirical surveys. The author there has developed employee share ownership model for Latvia, which includes recommendations in national and company level. The model consists of recommendations for improvement of the legal basis and the methodological principles and methodical guidelines for adoption of employee share ownership in enterprises. The author also conducted a quantitative study, which was designed to test the main hypothesis of this thesis. As a result of this study the hypothesis is confirmed. In order to make practical approbation of the employee ownership model, the author carried out a qualitative study, which approved the model.

## **THE MOST RELEVANT SCIENTIFIC RESULTS OF THE RESEARCH**

### **1. THEORETICAL SUBSTANTIATION OF EMPLOYEE SHARE OWNERSHIP**

Employee participation is a field of human resource management policy that includes the rest of forms of participation (financial and non-financial participation, and variations of those, including ESO). The main goal of employee participation is integrating employees into the business, thereby contributing to their higher levels of motivation, confidence in the organization, job satisfaction, striving for higher levels of productivity and competitiveness. Employee participation, types of it, and place and role of ESO in employee participation is schematically illustrated in Figure 1.1.

*Employee financial participation* (EFP) includes employee share ownership and profit sharing. EFP is a type of employee ownership which allows the employees to participate in sharing company's profits. EFP is mostly being organised as participation in distribution of additional income or profit and/or gives an opportunity to obtain the shares of the company. The employer grants the benefit in addition to regular salary depending on the economic results of the enterprise. The results may be measured by such indicators as profitability, output, cost savings, improvement of quality of production or services, etc. The main goal of EFP is the partly attraction of employee's income to the financial success of business. The employees' interest about EFP comes through the opportunity to get additional income and if it is provided – a chance to participate in decision making process in an enterprise.

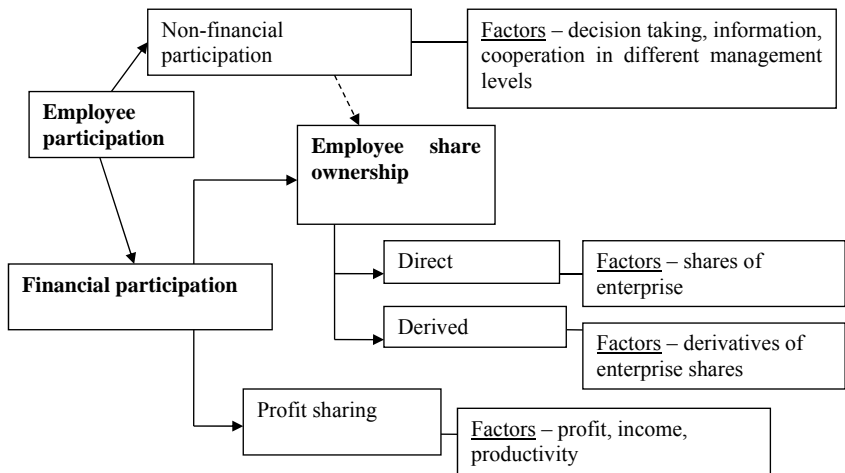


Figure 1.1 **Structure of employee participation**<sup>5</sup>

Employee financial participation is usually divided into two sub-types – profit sharing and employee share ownership. The profit sharing intends company's profit sharing for the current or previous year. Employee share ownership relates to the right and opportunity of getting company's profit through share value increase and/or dividends in the more distant future and participation in decision making process.

The author offers such definition of employee share ownership: *employee share ownership is participation of employees in redistribution of financial results of their employer's company with getting the company's shares or their derivatives, in order to increase employee motivation and productivity.*

Although the ESO is a type of EFP, in the structure of figure 1.1 the author partly includes employee share ownership into non-financial participation. This is due to ESO nature – it contains not only the financial benefit, but also non-financial.

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<sup>5</sup> Figure developed by the author



Summing up the characteristics of types of employee financial participation, the author has formulated the main differences of profit sharing and ESO (see Table 1.1).

Table 1.1

**Differences of types of employee financial participation<sup>6</sup>**

Criterion	Profit sharing	Employee share ownership
Difficulty of the model	Medium	High <sup>7</sup>
Risk for employee	Risk of changing future income	Risk of negative change in asset value
Liquidity	High - cash	Depends on whether the company is on the stock exchange and liquidity of shares
Performance period	Short term profitability <sup>8</sup>	One can value the performance after the “freezing period” of shares – current and future value of shares
Linking to the value of company’s shares	Indirect	Direct
Linkage to company’s profits	Direct	Semi-direct
Taxation aspect	Subject to income and social tax. Some countries have tax deductions for profit sharing	Subject to income, social and capital gains tax. Some countries have tax deductions for ESO
Accounting	Classified the same as salary	Depends on the type of ESO

The author uses the term *model* to describe employee share ownership and/or its logical types, a general description, which reflects the essence of participation, it’s most important features and principles, employee engagement intensity, etc.; and plan to designate specific forms of participation. Consequently, the concept of *model* in this work will be comprehensive, covering all the ESO implementation and enforcement issues related to the company. The plan is used to identify the way in which the shares are granted to employees.

The types of ESO that author analyses in the dissertation are:

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<sup>6</sup> Table developed by the author

<sup>7</sup> It depends on the type of ESO. Most often it is more difficult to implement ESO because it contains specific tuition of employees, more expenses in implementation of the model and more difficult accounting.

<sup>8</sup> Usually the bonus is paid after fixation of earnings

- 1) *Employee shares*. In this type of ESO employees may purchase or they are provided (free of charge or at a substantial discount) the shares that may be with or without voting rights. Sub-types of employee shares are:
  - a) *Share purchase plan* – in this plan predefined proportion of the company's shares is reserved for employees, and they are generally available to them at a discount or in combination with other shares (the principle of "get 2 for 1 price"). Thus employees can benefit financially by receiving dividends or share appreciation or both.
  - b) *Free shares or share based profit sharing* is a type of ESO where predetermined amount of company's profit is set aside to purchase company's shares to grant them to employees or hold them in a special fund. These shares are locked in for a certain period after which the employees are free to act with the stocks as they wish" [107, 11]. In this case, the employees receive the shares free of charge.
- 2) *Employee stock options* – employees have the right to buy company's shares at a predetermined price over a specified period in the future. Option purchase price is usually close to the current price or with a slight difference. Employee stock option period usually lasts for several years (typically 3-10). Employee financial benefit is resulting from the market and the share option price differences.
- 3) *Employee stock ownership plan* – predetermined amount of the company's share capital accumulation and shift into a special fund.

Studies of ESO analyse the impact of ESO on the business, its owners and the interests of employees, etc. However, in order to do a complete assessment of the economic importance of ESO, it is necessary to investigate its impact on all stakeholders – business owners and employees, as well as the country as a whole. Consequently, the author of this thesis has done theoretical analysis of the benefits and risks of ESO from points of view of three involved parties, namely, employees, employers and the state. This in-depth view is the theoretical novelty of the thesis.

Key benefits from ESO for employees are related to motivation, financial benefits, as well as social and emotional benefits. ESO provides the potential for additional income - dividends, profits, stock appreciation, interest, saved taxes (for relief from the expense, if any is intended), earnings per share at the expense of discounts (if the company's shares are granted at a substantial discount).

One must note that the motivating effect of the ESO model on **employees** can only happen if the value of the shares granted to an employee seems significant for him/her. Employee must consider it worthwhile and adequate compensation for their extra work, sharing of experiences, initiatives, etc. Regarding employee involvement in ESO, employees, and employers need to consider the factors dependent on their act or omission, as well as external risk factors. Factors dependent on employees are related to their work skills and abilities, level of expertise, as well as whether those employees would be interested to do additional to get a higher rate of return if they receive any of the ESO bonuses. They also need to understand the nature of participation and all of its aspects, such as the risks that are not related to employees and their role of changing the value of shares. These risks may be the stock market trend reversal, cyclical economic fluctuations, changes in consumer preferences, business changes and instability, etc.

As the ESO models are mostly long term models, the resources they accumulate can be used to create additional savings and security for retirement. When participating in an ESO model the employees should take into account a number of risk factors. These are stock value fluctuation risk, equity assessment risk and diversification risk. During the introduction of ESO models, these risks must be taken into account and employees must be informed about the possibility of them.

Employee share ownership is also an important social and emotional gain tool for employees. ESO allows employees to self-identify with the company and its owners. This may result in an additional sense of security and general interest in the company's activities.

ESO can be used in a **company** to achieve several objectives - motivating employees, increasing productivity, improving the stability of work environment, continuity in the company, compliance of owners' interests, etc. Thus, employee motivation, productivity and stability improvements, increase the company's competitiveness both domestically and internationally. ESO can be used as an element of corporate financing. In this perspective the share employees' holdings should be gradually increased. ESO can improve the company's level of independence on the bank loans and improve its financial performance. In exceptional cases, it may even be a solution for corporate restructuring case.

Motivation of employees with ESO models is a long-term remuneration method. ESO models can motivate employees to focus the long-term strategic goals. Long-term remuneration methods establish and maintain long-term incentives, because the employee receives / has the right to use the shares at the end of the ESO period.

One of the reasons why entrepreneurs adopt the ESO models is increase of productivity level. This may include issues such as performance of production quantity or quality, service, changes in staff attitude towards the employer (company) and its customers and partners, as well as greater effectiveness of professional development activities, etc.

However, ESO productivity gains should to be viewed as a miracle - that any business where it is introduced will definitely increase productivity. Employee attitude change in ESO model depends on how the company is structured and how it is controlled [38-31]. Attitude of the staff after introduction of ESO model may change if there are three prerequisites:

- 1) The amount of stocks granted to employees is sufficient for employees;
- 2) The company's internal culture helps employees feel like co-owners;
- 3) A common understanding of the business and shared objectives.

The attitude of the staff after implementation of the ESO model will not change at once, immediately. The attitude change depends on the total value of shares granted. It also depends on employee education level that helps them to understand the nature of participation and ownership.

There is also a critical point of view about productivity with implementation of ESO because it is possible that each group will have employees who will avoid unnecessary effort and use selfishly collective gain opportunities [50, 777-795]. In theory it is commonly referred to a free-rider problem. Free-rider problem may exist and progress in profit sharing and ESO models. In this case, the funds that are allocated for employee participation are not used properly and there is a need for additional staff supervision to mitigate the problem. However, there are theorists who oppose the view that the ESO contributes to the spread of the free-rider problem. In ESO models the employees can be required to monitor each other or to assess the performance of the team work together. Thus, an employee who works more productive will be interested to monitor the others. Otherwise, the benefit will be less than the contribution of employee [35, 7].

There may be situations when giving shares to employees may not be enough incentive to work harder if the employee believes that profits are more dependent on other factors (e.g., management decisions). Thus employees may take risks over which they have no control options. In this situation, it is important whether the employee shares are with or without voting rights. All the model effectiveness and meaning may depend of this factor. The possibility that the ESO model will contribute to higher levels of productivity, depends on its types and conditions.

The economic benefit from ESO to the company also depends of cost savings to the company at the expense of excessive staff turnover. In other words, the more loyal employees of the company are the less money and time will be spent on the attraction and training of new employees. Use of ESO models may encourage employees to stay longer in the company and attract new employees.

Countries where ESO models are very common, tax incentives are a contributing factor in the spread of these models. Watching the national statistics on the number of firms that introduced ESO models, the sharp increase is usually observed after significant changes to legislation in favour of ESO. However, the tax bonus should be seen as an additional benefit and it should not be the main reason for the introduction of ESO. ESO model can be successful also if the country does not have any tax benefits for it. Thus, the main determinants of the effectiveness of the ESO model is the amount and the value of shares granted, company's internal culture and employee awareness of the company's business and financial results.

There are several theories related to the interests of business owners: the principal - agent theory, stakeholder theory, the psychological ownership theory. The principal - agent theory analyses the economic relationship between the employer (the principal) and employee (the agent). This theory studies the behaviour of employees and employee-employer relationship. The principal - agent theory is used in economics, finance, marketing, political science and strategic management issues.

In this dissertation the object of principal - agent theory are the employees of the company and interest matching and merging of owners and employees. Principal - agent theory is discussed here according to the research subject, namely, employee motivation through giving

them shares of the company they are employed. Principal - agent theory can be used for regulating relationship between employees and the owner. This theory addresses two fundamental problems that may arise in employee relations. First, if there is a contradiction between the employees' and the owners' goals. Second, it is too difficult and costly to check for employers what that the employees are actually doing (i.e. if it is difficult to determine whether an employee has acted in accordance with the requirements).

According to the principal - agent theory, one of the main tasks of management is to organize the work of the company respecting shareholders' interests. The possible solution to the problem of interest respect might be tying executives' and shareholders' benefit, so that both sides have a common goal. This can be achieved through the ESO model - providing employee shares, stock options or a combination of these as essential components of executives' compensation.

An important factor in the implementation of ESO is educating employees about it. For ensuring effective communication with employees they have to get a clear understanding of the company's target, processes in the ESO model, time limits and duties to be performed. The way how employees perceive and appreciate the ESO model depends on communication.

**Governments** may have different kinds of reasons for promotion of ESO. Such as income and wealth redistribution, medium and long-term savings promotion, wage flexibility, business development, etc. From the analysis of ESO models in the world we can conclude that the usage of these models depends on national legal regulation and government's position on this issue. The main precondition for the existence of ESO is the legislation that allows creating them.

It should be noted that the literature and studies about ESO during the last century have increased considerably, but the context of ESO is concentrated on the enterprise level. Little attention is devoted to the phenomenon of ESO's socio-political context [54, 130].

State benefits and the role of development of ESO models is the stabilization of the labour market, social dialogue development, steady income redistribution promotion, provision to the development of the national economy and the improvement in efficiency of domestic demand adjustment in accordance with the economic cycle phases.

Table 1.2

**Benefits and risks of ESO to its stakeholders<sup>9</sup>**

Stakeholders	Benefits	Risks
Employees	<ul style="list-style-type: none"> <li>- Improvement of motivation</li> <li>- Financial benefit (dividends, increase in value of shares, price increase bonus, tax incentives*)</li> <li>- Social and emotional benefit (security of job stability, rights to participate in decision-making, owner's status, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>- risk of fluctuations in the value of shares</li> <li>- Equity assessment risk (OTC companies)</li> <li>- Diversification risk</li> </ul>
Employers	<ul style="list-style-type: none"> <li>- Employee motivation</li> <li>- Productivity improvement</li> <li>- Work environment stabilization (regulating mobility of employees, specialist retaining)</li> <li>- Continuity of the company</li> <li>- Respecting owner's interests</li> <li>- Improvement of competitiveness</li> <li>- Reduction of tax burden*</li> </ul>	<ul style="list-style-type: none"> <li>- Model implementation and maintenance costs</li> <li>- Free-rider problem</li> <li>- Opinion differences in decision-making</li> </ul>
State	<ul style="list-style-type: none"> <li>- Income redistribution</li> <li>- Promotion of long-term savings</li> <li>- Wage flexibility</li> <li>- Business development (thus increase in tax revenues in the state budget through corporate income tax, value added tax, capital gains tax)</li> <li>- Labour market stabilization</li> <li>- Social dialogue</li> <li>- Adjustment of domestic demand</li> <li>- Balancing economic cycle</li> </ul>	<ul style="list-style-type: none"> <li>- Reduction in tax revenue* (income tax, social security contributions, corporate income tax)</li> </ul>

\* - if tax incentives are provided

Summing up the material analysed in this chapter and answering the first research question: *What is the theoretical background of ESO and its impact on employees, business owners and the state*, it should be noted that employee share ownership is participation of employees in redistribution of financial results of his/her employer's company with getting the company's shares or their derivatives, in order to increase employee motivation and productivity. ESO has several types, including the three most widely used by employee shares, employee stock options and employee stock ownership plans (ESOP). The impact of ESO on the stakeholders -

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<sup>9</sup> Table created by the author

employees, business owners and the state - the author summarized in a table mentioning theoretical benefits and risks of ESO (see Table 1.2).

## **2. EMPLOYEE SHARE OWNERSHIP IN EUROPEAN COUNTRIES**

In this chapter the author will find the answer to the second research question about the ESO experience and its models in the European Union countries. In some European countries ESO is very widespread and companies use it successfully, but some countries the opposite. The question is why this situation has occurred.

The study done in this chapter is the basis for the sixth scientific novelty: recommendations for pan-European international organizations active in the social dialogue about employee financial participation matters. These recommendations concern ESO development start-up and promotion of ESO in Eastern European countries.

The European Commission provides information support about ESO experience in different countries. The widest range of information about employee financial participation and its deployment in Europe is found in the PEPPER reports, which explain the nature of EFP, regulatory peculiarities and tax benefits, and outline the current situation of the EFP practices in the EU Member States.

From the side of European Commission it is recommended for member states to introduce ESO models. The countries are informed about the experience and the benefits of ESO, as well as developed a common framework and principles of ESO use. However, the introduction of ESO is on responsibility of each member state separately. At the moment the laws and tax systems are not designed in a uniform manner and cannot be cross-checked for this process to be run centrally. ESO models in European Union countries are now different in purpose and legal framework, as well as the use of ESO types depend on each country's politico-economic situation, historical course of events, and access to treatment and the role of employees in general. In 2002 the European Commission (EC) proposed to launch joint policy in the EU for development of financial participation models and exchange of information about them.

The main benefits identified by EC that are associated with ESO are motivation and increased productivity, improved competitiveness, smooth reallocation of resources among citizens, increased employee involvement in decision-making, promotion of common goal and employment stabilization.



Principles recommended by EC for creation of common ESO policy and legal framework in the EU Member States are:

- a) Voluntary participation for employees in ESO models,
- b) Free access to ESO models for all employees of company introducing ESO,
- c) Clear formulation of EFP benefits and linkage with company's performance,
- d) If ESO models perform well, they should be used regularly,
- e) Clear formulations and rules of the ESO model,
- f) Employees must be informed about the potential risks associated with investment decisions,
- g) Regular wage separation from ESO models and information to employees about it. ESO should not compensate the regular wage,
- h) Not to create barriers to mobility of employees [78, 4].

ESO model development barriers observed in the EU Member States are: different, not coordinating tax system; uncertainty about the extent of the application of social security contributions on income from ESO; differences in legislation, culture and traditions and lack of information about ESO. Barrier elimination and joint policy formulation depends on joint implementation of ESO main principles in the EU Member States by exchange of information, defining common goals and keeping track of progress.

The intensity of use of ESO models in companies in European countries is very different - from 0 up to 40% of the share of large enterprises. In general, a trend in the new EU Member States (CEE) is that ESO models are either in initial stage of development, or practically non-existent. The exceptions are Poland and Bulgaria, where despite that there are no tax incentives to promote ESO, still large companies use ESO and grant shares for their employees. In Central and Eastern European countries the ESO experience is associated with privatization. The author of this thesis does not consider it as true ESO.

However, in the 15 old EU member states ESO practice is more common and there is a wide variety of ESO models (e.g. France, Ireland, the United Kingdom, Germany, Netherlands, Austria, Sweden, Finland, and elsewhere) where they are used for several decades. However, employee share ownership in each EU country has a different role. Three of the EU member states are distinguished by particularly "friendly" tax treatment of employee financial participation (Ireland, Britain and France). In Northern EU countries, such as Denmark, regardless of the holder of the issued dividends they are subject to a progressive tax on capital

gains. Tax on profits from employee shares is paid by the employer. In Southern Europe - Italy, Portugal, the legislation did not include any tax relief on capital gains or dividend tax, the Greek legislation does not regulate employee financial participation at all. In the Benelux countries, employee financial participation schemes are not granted with tax bonuses.

International Association for Financial Participation in agreement with the European Commission and in collaboration with an international team of experts has developed a Model Plan for employee financial participation in the European Union countries. This plan includes a number of operating principles and practical recommendations of business leaders, employees and social partners. This plan is intended to be used in both large multinational companies operating in the EU, as well as small and medium-sized enterprises.

The Model Plan highlights and updates such important issues as the employees' interests and rights, democratic attitude, transparency, excellent communication, but it lacks practical recommendations for ESO in national or company level. In this case, the Plan discusses more about respecting all interests on involved persons, but there is lack of practically applicable methods that could be used as a sample for implementation of EFP plans.

To author's mind, in order to achieve the objective of spread of employee financial participation across all EU countries, Eastern European countries need more informative and consultative support from Western countries. It is important to share practical experience or cases directly at company level - how companies implement these plans, and the goals they achieve, etc. While the state level - information on the legal framework, as well as tax benefits, if any. Gathering and dissemination of such information must be undertaken by several stakeholders, particularly the social partners, trade unions, the institutions involved, as well as academic staff of universities.

Current ESO experience in Latvia is associated with the privatization period, when the share of state property (real estate and companies) was mass-transferred to the people through the privatization vouchers. Some features of ESO developed during the privatization process. But it was largely ineffective because the companies did not care about so called ownership culture - employees were not considered to be the owners. In many places of business ownership transition from staff to management, the value of shares was reduced for several reasons - inflation, failure to pay dividends, in some cases, so-called share value "dilution" by increasing the number of shares in additional issue [29, 186]. Consequently, the management of the companies was

particularly advantageous to buy shares at a low price from the employees, who were in financial difficulties. Thus, in companies whose shares were granted to employees, the management has often used their position selfishly.

It should be noted that the reason of mass privatization was ownership change, rather than the employee share ownership or facilitating and increasing the impact of their involvement, or improvement of the labour effectiveness [98]. Privatization was a deal between the state and the holders of privatization certificates rather than employee compensation for the results achieved. Consequently, the process of privatization, giving shares of enterprises to their staff cannot be regarded as an employee share ownership for the following reasons:

- 1) Urgent need and necessity for the government to move from a centralized, planned economy to a decentralized market economy by transferring state-owned enterprises in whole or in part, in the hands of private owners;
- 2) The market value of the companies was mostly not to be determined due to rapid inflation and the lack of assessment methods. Thus ESO did not work as it normally does when company shares are granted to employees, and they strive to increase their value.
- 3) Many of the public enterprises under privatization were insolvent. Thus we cannot consider serious employee share ownership in business from what they were not paid wages and taxes.
- 4) The main objective of the state regarding privatization of companies was attracting strategic investors who would be able to restore companies, restructure them and invest for further development of these companies.

In Latvia currently employees' shares are an object to taxation the same as salary plus additional taxes related to capital gains. Complete guidelines for implementation of ESO models are not developed. Laws which constitute any of ESO types apply only to personnel shares. Accordingly, the allocation of shares for the employees in accordance with local legislation can only happen in joint-stock companies. In addition, the staff shares have no voting rights. In contrast – in other developed countries, there exists the possibility of granting employees shares with or without voting rights. The decision to adopt the most appropriate type of ESO is in hands of the business owners.

In Latvian tax legislation employee share ownership models (in this case the only kind - personnel shares) have no tax benefits. In a situation when wage levels are relatively low, employees prefer to take material bonuses right away. Consequently, the most popular methods of encouraging staff loyalty currently in Latvian companies are intangible benefit guarantees, such as telephone conversations compensation, occupational use of the vehicle for private purposes, health insurance, additional holidays, etc.

Since none of the Latvian tax laws does not distinguish personnel securities or includes them in the salary, they are subject to the following taxes: personal income, business income, income from capital gains tax, and social insurance contributions.

Table 2.1.

**Types of financial reward and their taxation in Latvia<sup>10</sup>**

		Salary	Personnel shares	Profit sharing <sup>11</sup>
Employee	Social contributions (11%)	Yes	Yes	No
	Income tax (24%)	Yes	Yes	Deferred payment <sup>12</sup>
	Capital gains tax (10%)	No	Yes	Yes
	Return of capital tax (15%)	No	Yes	No
Employer	Social contributions (24.09%)	Yes	Yes	No
	Corporate income tax (15%)	No	Yes	No <sup>13</sup>

Thus there is the situation that is not profitable to grant shares to the employees because they are treated as regular wages. And due employees have to pay additional tax for ESO income from capital and capital gains, they become even particularly unfavourable (see table 2.1). Thus, employee share ownership in Latvia is the least favourable for its taxation position. In the author's view, it is necessary to equally balance the tax relief for all forms of employee financial participation, including employee share ownership.

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<sup>10</sup> Table made by the author according to existing taxation laws in Latvia (Jan 1, 2013) for residents of Latvia.

<sup>11</sup> The payer – employer; type of bonus – life insurance with capital savings and/or private pension contributions.

<sup>12</sup> The tax must be paid at the end of savings period when the beneficiary gets the savings.

<sup>13</sup> If the company has no tax debts on the last day of taxation period

### **3. DEVELOPMENT OPPORTUNITIES AND PERSPECTIVES OF EMPLOYEE SHARE OWNERSHIP IN LATVIA**

The legal framework plays an important role in the development of ESO. There are several countries where ESO models developed rapidly after the introduction of tax relief (but it was not always a key factor). To answer the third research question: what should be the ESO model for Latvia, we have to clarify the following:

- 1) What should be the framework conditions of ESO model?
- 2) How would ESO affect the employees in Latvian companies?
- 3) What is the business owners' view on ESO model and its implementation potential for companies?

To clarify this, the author conducted three empirical studies. For developing the model framework conditions author used expert interview method, as well as document analysis method. Then, the author carried out a quantitative study aimed to clarify the Latvian company employees' attitudes about share ownership, as well as how granting shares might affect the level of their productivity. For approbation of the developed ESO model the author conducted expert interviews with chief representatives of Latvian enterprises.

This chapter forms the basis for the fourth novelty of this thesis which is creation of employee share ownership model. This model includes proposals for improvement of Latvian legal framework and fiscal stimulus, and the methodological principles and methodical guidelines for practical implementation of ESO in an enterprise. The quantitative results of the study support the fifth novelty.

The qualitative study for ESO model development was conducted from December 2009 to April 2010. During the study, the author interviewed 7 experts - both Latvian and foreign. The main criteria for the selection of experts was sufficient level of competence about ESO (knowledge and understanding of the processes of economic, business, financial markets and understanding the nature of employee share ownership) as well as experience in the analysis of this issue, handling and/or addressing it - participation in conferences, publications, participation in the ESO-related organizations, etc. Expert interview results were processed using qualitative research data processing software NVivo8. The result of the study is recommendations for state-level improvements - legal basis for ESO and the methodological principles and methodical guidelines for adoption of ESO in companies.

### **State level recommendations for improvement of ESO**

Concluding from the Latvian law analysis about ESO and the data of qualitative study, the author recommends the following changes to Latvian legislation:

- a) In Commercial Law: specify and define the stock options financial and employee financial participation instrument and the allocation and disposal procedures of stock options;
- b) To make changes to the Law on State and Local Government shares and companies, including the company's shareholders – employees in the list of dividend recipients;
- c) In Commercial Law: introduce the opportunity to issue employee shares with or without voting rights, allowing employers to choose which employee shares to be issued - with or without voting rights,
- d) Restore the Ministry of Finance working group and put as one of its primary tasks to consider following tax incentives to be activated in Latvia, which would be equivalent to existing tax incentives for the long-term savings:
  - i. to apply the following tax incentives to employee share ownership:
    - Income tax, capital gains and return of capital;
    - Mandatory social insurance contributions;
    - Corporate income tax.
  - ii. determine the amount of tax relief:
    - One of the average gross monthly salary per year or
    - Up to 10% of each employee's annual gross income, if used long-term (5 years or more) ESO plans, personal income tax refund by a similar procedure as currently exists regarding life insurance savings and investments in private pension funds.

To the author's mind the personnel shares should be placed on an equal level, as the savings in life insurance and private pension funds for staff. These savings have generous tax advantages for both companies and individuals. One of the purposes of the tax advantages was the improvement of people welfare by promoting the accumulation of savings. For employee share ownership the author applies an objective, as these its tools and models are to facilitate

the formation of deposits and prevents the employees to immediately spend the funds allocated to them (via salary). The ESO would "freeze" these funds in shares. Consequently, the ESO promotes both endowment and long-term help to improve employee well-being, making them the company's shareholders.

### **Enterprise level recommendations for implementation of ESO**

The most often models of employee share ownership are introduced in large and medium-sized enterprises. This is confirmed by empirical studies [72, 43]. ESO incidence and experience in small and micro-enterprises is not high and the models and their specifications are still in the development stage. Developing the ESO model for Latvian companies, the author believes that it would be the most effective in large and medium-sized enterprises. The size determination criterion is the number of employees. Initially - before any of the employee share ownership plans were established - the company needs to make a series of preparatory work: a case study carried out at the beginning and the assessment used to determine the target(s) and to develop an action plan.

In Figure 3.1 the author has developed a sample of ESO model implementation in an enterprise. This model consists of four main phases: preparation, action plan, implementation and assessment. Preparation phase includes analysis of situation and setting targets. After this phase it can be concluded whether ESO is appropriate for the particular company. In case of positive result it is necessary to work out the action plan that includes the decision about implementation of ESO, selection of the type and employee valuation criteria and the maturity of the ESO plan. Implementation phase includes informing the employees about the essence of the model, reporting procedures, tenure status and the importance of stock ownership related risks. Administration and accounting provides contracts with employees, account of shares opening and maintenance, and preparation of reports for both staff and the management. After the expiration of the plan the performance evaluation is carried out and made the decision about to continuity or re-examination and/or termination of ESO plan.

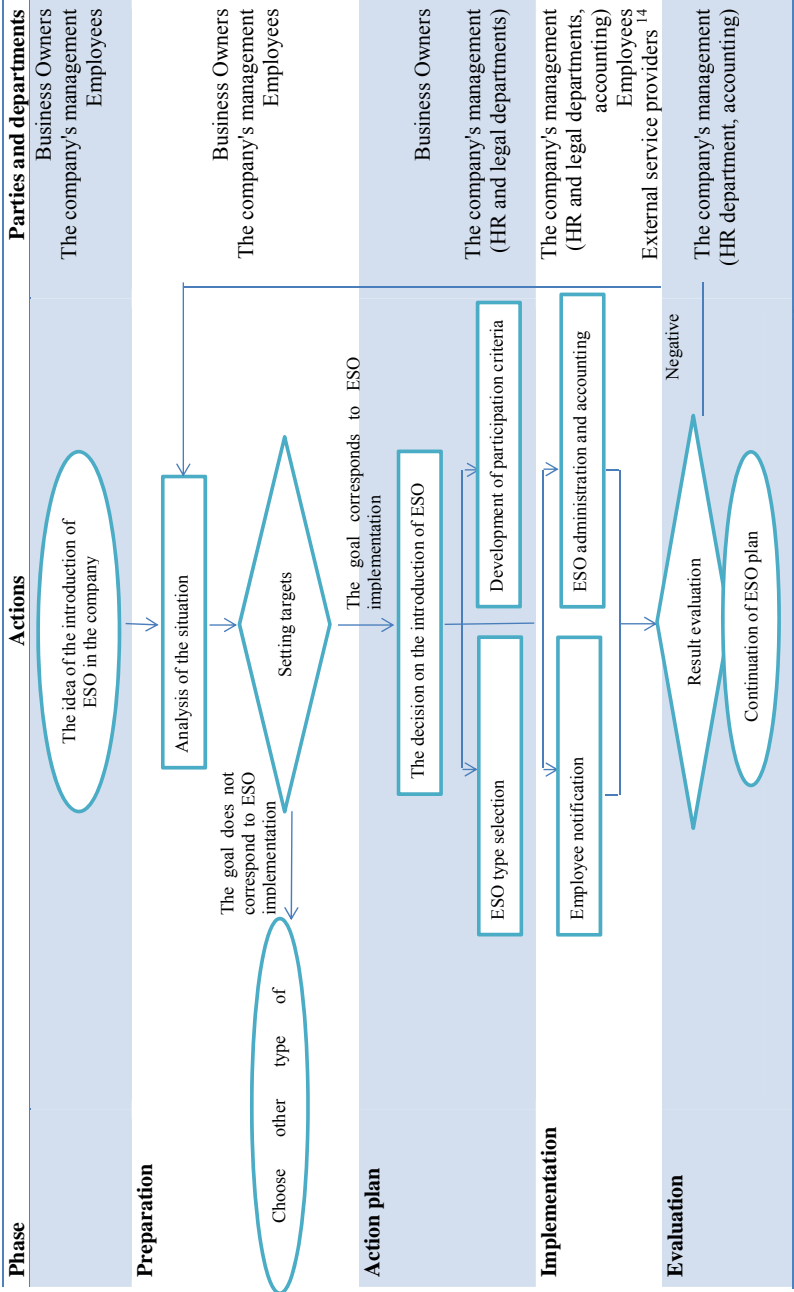


Figure 3.1 The sample of ESO implementation in an enterprise<sup>15</sup>

<sup>14</sup> In case if the company has decided to delegate ESO administration, training or a securities account management to outsource company  
<sup>15</sup> Figure created by the author



The author carried out a quantitative study in order to determine whether the employers and employees would be willing to participate in a contemporary ESO model and perceive it as a motivating element that could improve employee productivity. The study aims to clarify the relationship between the allocation of shares for employees and improvement of their productivity in Latvian economic conditions. The research question of this quantitative study is: *how ESO would influence employee motivation and the related factors in Latvia?*

The general set of this study consists of employees of large and medium-sized joint-stock companies, because the shape and size of the business is directly related to the share purchase opportunities to these employees. The size of study general set is 61.095 employees. The sample size of the study is 610 employees from 19 large and 42 medium-sized joint-stock companies. The author conducted the survey using electronic means and capabilities, as well as paper questionnaires. The total number of completed questionnaires was 614, 140 of them in paper and 474 in electronic form.

The research data were collected during the period from 1 August 2012 to 31 October 2012. The study data were processed by the following programs: SPSS 16.0 and Microsoft Excel 2010th. For interpretation of the results of the study the author used correlation coefficient (Pearson and Spearman) tests, chi-square tests, as well as graphical and cross-table analysis.

Analysing the factors that respondents who hold shares noted as important in the context of share ownership, they are the financial benefits of the shares - dividends and value appreciation. The main factors that influence employee motivation is a regular salary, great team, confidence about job security, working conditions and environment.

Assessing employee satisfaction with work in the company, it should be noted that 53% of respondents are satisfied with the work of the company. 37% are partially satisfied. While the proportion of dissatisfied employees is 10%. It is important to know whether there is a correlation between employee satisfaction and whether the employees would purchase shares and on what conditions. 90% of respondents were generally satisfied or partially satisfied with the work. 77% of them would purchase shares at 50% discount. 80% of the satisfied they would be willing to buy shares from the existing shareholders if they are willing to sell them. 10% of respondents were not satisfied with the work. 53% of these would purchase the shares at 50% discount, but 66% would buy shares from existing shareholders. In hypothesis testing with chi-square test, it was confirmed that the treatment of the acquisition of shares respondents does not depend on how

they are satisfied with the work. Also, in both cases, the correlation coefficients indicate that the relationship between job satisfaction and attitudes towards the acquisition of shares is low (0.168 and 0.074).

IN analysis of the respondents' answers to questions about the company's share purchase options, the author found that, overall, 75% of the respondents would purchase shares at a 50% discount with the "freezing" term of 3 years. Conversely, responding to the question about the acquisition of shares (without discount) if any of the shareholders would be willing to sell them, 78% responded positively.

In order to evaluate the impact of privatization period to employees' attitude regarding share purchase the author created cross-tables (see Tables 3.1 and 3.2). Respondents were divided into age groups:

- a) Those who were not yet of working age at the time of privatization (i.e., did not have the first-hand experience): age group "till 25" and "26-40", total 448 respondents;
- b) Those who were of working age during privatization: the age group "41-55" and "over 55", in total 166 respondents.

Table 3.1

**Impact of privatization period on employees' attitude towards share purchase**

		(V11) If you have an opportunity to purchase shares of the Company with a 50% discount, provided that such shares will be frozen for 3 years period, you would:					Total
		Purchase them for $\geq 30\%$ of your income	Purchase for 20%	Purchase for 10%	Purchase for premium	Not purchase	
Age groups	Till 25	32	31	30	20	33	146
	26-40	42	49	69	77	65	302
	41-55	15	12	37	32	49	145
	over 55	3	3	5	4	6	21
Total		92	95	141	133	153	614

Evaluating responses of the youngest group 22% of them would not have purchased the shares at a discount, and 78% would buy them. A group that experienced the privatization period has a more cautious attitude – 67% would purchase shares. This difference can be explained by

both the privatization experience and the risk "appetite" decline with ageing. The correlation coefficient for the age groups and the issue of V11 indicates that the relationship between variables can be assessed as low (0.158).

Table 3.2.

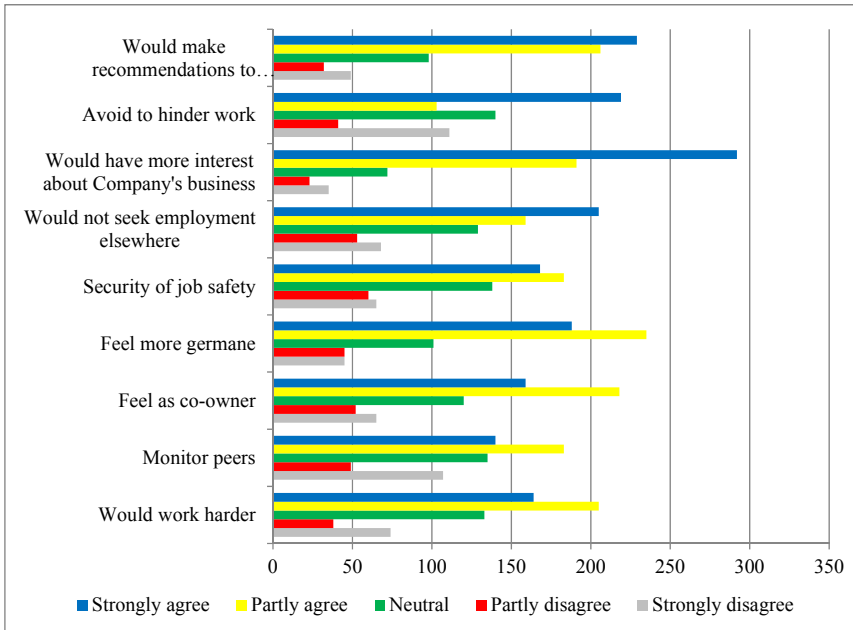
**Influence of privatization experiences in employees' treatment  
to acquisition of shares (V12)**

		(V12) If any of the shareholders of the Company would inform that they wanted to sell their shares, would you be willing to buy some of them?					Total
		Yes, definitely	If I had free capital then yes	I would consider it depending on the price	No, I have no interest	No way!	
Age groups	Till 25	19	56	42	19	10	146
	26-40	39	113	94	42	14	302
	41-55	8	58	34	33	12	145
	over 55	3	9	5	2	2	21
Total		67	236	175	96	38	614

Evaluating the responses of the youngest group 19% of them would not have purchased the shares, 81% would purchase. Privatization period experienced group is more cautious in their attitude – 71% would purchase shares. Although there is difference between both age groups in treatment of the acquisition of shares by comparing the response to the previous question, in all age groups there is growing number of interested persons for the acquisition of shares. Perhaps it is because of the freezing period in the previous question (V11). The correlation coefficient for the age groups and question V12 indicates that the relationship between variables can be assessed as low (0.067).

In order to determine the impact of employee share ownership on employee attitudes towards the factors discussed in the theoretical part of this thesis such as productivity, peer monitoring, the owner's psychology, the security of job stability, employee loyalty, interest in the company, its performance, decreasing delays, and participating in decision process, the respondents answered the question with a number of evaluation parameters, which they rated on a Likert scale. Responses are summarized in Figure 3.2.

The majority of respondents completely (on average 32%) or partially (on average 30% of respondents) agree that their attitude towards work would change in all mentioned factors. On average, 19% of participants have a neutral position. The part of respondents that agree partly is an average of 7%, but fully disagree on average 11% of respondents - their attitude towards work would probably not depend on whether they own shares of the company or not.



**Figure 3.2 Impact of share ownership on employees' attitude towards their work**

The dissertation hypothesis is related to that the allocation of shares to employees can improve employee motivation and thus also the productivity. Figure 3.2 shows that stock ownership links with productivity there. 27% of respondents noted that because they are/would be the shareholders, they work/would work harder, more productive. 33% somewhat agree with this statement. 22% of respondents have a neutral opinion on the matter, while 18% disagree in whole or in part.

The question of how the productivity has/would change by becoming a shareholder, 51% responded that it has/would improve. 49% of respondents noted that the level of productivity has/would not change. The correlation coefficient between variables V8 and V9\_1 is 0.442, which indicates a medium close correlation.

From overall results of the study it can be concluded that the distribution of employee share ownership may contribute to higher levels of employee motivation and productivity. Thus, quantitative analysis of the data approves the thesis put forward in the hypothesis – to promote the motivation of employees of Latvian companies to higher level it is useful to create the employee share ownership model.

For approbation of the developed ESO model and methodology in Latvian companies the author has done a qualitative study. For this purpose it was necessary to get the opinion of business management representatives about the developed ESO model and the related areas of businesses. As the study participants, for the evaluation model, had to be previously acquainted in detail about the model, the author chose to do research with the qualitative method of research. Since the target group were leading experts from large and medium-sized enterprises, the qualitative study was conducted with the help of expert interview techniques. The author considered the possibility of a focus group discussion (FGD), but taking into account the position of the interview participants it was not possible for everyone to coordinate a common time and place for FGD performance. In addition, the expert interview method provides a more in-depth, detailed discussion of the ESO model and the company's position on this issue. It also ensures that all the experts will answer all the questions and they will not affect other experts' opinion.

Selection of respondents was based on the following criteria:

- 1) Company size - large, medium;
- 2) The respondent's position - a leading employee related to personnel management;
- 3) The respondent's work experience - at least 3 years in the company.

The study included nine experts representing different sectors large (5) and medium (4) companies (see Table 3.3. below). Given the specifics of research questions and the targeting criteria, the participants were leading personnel specialists.

Table 3.3

**List of survey experts**

Nr.	Position	Experience (years)	Size of the company	The company's main activity
E1	Head of HR	5	Large	Manufacturing of medicines
E2	Legal Adviser	8	Medium	Elevator construction and maintenance
E3	Personnel Director	5	Large	Wholesale and retail trade
E4	Head of HR	17	Medium	Food production
E5	The Executive Director	20	Large	Household goods production
E6	Personnel Director	3	Medium	Retail trade of agricultural goods
E7	Staff Development Director	4	Large	Information and communication service
E8	Personnel Director	6	Large	Financial Services
E9	Managing Director	5	Medium	Telecommunication equipment manufacturer

The research method was semi-structured interviews. This means that the author has developed guidelines for the interviews, but the interview structure is loose and if necessary can be changed (for example, depending on the expert's experience, the interview time available, etc.).

Analysing the hierarchy in companies involved in survey, the author found that in almost all large firms it is vertical, in medium companies – horizontal. Internal communication methods in companies are quite different. In some places they use traditional forms of communication - meeting with management, meetings, reports, etc. There are companies that mostly use electronic communication like e-mail, intranet, blogs, etc.

The author noted two main problems in survey companies - the aging of personnel and attracting qualified specialists problem. Some experts noted that they would like to improve their employee incentive system accommodating them more to the needs of individual employees, by diversifying bonuses.

Of financial bonuses in companies there primarily are health insurance and premium awards. Production companies have separate bonuses for employees who are developing new products. Only one of the companies has long-term savings program with tax incentives – private pension savings for executives. There were experts who noted that they evaluated these opportunities.

Several experts noted the problem that higher education institutions either not prepare or poorly prepare students for real work. Another expert mentioned the problem of aging workers. In this situation attracting new qualified specialists might help. But here too, the enterprises are facing difficulties - both attracting new and retaining existing staff. Many companies are faced with competition in employee retention from micro-enterprises, because they are in a better position from tax the regulatory framework. Several experts said that they want to improve employee motivation system so that all the employees would be motivated.

The compilation of the company's shareholders characteristics of expert companies, the author created a Table 3.4 which shows the estimated count of the shareholders, whether the shares are listed on a stock exchange, whether there are employees - shareholders, nationality of the shareholders and their legal status.

Table 3.4

**Description of the companies' shareholders**

Expert	Stock exchange /OTC company	Count of the shareholders	Employees - shareholders	Nationality	Legal status <sup>16</sup>
E1	Stock exchange	5 large + minority shareholders	yes	various	FP and JP
E2	OTC	1	no	foreign	JP
E3	OTC	A small group of people	no	local	FP
E4	OTC	1 large (>90%) + minority shareholders	yes	various	FP, JP
E5	OTC	Around 500	yes	various	FP, JP
E6	OTC	Several dozens	yes	local	FP, JP
E7	OTC	1	no	foreign	JP
E8	Stock exchange	minority shareholders	yes	various	FP, JP
E9	Stock exchange	5 large + 500 minority shareholders	yes	various	FP, JP

Many employees who acquired shares during privatization (mostly from 1992 till 1994), sold them soon after obtaining for a very low price. However, there were also those who understood the nature of ownership of shares, and saw their potential for the future. Many of these employees have already retired and continue to hold the shares. Others sold them or

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<sup>16</sup> FP – individual, JP – legal person

transferred by inheritance. There are also employees, who continue to hold the shares or sell them if they receive an attractive proposition. Employees from companies listed on the stock exchange use to buy shares either on their own initiative or encouraged by the employer.

In a large proportion of companies in which interviews were conducted (see Table 3.4.), employees own shares. Three of the companies are listed on the stock exchange, where everyone, including the staff, is free to buy shares. Only one company where employees had stock ownership is not the motivating factor, rather the contrary, because the share value has declined.

In some companies owners are senior management members, for example, E8 and E9. One of the companies (E5) is owned by the majority of employees and the management. The employees of the existing model are highly satisfied. In addition, the company's major shareholders have the position that the shares are not traded to foreign or outside investors. Only those that are directly associated with the company may purchase shares.

### **Evaluation of the ESO model**

The experts evaluated the ESO model, its structure and the two basic parts - the national level and the corporate level. At the national level they evaluated the proposed ESO types, the presence of the voting rights and the proposal of tax benefits. Expert opinions on the types of ESO, which will be better for their particular company, were different and every expert explained it having different reasons. The conclusion is that companies can use all three of the proposed ESO types. Nearly all experts agreed that companies should be allowed to choose to grant employees the right to vote or not. One expert (E3) believes that employees should not be granted the right to vote, because it is too much diversity of opinions and it is hard to agree for all. Some experts see the problems rights in the administration of the voting. On the other hand experts suggest that voting rights have a positive effect on staff and encourage development of psychological ownership.

Regarding tax relief - the experts support the idea, agreeing that the ESO can be considered as long-term savings program that will be evaluated as equivalent to the existing long-term saving modes. One expert (E7) noted that the Company complies with the social security function through the ESO models that should be done by the state. ESO needs to be linked to the pension system.

E9 expert also noted problems in the Latvian tax regulations relating to the allocation of shares employees with whom the company faced a few years ago. Employees' shares in Latvia



are subject to tax at the moment when they are granted, rather than when the employee receives a real tangible benefit (sells the shares). This situation is absurd, because decline in the case of the share price the employee will have paid too much tax. Here the tax is levied when the real benefit of the bonus has not yet been received.

On company level the experts estimated following ESO model (see Table 3.5): preparation, implementation and evaluation. In general, experts evaluated the model positively. If there would exist the recommended legislation in the first part of the model, some would be willing to implement ESO in their organization.

Table 3.5

### ESO Implementation phases in an enterprise

	Activity	Result
Preparation	Analysis of the situation: <ul style="list-style-type: none"> <li>✓ Studying the regulatory framework;</li> <li>✓ Find out employees' interests about stock purchase;</li> <li>✓ Find out employers' interests regarding selling or granting stocks to employees.</li> </ul>	The <u>decision</u> for or against ESO implementation
	Setting target: <ul style="list-style-type: none"> <li>✓ Targets of employees;</li> <li>✓ Targets of business owners;</li> <li>✓ Common targets.</li> </ul>	Choosing the ESO <u>type</u>
Implementation	Setting criteria for participation rights; Determination of the amount and origin of the financial resources; For OTC companies – selection of share evaluation method; Setting the terms; Development of informing policy for employees.	ESO model in an enterprise
Evaluation	Setting the target criteria or employer's benefits (company value, profits, output volume, cost savings, revenue growth, create innovation, etc.) Employee benefit determination Intangible benefit determination (motivation, knowledge, engagement, retention) Evaluation of model expenses (bonuses, administration costs, etc.)	Decision about continuation of ESO model in the enterprise

Several experts emphasized the importance of employee awareness and understanding about the ESO model and its objectives, as well as pointed out some of the things that employees should be particularly explained about like securities account maintenance, the benefits of ESO, financial reporting analysis, etc.

Regarding the possible term of ESO model the views experts were different. Most of them supported the idea of a period of 3-5 years. The experts pointed out that the most likely they would choose a model where employees can voluntarily apply for ESO.

In general the experts evaluated the ESO model positively. If they would implement ESO, they would be able to use this model in practice. Survey experts also made a number of recommendations to improve the ESO model:

- 1) Offer the stock assessment method;
- 2) Development of case studies, so that other companies would have access to best practice model of ESO implemented in Latvian enterprises;
- 3) To develop ESO link with the pension system.

## **CONCLUSIONS**

During the research the author came to following conclusions:

- 1) After examining the ESO definitions from various authors, the author concludes that they are not complete. Consequently, the author of this thesis offers the concept of employee share ownership with the following definition: *employee share ownership is participation of employees in redistribution of financial results of his/her employer's company with getting the company's shares or their derivatives, in order to increase employee motivation and productivity.*
- 2) The main types of employees share ownership are employee shares (employees can buy or get shares of the company which may be with or without voting rights) employee stock options (the employees have the right to buy company shares at a predetermined price within a limited period in future; employee benefits result from the price difference) and employee stock ownership plans.
- 3) ESO may give impact on the company employees, owners, as well as the country as a whole. Employee benefits are an increase of motivation, financial benefits, social and emotional benefits. Motivational, emotional and social benefits will reinforce the effect, if the shares are with voting rights.

- 4) For the company, the successful completion of ESO model yields a higher level of motivation of employees which may result with increased productivity, increased competitiveness, and respecting owners' interests. It is also possible to limit staff turnover, retain qualified professionals, provide business continuity, and reduce the tax burden.
- 5) Nationally ESO models help to stabilize the labour market - a factor associated with excessive employee mobility limitation during economic recovery periods and job stability in the economic downturn. ESO increases employees' motivation and encourages higher levels of productivity, as well as helps to improve the overall economic situation in the country.
- 6) The financial benefit that employees get from ESO is additional income from dividends and earnings, gain for share price difference and/or tax savings. The personnel involved in ESO model must assess of themselves and their act or omission dependent factors, as well as external factors of risk. Factors dependent of employees are related to their work skills and abilities, competence and additional "power" capabilities, that is, whether these employees would be interested to work in addition to get a higher rate of return if they get ESO bonus. The risks related with the ESO are share value volatility risk, share assessment risk and diversification risk.
- 7) In international practice there are differences in ESO models in their volume and types. This is due both to the particularities of legislation, tax incentives, as well as differences in corporate governance systems. From the analysis of ESO in the European Union the author concluded that the European Commission in the Member States are recommended to introduce ESO models, but creating the prerequisites for the introduction of ESO (legislative) depends on the Member States. Several years of research in the EU countries, confirms that companies whose employees are granted share ownership are more productive, create more jobs and thus are better taxpayers than similar non-ESO firms.
- 8) In the new EU Member States (CEE) ESO models are mostly either in the initial stage of development, or practically non-existent. Distribution of ESO in the EU is hindered by factors such as different tax policy, differences in legislation governing securities trading and employment issues, cultural differences, different corporate governance principles and the treatment of ESO, lack of information on the ESO. The most from EU countries ESO models are common in Denmark, UK, Belgium and Austria.

- 9) The International Association for Financial Participation has developed a Model plan for employee financial participation in the European Union countries. It includes ESO principles and practical recommendations to managers, employees and social partners. As a solution for a common ESO strategy in EU is gradual transformation of national systems that might happen through the exchange of information, joint goal setting and regular monitoring of progress. The author concludes that the Model plan has lack of practical recommendations in both national and company level about how to implement ESO plans. The Model plan is referred to ensure respect for the interests of the parties but it does not offer really applicable methodologies that can be used as a model for implementation of the ESO plans.
- 10) In Latvia there is a specific historical experience of ESO gained through privatization mostly during the beginning of the 90-ties. Many companies granted their shares to employees but they did not build or develop ownership culture in their employees. Therefore, the practice of privatization cannot be regarded as a classic, universal employee share ownership practice. Most of the studies on the ESO done in Latvia in general reflect and describe the historical situation of privatization, experience and problems of that time.
- 11) In Latvia the national concept of the ESO model has not yet been developed. Consequently, there is no regulatory framework base and entrepreneurs who have tried to introduce ESO have faced with a legal vacuum. Latvian legislation concerning the ESO issues is very limited and imperfect, the tax policy hinders the development of ESO.
- 12) Currently, the Latvian law includes only one type ESO - employee shares, but the present framework is incomplete with regard to voting rights, dividend, corporate opportunities for use of ESO and the taxation. Stock options and employee share ownership plans are not regulated in Latvia at all.
- 13) The main motivating factors in favour of the introduction of the ESO for Latvian entrepreneurs is the opportunity to increase staff productivity and profitability indicators, promotion of employee cooperation and output increase, employee involvement in the company's future development and retention of talented employees. The most important obstacles for introduction of the ESO are the current economic situation, and the fact that ESO does not have a financial advantage over other forms of employee financial

incentives, rather the opposite. The main restrictive legal and administrative factors for employers are insufficient ESO regulation laws and unclear statutory and tax procedure. Necessary conditions for entrepreneurs are stable economic environment and tax rules to promote financial incentives. The most stimulating tax incentives should regard salary taxes and corporate income tax. The tax advantages for ESO could be similar to the already existing Latvian tax incentives for savings in life insurance companies or pension funds.

- 14) In the Latvian tax laws personnel securities are not distinguished or included in the remuneration. Employee shares for entrepreneurs and workers are particularly disadvantaged because they are treated as regular wages and they have to pay extra tax for income from capital and capital gains. Employee share ownership in Latvia is the least favourable if we look from taxation position. Thus ESO can be promoted through completing the regulatory framework and tax laws and improvement of entrepreneurs' and employees' knowledge and understanding of the ESO.
- 15) Results of the quantitative study show that the ESO can improve the employees' attitudes of Latvian companies towards factors such as labour productivity, the formation of psychological ownership, security of job stability, employee loyalty, interest in the company performance indicators, time delay reduction as well as the participation of employees in decision-making and consultation processes.
- 16) More than 75% of survey respondents (employees of medium and large joint stock companies) expressed interest in the opportunity of buying shares in their employer's company. More positive attitude towards the acquisition of shares had the group of respondents younger than 40 years of age. Group of respondents who experienced the privatization time during beginning of the nineties desire to buy your employer's shares in the company less.
- 17) During large and medium sized joint stock company executive interviews, the author found out that the developed ESO model can be used in Latvian companies after the implementation of the proposed regulatory changes. The ESO model can be developed further in several directions that are associated with the ESO case-studies of good practice for the practical example base for Latvian enterprises; offer the capital valuation methods that might be applicable to the ESO model; detailed design of the evaluation criteria for the results of the ESO model.

## PROPOSALS

After the analysis of Latvian legislation regarding the ESO, the author found that the current regulation is out of date, incomplete, and needs to be improved. For proposal evaluation and initiation the Latvian Ministry of Finance needs to restore the work-team, involving social partners. The suggested directions for legislative changes are:

- a) In Commercial Law: specify and define the stock options financial and employee financial participation instrument and the allocation and disposal procedures of stock options;
- b) To make changes to the Law on State and Local Government shares and companies, including the company's shareholders – employees in the list of dividend recipients;
- c) In Commercial Law: introduce the opportunity to issue employee shares with or without voting rights, allowing employers to choose which employee shares to be issued - with or without voting rights,
- d) Restore the Ministry of Finance working group and put as one of its primary tasks to consider following tax incentives to be activated in Latvia, which would be equivalent to existing tax incentives for the long-term savings:
  - i. to apply the following tax incentives to employee share ownership:
    - Income tax, capital gains and return of capital;
    - Mandatory social insurance contributions;
    - Corporate income tax.
  - ii. determine the amount of tax relief:
    - One of the average gross monthly salary per year or
    - Up to 10% of each employee's annual gross income, if used long-term (5 years or more) ESO plans, personal income tax refund by a similar procedure as currently exists regarding life insurance savings and investments in private pension funds.

For Latvian entrepreneurs as well as the Latvian Employers' Confederation:

- e) To practice and/or recommend companies to use the author's methodological principles and methodical guidelines in the development and implementation of employee share ownership plans.

For promoting ESO in the European Union Member States, the author puts forward the following recommendations:

- f) The Association of Universities: European Universities and institutions of higher education: improvement implementation and supplementation of curriculum on employee financial participation;
- g) For the International Association for Financial Participation supplement the Model plan with practical advice for initial deployment of the ESO in the company. This proposal aims to contribute to the implementation of ESO in EU countries (including Eastern Europe), where it has not yet distributed because of poor information and a lack of appreciation.
- h) The European Commission DG of Employment, Social Affairs and Inclusion – development of new guidelines for promotion of ESO models across the EU:
  - i. practical development of detailed pilot projects of ESO (especially in the new EU Member States);
  - ii. The results should be published in at least two official EU languages - English and French.